Action Plan on Base Erosion and Profit Shifting

An Indian Perspective

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Abstract

The discussion in this paper highlights some evidence to support the notion that there is base erosion in India. On the specific action points listed in the OECD's Action Plan, a perspective from India's stand point has been presented along with a brief discussion on the steps needed to prepare for complying with likely proposed measures.

Action Plan on Base Erosion and Profit Shifting

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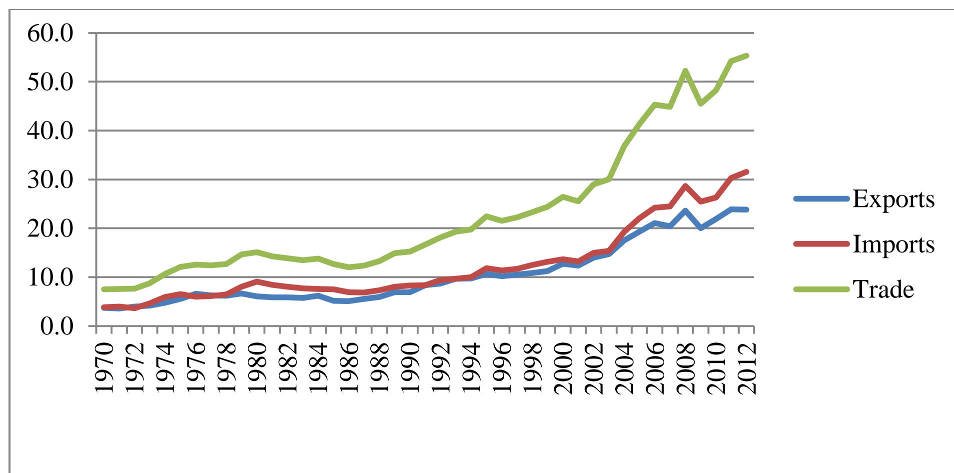
Section 1: Introduction

India has traditionally been a net capital importing country, with relatively low dependence on international trade, with trade to GDP at less than 20 percent till the end of the last century. However since the turn of the century there has been a sharp increase this ratio with the current levels being over 45 percent. Imports contributed more to this increase than exports – of the 25 percentage point increase, imports contributed 17 percentage points while exports contributed 7 percentage points. This increase in the ratio of trade to GDP indicates both a closer interaction with the global economy and an increased dependence on the same too, in order to finance the gap which has increased from less than 2 percent in 2002-03 to over 10 percent during 2010-12.

Figure 1: Trade in Goods and Services as percentage of GDP



Source: World Development Indicators, World Bank.

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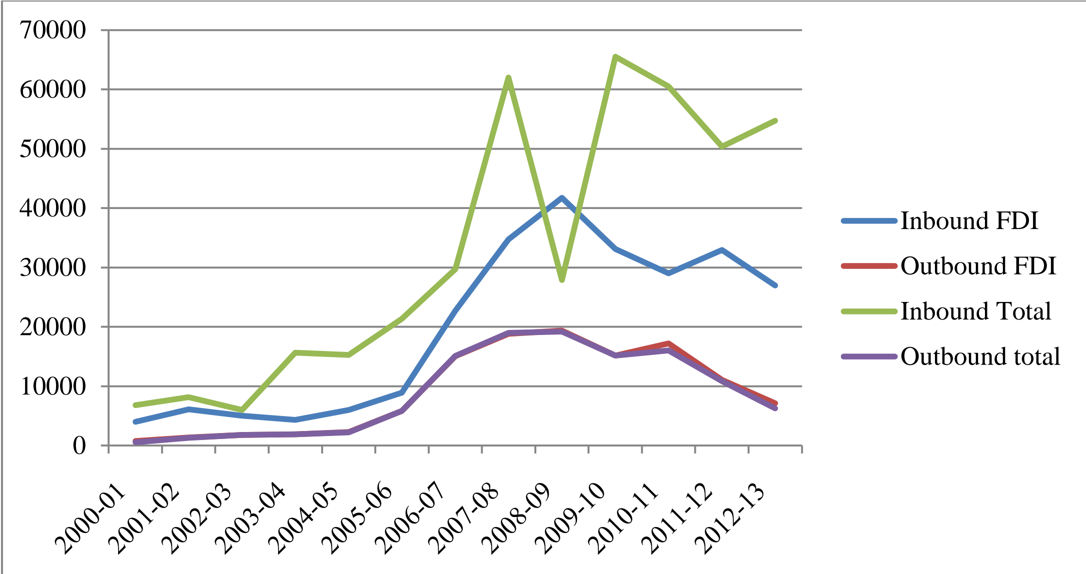
In order to finance this gap, the country has been dependent on capital inflows with a stated preference for Foreign Direct Investment (FDI). During the same period when there was a sharp increase in the trade to GDP ratio, India saw an increase in FDI flows from less than US$ 10 billion to over US$ 25billion. This would necessarily have helped in restoring some balance to the Balance Of Payments position of the country. However, in the same period, there was an increase in the outbound investment from India as well. These indicators too suggest a greater engagement with the international economy.

A significant feature of the FDI coming into India is that over 53 percent comes from low tax jurisdictions an indicator of possible aggressive tax planning leading to tax base erosion.

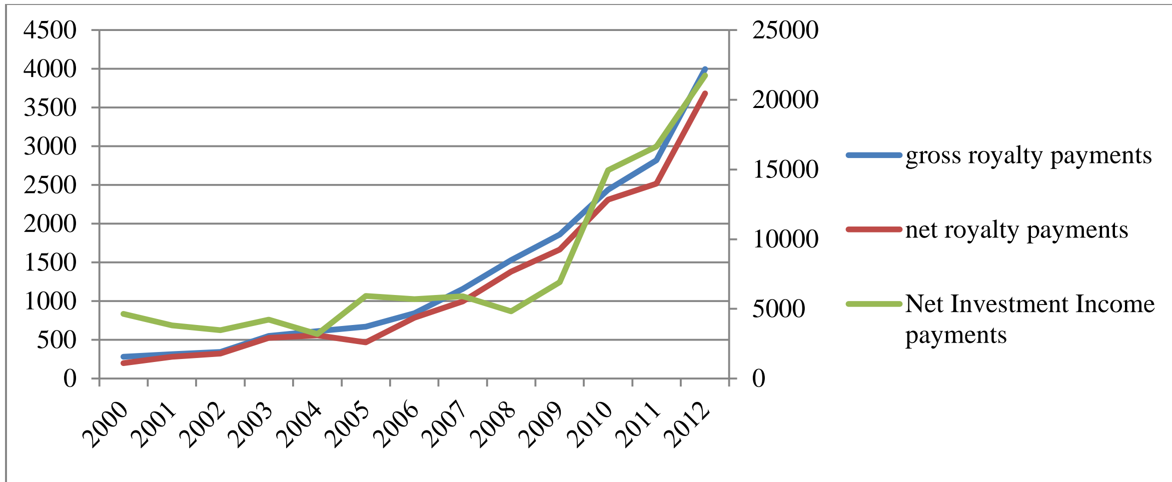
Figure 2: Trends in Foreign Investment: India, US$ million



Source: Handbook of Statistics on Indian Economy, RBI

In terms of passive incomes, royalty payments and payments on investment income by India show a sharp increase in the same period. (Figure 3) These trends suggest that of the incomes sourced in India, there is an increasing component moving out of the country.

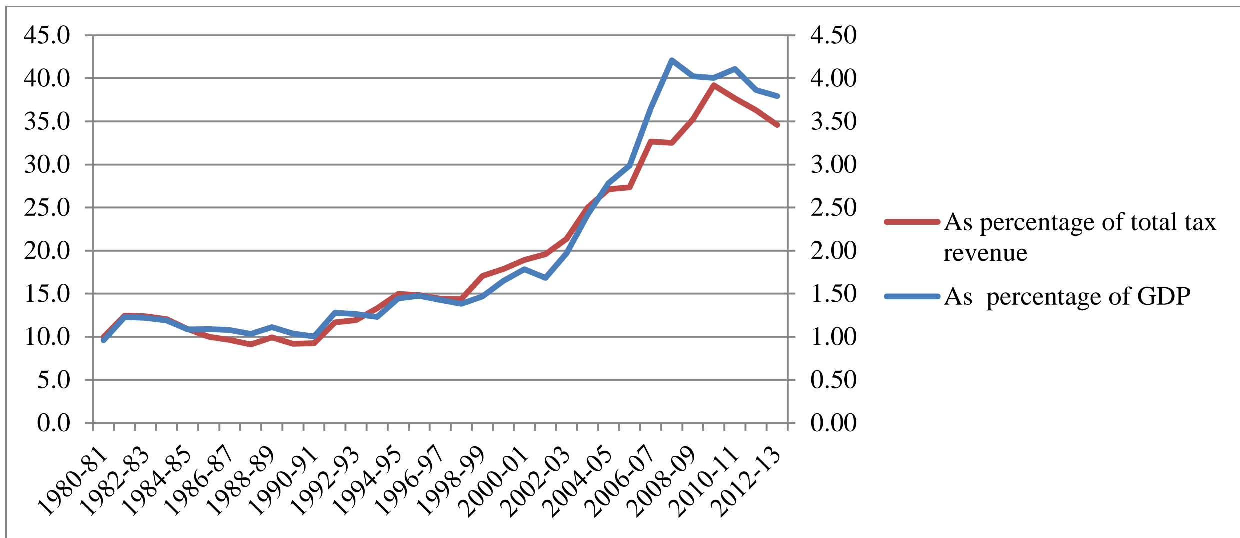
Figure 3: Passive Incomes: Net Payments by India (US$ Million)



Source: Balance of Payments, IMF

With greater integration of the domestic economy with the world economy, issues of international taxation acquire a lot of importance. This is even more so the case since these heads would affect corporate income tax collections in India, which is one of the major heads of revenue for the government. (Figure 4) While the reported figures for corporate tax include payments of Dividend Distribution Tax, which should be reported as a part of personal income tax, the over trends do suggest that corporate tax rose very sharply in the period since 2000 and has settled at a high of over 3.5 percent of GDP. Changes in the structure of the economy, could potentially affect the revenues on this count and therefore both the changes and the emerging discussion on base erosion and profit shifting globally are of interest to India.

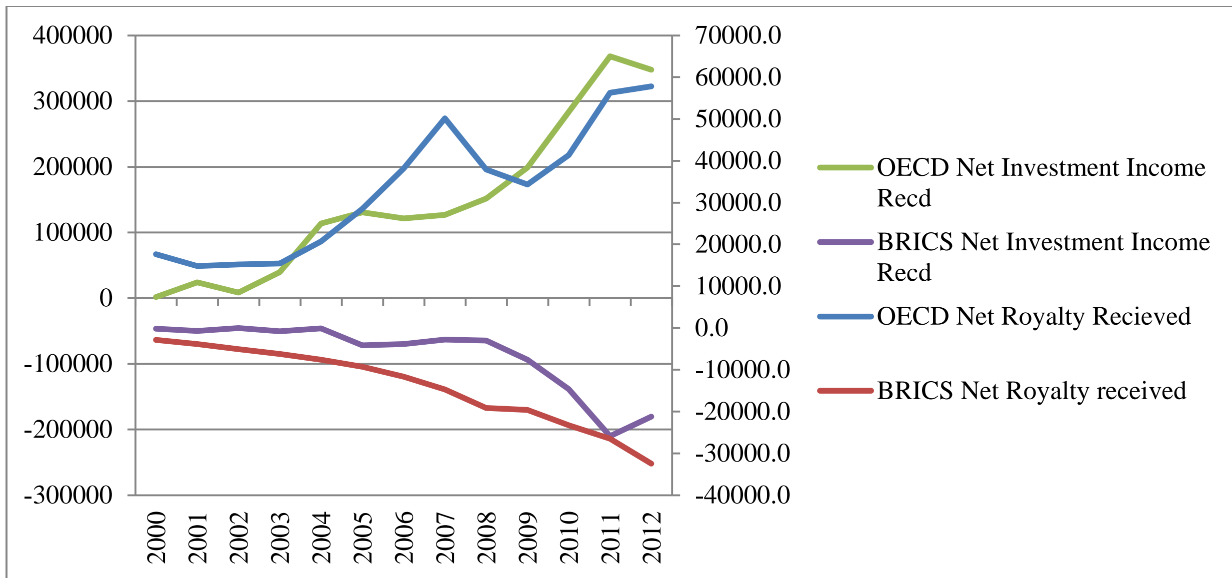
Figure 4: Trends in Corporate Tax



Source: Receipts Budget, Government of India.

Here it may be pointed out that some of the trends observed in India are observable for other developing countries as well. For instance, if we look at royalty payments, during the period since 2000, there is a consistent increase in the payments made out of BRICS. It is also interesting to note that while for the BRICS, there is a net outflow on this count, for the OECD there is a net inflow, even if there is a dip in the flows since 2007. If one considers net flows on account of investment income too, a similar trend is evident. These trends suggest that the interests of the developing countries in protecting their tax bases from erosion may not be exactly aligned with those of the developed countries. However, given the limitations to structuring an independent tax policy for any individual country, more so for developing countries, it is important for India to assess any proposed changes in the existing regimes and to the extent possible, protect its interests from being further diluted. The present note is an attempt to assess the recent initiative of the G20 and OECD on Base Erosion and Profit Shifting as summarized in the Action Plan on Base Erosion and Profit Shifting.

Figure 5: Net Royalty Receipts: US$ million



Source: Balance of Payments, IMF

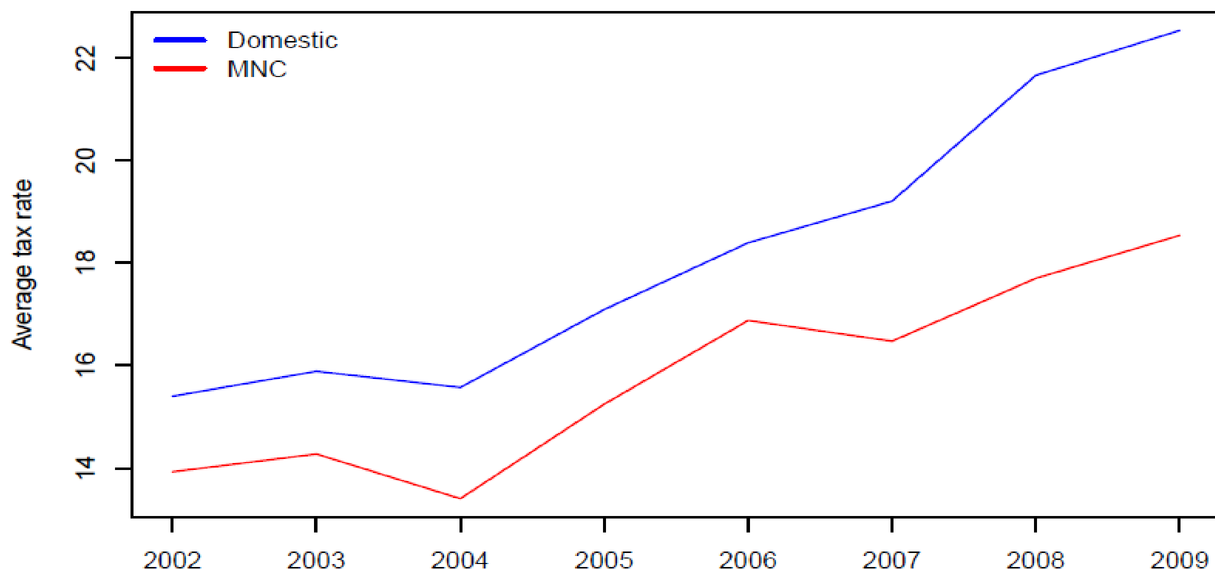
While all of these trends suggest that issues of international taxation are of growing importance for the Indian economy, it is equally important to ask whether there is any evidence of base erosion on account of closer links with the international economy. In the following sections, therefore, we seek to identify any evidence for India, which could answer the question on whether there is base erosion in India (Sections 2 and 3). This would be followed by a discussion on the assessment of the Action Points of the OECD Action Plan and India's preparedness on the same.(Section 4) Taxes are often argued to be an important factor in influencing the investment decisions of companies, especially of Multinational Corporations. In the context of discussion on the need for changes in the international tax regime, it is important to ask ourselves whether such changes would adversely affect the economic environment and therefore reduce the attractiveness of the domestic economy to both domestic and international investors. An attempt would be made to summarise the literature on the determinants of investment location decisions to seek an answer to this question. (Section 5) Section 6 presents some concluding observations.

Section 2: Tax Base Erosion in India: Empirical Evidence

Before exploring the utility of the BEPS project for India, it is useful to first ask whether there is any evidence of base erosion and profit shifting in the context of India. International studies have used broadly two approaches: one approach undertakes a comparison of the effective tax rates for multinational firms and firms which operate only in one country. Many of these studies use evidence either from company accounts or from the returns filed by these companies to examine for differences in effective tax rates. In the Indian context, one such study, Patnaik and Shah (2010) reports results to support the hypothesis that the effective tax rate for Indian MNCs is lower than the effective tax rate for domestic companies. (See Figure 6) Another study by Jansky and Prats (2013) titled 'Multinationals Corporations and the Profit Shifting Lure of the Tax Havens'[1] works with India specific data from a financial and ownership database, Orbis and demonstrates that MNCs operating in India with tax haven connections:

- report 1.5 per cent less profits
- pay 17.4 per cent less in taxes per unit of asset
- pay 30.3 per cent less in taxes per unit of profit
- have 11.4 per cent higher debt ratios than MNCs with no connection to tax havens.

Figure 6: Average Effective Tax Rate of MNCs and Non-MNCs



Source: Reproduced from Patnaik and Shah, 2010.

[1] http://www.christianaid.org.uk/images/ca-op-9-multinational-corporations-tax-havens-march-2013.pdf

This strand of literature works on the hypothesis that differences in tax rates would allow the firm to optimize and choose both their location of business as well the form of reporting of income so as to minimize the total tax liability of the company across all jurisdictions. Since the tax due in any given jurisdiction then can be at variance from the level of economic activity in that economy, this is considered evidence of profit shifting, or even base erosion. However, differences in the tax liability could be the result of differences in access to or utilization of various incentive measures provided by various governments and by looking at overall effective rates of tax, it would not be possible to segregate the effect of profit shifting from availing tax exemptions available in the tax regimes.[2] OECD proposes the use of hypothetical cases which incorporate the effects not only of tax exemptions and concessions but also the effects of the different tax regimes in different countries.

A second strand of literature focuses on the mechanisms used by the firms to shift profits to low tax jurisdictions and provides evidence on the use of such mechanisms. (See Heckemeyer and Overesch (2012), Dischinger and Riedel (2008) and Cristea and Nguyen (2013) for instance). The main mechanisms through which profit shifting or base erosion happens can be classified in 3 categories: financing mechanisms and the use of interest payment, intangibles and the related payment of royalty and transfer pricing mechanisms on sales and purchases from related parties. Increase in these forms of payments would reduce the reported profit or income that would be subject to tax in the hands of the corporation in the country where the economic activity takes place.

In order to find answers to the question on whether there is evidence of base erosion along the lines described above, we focus on two of these mechanisms – interest payments and royalty payments. For the purposes of this exercise, we work with company accounts data from PROWESS, for the period 2006-11. The question being posed is – are the interest payments/ royalty reported by companies different for "domestic" and "non-domestic" firms. For answering this question, firms need to be classified into two categories, "domestic" and "non-domestic".

[2] OECD (2013) calls this the "backward" looking ETRs and against an exercise which works out the potential tax liability on an economic activity based on the policy regime after incorporating the effects of all tax exemptions and the tax regimes in competing countries. The latter is referred to as a "Forward" looking ETR. See OECD (2013) for a more detailed discussion on the existing studies using this approach.

This classification is done on the basis of information provided in the PROWESS database on "Related Party Transactions". As per the documentation of the database, "Related party transaction is a business deal or arrangement between two parties (entities) that are joined by a special relationship prior to the deal. This data field describes the relationship of the related party with the company. The related party could be a key personnel of the company, relatives of key personnel or subsidiaries."

> "Accounting Standard 18 (AS-18) of the Institute of Chartered Accountants of India (ICAI) provides the guidelines regarding disclosures of related party transactions. Disclosure of such information became mandatory from 2004. Disclosures are mandatory for listed companies, banks, financial institutions, companies with sales of over Rs.500 million, or with a borrowing of over Rs.100 million, or the holding or subsidiary companies of any of these. Prowess classifies the related parties and the transactions into standardised types of related parties and transactions. These standardisations make it possible to access the information with some predictability. It overcomes the problem of a high degree of variability in the nomenclature used by companies in describing related parties and their transactions."

The database classifies the transactions under six categories, "holding company", "subsidiary", "Parties where control exists", "Key Personnel" and "Relatives of key personnel" and "others". Any company which reports transactions under any one of these categories is considered a "non-domestic" company with some opportunity to undertake actions which could result in base erosion. All other companies were considered "domestic" companies. It may be noted that by this classification, the status of a company could change over the years, if it reported some related party transactions in some years and did not in other years.

Since the database covers a wide variation in companies both in the kinds of activities they undertake and in their size, for comparability a subset of the firms in the database is considered for analysis. For the purposes of the present exercise, we exclude financial firms since the income flows for such firms would be quite different from those for other firms. For instance, interest receipt and interest payment may be much larger for these firms than for non-financial firms. Second, since the reporting requirements on related party transactions are mandatory only for large firms, as mentioned above, we excluded all firms which have total revenue below Rs 1

billion[3]. It may be mentioned here that prior to this exclusion, the size of non-domestic firms on average is much larger than the average size of domestic firms. By limiting the firms to those with revenue above Rs 1 billion, the firms in both categories are of comparable dimensions, making the analysis more meaningful.

Interest Payments:

To begin with we focus on interest payments as reported by the companies. The question being asked is whether there is any difference in the quantum of interest paid by domestic and non-domestic firms. A simple test of averages suggests that non-domestic firms pay more interest per firm than domestic firms, but domestic firms seem to pay more interest per unit of borrowing than non-domestic firms. To check for the possibility of a non-linear relation between interest and borrowing and for differences in the relation between domestic and non-domestic firms, we postulate a log-linear relation of the following form:

$$\log(interestpaid) = \alpha + \beta * \log(borrowing) + \gamma * dummy + \delta * dummy * \log(borrowing)$$

where $dummy = 0$, for domestic firms and 1 otherwise.

In this relation, if the underlying relation between interest paid and borrowing is linear with differences in interest rate paid by domestic and non-domestic firms, then while 'γ' will be non-zero and 'δ' would not be significantly different from zero, while 'β' should be equal to 1. On the other hand, if the relation is non-linear, in the sense the interest rates themselves could be varying with changes in the level of borrowing, then 'β' or '$\beta + \delta$' would be different from 1.[4] Using this formulation, we find that for all the years being analysed, the data suggests that a one percentage point increase in borrowing results in a less than one percentage point increase in interest payment. (See Table 1) This suggests that with an increase in the level of borrowing, the interest payment per unit of borrowing would be lower. The other feature evident from the table is that for four out of the six years, non-domestic firms show a larger level of interest payment for any given level of borrowing when compared to domestic firms. This result appears to

[3] Revenue here refers to the sum of sales and other incomes reported in PROWESS. In the database, this category is referred to as Income. However, since the word "income" has different connotations in taxation as well as in economics, we use a more neutral term for clarity.

[4] Wald test was performed to check whether either of these coefficients are equal to 1. The results indicate that the hypothesis is rejected – the coefficients are not equal to one, in any of the years.

suggest that non-domestic firms either face higher costs of borrowing or alternatively, they could be using interest payment as a mechanism for transferring resources from one company to another whether domestically or internationally.

A second route to explore the difference between domestic and non-domestic firms is to explain the performance of these firms, in terms of the revenue generated. Revenue of a firm is postulated to be a function of the level of gross fixed assets of the firm and the level of borrowing of the firm. Dummies are incorporated to isolate the differences between domestic and non-domestic firms.

The second panel in Table 1 presents the results for Revenue. Higher levels of borrowing are associated with higher levels of revenue, and higher levels of Gross Fixed Assets (GFA) too are associated with higher levels of revenue. Further, these results too suggest that there are some differences between the performance of the domestic and the non-domestic firms. In five out of the six years considered, for given levels of GFA, the non-domestic firms report a higher level of revenue for given levels of borrowing. On the other hand, for given level of borrowing, the non-domestic firms report a lower level of revenue. Since we are examining the impact of borrowing on the firm, we focus on that component of the result. The result suggests that given the level of GFA, for a given level of borrowing, the non-domestic firms have a lower level of revenue when compared to domestic firms.

Given that both revenue received and interest paid of domestic and non-domestic firms respond differently to borrowing, it is useful to ask whether the amount of corporate tax paid by these firms is different corresponding to any given level of borrowing. Since revenue received and interest payment would affect corporate tax in different ways - the former increases the amount of tax liability while the latter reduces it - they are considered separately in the equation. The results suggest that for any given level of revenue received, non-domestic companies pay higher taxes. There is no difference in the impact of interest on taxes between these two types of firms.

Table 1: Econometric Year wise Estimates

Variable	2006	2007	2008	2009	2010	2011
Log (interest)						
Log(Borrowings)	0.76***	0.76***	0.77***	0.76***	0.81***	0.83***
Log(borrowings*Dummy)		0.014*	0.014**	0.017**	0.012**	
Constant	-1.15***	-1.15***	-1.05***	-0.87***	-1.22***	-1.40***
R^2	0.7169	0.7054	0.7232	0.7274	0.7869	0.7815
Log (Income)						
Log(borrowings)	0.19***	0.12***	0.2***	0.197***	0.2***	0.23***
Log (borrowings*Dummy)	-0.09***		-0.07***	-0.06**	-0.06***	-0.09***
Log(Gross Fixed Assets)	0.27***	0.32***	0.24***	0.27***	0.28***	0.27***
Log (Gross fixed Assets*Dummy)	0.1***	0.01*	0.09***	0.08***	0.08***	0.11***
Constant	5.04***	5.14***	5.14***	4.99***	4.94***	4.78***
R^2	0.4709	0.4506	0.4684	0.4952	0.5056	0.5282
Log (Corporate Tax)						
Log(Income)	1.33***	1.32***	1.28***	1.31***	1.27***	1.26***
Log (Income* Dummy)	0.05***	0.06***	0.04***	0.04***	0.06***	0.03***
Log (Interest)	-0.2***	-0.16***	-0.17***	-0.2***	-0.17***	-0.17***
Constant	-6.98***	-7.01***	-6.31***	-6.7***	-6.29***	-5.96***
R^2	0.4479	0.4881	0.4882	0.4674	0.5179	0.5382

Source: Based on data extracted from PROWESS

Note: 1. The above are estimates from a simultaneous equation system with three equations using SUR estimation.

2. * significant at 10%, ** significant at 5% and *** significant at 1 per cent. The R^2 reported are adjusted R squares.

Collating the effects across these three results, it appears that for a given level of borrowing, non-domestic firms pay more interest, and earn less revenue. Incorporating these effects into corporate tax, a given level of borrowing would therefore result in lower tax on account of interest for non-domestic companies when compared to domestic companies. In case of revenue, the effect is mixed – for a given level of borrowing, non-domestic companies generate less revenue, but for a unit of revenue, they report higher taxes. The net effect could go in either direction. The net combined effect of borrowing through these two channels on corporate tax can be worked out through the coefficients in the estimated equation as follows:

$$\frac{\partial CT}{\partial borrowing} = \frac{\partial CT}{\partial revenue} * \frac{\partial revenue}{\partial borrowing} + \frac{\partial CT}{\partial interest} * \frac{\partial interest}{\partial borrowing}$$

Table 2 presents the net effect of a one percentage point increase in borrowing on corporate tax for domestic and non-domestic firms. The results indicate that for domestic firms the corporate tax would increase more than that for non-domestic firms, except in 2007. In other words, for a given level of borrowing, domestic firms appear to pay more taxes than non-domestic firms, given other parameters.

Table 2: Net Effect of Borrowing on Corporate Tax

Category of firm	2006	2007	2008	2009	2010	2011
Domestic firms	0.094	0.039	0.126	0.101	0.117	0.154
Non-domestic firms	-0.022	0.044	0.034	0.026	0.051	0.044

Royalty

Turning to royalty, there is some discussion in the press about the sharp rise in the royalty payments by Indian subsidiaries of Multinational Corporations. (See Business Standard June 23, 2013, article titled "Royal Flush".[5]) The article pulls together information from various sources to suggest that subsequent to the relaxation of the cap on royalty and fee for technical collaboration etc. with effect from December 2009, there is consistent increase in the royalty payments out of the country. The article quotes estimates by Espirito Santo Securities to indicate that "payments of 25 top multinationals - including Maruti Suzuki, HUL, Nestle India and Colgate-Palmolive India - have jumped 140 per cent. Maruti's royalties to Suzuki Motor Corporation leapt almost three times from Rs 677.7 crore in 2008/09 to Rs 1,803.1 crore in 2011/12, which was 110 per cent of its profit after tax."

The article also refers to a study by IIAS which indicates that for the top 25 MNCs in India, royalty payments have increased much more sharply than dividend payments: the former doubled between 2008 and 2012 while dividends increased only by 30 percent. Table 3 below summarized the numbers for a few MNCs which highlight this point.

[5] http://businesstoday.intoday.in/story/royalty-payments-by-multinational-companies/1/195398.html

Table 3: Increase in Royalty Payouts: Some Examples

	2011-12	2008-09	Percentage increase
Bosch Ltd.	148	51	190.2
Maruti Suzuki India	1803	678	165.9
HUL	290	116	150.0
ABB	249	125	99.2
Colgate- Palmolive (India)	141	72	95.8
Nestle	289	176	64.2
Glaxo Smithkline Consumer Healthcare	106	70	51.4
Proctor &Gamble Hygeine &Healthcare	63	42	50.0

Source: http://businesstoday.intoday.in/story/royalty-payments-by-multinational-companies/1/195398.html

While it can be argued that there was overall growth in the economy and hence these companies could have shown higher sales and hence higher royalty payments, the following table, summarized from a report by Institutional Investor Advisory Services (IIAS) indicates that the ratio of royalty to net sales has increased quite sharply for some of these companies.

Table 4: Royalty as a percentage of Net Sales

		2007-08	2011-12	Percentage increase
1	Maruti Suzuki	2.80%	5.20%	186%
2	Hindustan	0.60%	1.40%	233%
3	Colgate Palmolive	2.50%	4.50%	180%
4	ABB	2.50%	5.10%	204%
5	Alstom	0.40%	2.20%	550%
6	Bosch	0.70%	1.60%	229%

Source: Annexure A of "Royalty Payments and Minority Shareholders"
http://www.iias.in/downloads/institutional/Royalty%20payments%20and%20minority%20shareholders%20(Final).pdf

An alternative method to ask the same question, is to compare the quantum of royalty payments made by companies which report some payments made for royalty and technical fees. The PROWESS database provides information categorized into three categories: royalty payments, fee for technical services and license fees. Since all three are payments for intangibles, we consider them together as one category. It is postulated that these payments would be related to the turnover of the firm, i.e., the sales of the firm and not the revenue of the firm, since the latter includes incomes from financial instruments which would not be related to royalty payments.

The question being asked once again is whether there is a difference between domestic and non-domestic firms in the amounts of royalty and other such fees paid. For this purpose, a dummy separating the firms into the two categories is used. The results are reported in Table 3. The results indicate that for each of the years considered, while royalty increases with an increase in sales, there is a difference in the level of royalty paid between domestic and non-domestic firms, where the latter pay a higher amount of royalty for a given level of sales.[6] It may be noted that on average the non-domestic companies have higher levels of sales than domestic companies as well.

Table 5: Royalty Payments: A Comparative Analysis

Log(Royalty)						
	2006	**2007**	**2008**	**2009**	**2010**	**2011**
Log(Sales)	0.99***	1.15***	1.04***	0.88***	0.78***	1.05***
Dummy	0.59***	.517**	0.47**	0.92***	0.74***	0.59***
Constant	-6.12***	-7.65***	-6.65***	-5.75***	-4.49***	-6.49***
R^2	0.2957	0.3194	0.29	0.2521	0.4053	0.3611

Note: * significant at 10%, ** significant at 5% and *** significant at 1 per cent. The R^2 reported are adjusted R squares.

Both the sets of results presented here suggest that for interest payments as well as royalty, there are differences in the behavior of domestic and non-domestic firms with the latter showing higher levels of both interest payment and royalty payment corresponding to given levels of borrowing and sales respectively. While these do not directly suggest that there is profit shifting out of the country, they do suggest that there is profit shifting out of the company being analysed.

[6] While these results are consistent across the years, the R^2 values suggest that there could be some more variables contribute to the variations in royalty payments across firms.

Section 3: Cases specific to India

While overall numbers do indicate that there is some evidence of base erosion from India, the specifics of the forms of base erosion can only be ascertained through cases identified by tax authorities in India. Corporate tax case laws available from databases provide the requisite information. In order to get a flavor of the forms relevant for India, summarized below are some cases that have been raised and/or disputed in India.

3.1. eBAY International AG Vs. ADIT[7]

eBay AG is incorporated in Switzerland. eBay AG operated India specific websites providing an online platform for facilitating the purchase and sale of goods and services to users based in India.

Any seller is entitled to list its products for sale on the website. At the time of listing, the seller is required to provide various details regarding the product that it wished to be sold through the website. Any buyer can also register himself for buying of the goods through the website. The buyer is required to choose any of the payment methods for making payment of the product directly to the seller. Once the buyer clicks 'Buy It Now' button after registering with the website and agreeing to the terms and conditions of sale as displayed by the seller on the website, an email is sent by the assessee to the seller confirming the sale of his product listed on the website. The seller then delivers the product to the buyer and settles the payment in respect of sale. The sellers registered on the website are required to pay 'User fee' on every successful sale of their products on the website. On the successful completion of the sale, the assessee raises periodic invoice on the seller for the “user fee”. The sellers are required to make payment of the user fee to eBay India/eBay Motors for the transactions undertaken on the websites. After making collection from the sellers, eBay India/eBay Motors remit the user fee to the Swiss company. For the assessment year 2006-07, eBay AG earned revenue amounting to Rs.4,94,27,530/ - from the operations of its websites in India. The taxpayer claimed that such revenue represented business profits and could be taxed in India as per the provisions of Article 7 of the DTAA between India and Switzerland only if it had a PE in India as per the provision of Article 5.

[7] 2012-TII-169ITAT-MUM-INTL

One of the arguments taken by the Revenue in its efforts to tax the foreign company on its income from India was that the taxpayer had a dependent agent PE in India in the form of the two websites. In that context the Tribunal held that there was no dispute about the fact that eBay India and eBay Motors were providing their exclusive services to the taxpayer; that It has been admitted that these two entities had no other source of income except that from the assessee in lieu of the provision of service eBay India and eBay Motors definitely become dependent agents of the assessee.

At the same time, the Tribunal pointed out eBay India had at no stage negotiated or entered into contract for or on behalf of the foreign company. By providing marketing services to the assessee or making collection from the customers and forwarding the same to eBay AG, it could not be said that eBay India entered into contracts on behalf of the assessee. The Tribunal held that eBay India and eBay Motors do not habitually exercise 'an authority to negotiate and enter into contracts for or on behalf of' the assessee. Therefore, under the extant rules, they could not be called dependent agent PE of the taxpayer and the income could not be taxed in India.

3.2. Asia Satellite Telecommunications Co Ltd vs DCIT[8] & New Skies Satellite NV Vs ADIT[9]

Popular TV channels like STAR TV, STAR Plus, STAR News etc. were being operated in India by *Satellite Television Asian Region Ltd*, Hong Kong which entered into a transponder lease agreement with *Asia Satellite Telecommunication Ltd,* Hong Kong, so that the content developed for the Indian audience could be relayed in the footprint area of the Satellite that covered India. The ultimate territory of commercial exploitation being India, the tax officer held that the taxpayer had a business connection in India thereby making the receipts subject to Indian taxes. On appeal, the Commissioner of Income Tax (Appeal)[CITA] accepted the contention of the taxpayer that, there being no place of operation of the company in India, it was not a case of business connection. However, he held that the income was liable to be taxed as royalty within the meaning of that term under the Indian domestic law.

[8] 2003-TII-03-ITAT-DEL-INTL
[9] 2009-TII77-ITAT-DEL-SB-INTL

On further appeal, the Tribunal held that viewership by the public at large is achieved only through the series of steps taken by receiving the uplinked signals, amplifying them and relaying them after changing the frequency in the footprint area including India. The particular end is achieved only through the series of steps taken in this regard. Accordingly, it held that the TV channels were using the process made available by the assessee through its transponder, giving rise to payment for royalty taxable in India.

Following a different view taken in the case of Panamsat International Systems LLC Vs DCIT[10] , a special Bench was constituted. In New Skies Satellite, the Special Bench dealt with the concept of user. The Tribunal, inter-alia, held: *It is neither practical nor possible to have the physical control over the transponder either by the satellite companies or by their customers. The "control" or "user" if any of the transponder is through the sophisticated instruments either installed in the ground stations owned by the satellite companies or on the earth stations owned by telecasting companies. Therefore, the "control" or "user" of the transponder and its capacity has to be seen from the practical angle. Once the process in the transponder is predetermined & pre guided by the satellite companies, it is made available for "user" to the customers who pay a consideration for the same. Such process is used by the telecasting companies according to their need*."

After the Special Bench decision on October 16, 2009, on 25/11/2009, the OECD issued a discussion draft on the issues specifically arising out of the taxation of telecom companies and suggested changes in the Commentary, reiterating its stand of no change in the context of changing business environment. The OECD was of the view: "Satellite operators and their customers (including broadcasting and telecommunication enterprises) frequently enter into "transponder leasing" agreements under which the satellite operator allows the customer to utilise the capacity of a satellite transponder to transmit over large geographical areas.

Payments made by customers under typical "transponder leasing" agreements are made for the use of the transponder transmitting capacity and will not constitute royalties under the definition of paragraph 2: these payments are not made in consideration for the use of, or right to use, property, or for information, that is referred to in the definition (they cannot be viewed, for

[10] 2006-TII-14ITAT-DEL-INTL

instance, as payments for information or for the use of, or right to use, a secret process since the satellite technology is not transferred to the customer). As regards treaties that include the leasing of industrial, commercial or scientific (ICS) equipment in the definition of royalties, the characterisation of the payment will depend to a large extent on the relevant contractual arrangements. *Whilst the relevant contracts often refer to the "lease" of a transponder, in most cases the customer does not acquire the physical possession of the transponder but simply its transmission capacity*: the satellite is operated by the lessor and the lessee has no access to the transponder that has been assigned to it. In such cases, the payments made by the customers would therefore be in the nature of payments for services, to which Article 7 applies, rather than payments for the use, or right to use, ICS equipment. A different, but much less frequent, transaction would be where the owner of the satellite leases it to another party so that the latter may operate it and either use it for its own purposes or offer its data transmission capacity to third parties. In such a case, the payment made by the satellite operator to the satellite owner could well be considered as a payment for the leasing of industrial, commercial or scientific equipment."

In other words, according to the OECD commentary, payment for transponder leasing by source countries cannot be taxed as royalty and can only be taxed as business income and for business income to be taxed by source countries, there must be a PE. Lest anyone claims that there is a PE because of the satellite being above their space, the move is also preempted by the addition of another Para in the commentary to Article 5 dealing with the permanent establishment as follows: *"Clearly, a permanent establishment may only be considered to be situated in a Contracting State if the relevant place of business is situated in the territory of that State. The question of whether a satellite in geostationary orbit could constitute a permanent establishment for the satellite operator relates in part to how far the territory of a State extends into space. No member country would agree that the location of these satellites can be part of the territory of a Contracting State under the applicable rules of international law and could therefore be considered to be a permanent establishment situated therein. Also, the particular area over which a satellite's signals may be received (the satellite's "footprint") cannot be considered to be at the disposal of the operator of the satellite so as to make that area a place of business of the satellite's operator."*

According to "State of the Satellite Industry Report (August 2010)" sponsored by Satellite Industry Association [SIA], the world satellite revenues in 2009 was of the order of $ 160.9 billion with an average annual growth of 11.7% from 2004 through 2009. Out of this, the share of satellite service industry was $ 93 billion. What is remarkable is that despite worldwide recession, satellite services revenue grew by almost 11% from 2008 to 2009. Satellite technology is invaluable for propelling growth in many areas such as telecom, news, media, and entertainment - to name a few. In India, as perhaps elsewhere, the satellite industry has a symbiotic relationship with the media and entertainment and television. The Indian Media and Entertainment Industry stood at $ 12.9 billion in 2009 and according to a KPMG study, the size of this industry is expected to reach roughly 25 billion $ by 2014.

There is therefore considerable revenue involved in a lot of cross border transactions, which are inevitable for this important sector. And whenever, there is considerable revenue in a cross-country situation, question of sharing the revenue also becomes inevitable. Inevitably, the leading soft power in the world of international taxation, the OECD got into the picture and decided against the assertion of source country taxation rights in such situations.

It may be noted that when the Asiasat case reached the Delhi High Court,[11] the Court upturned the decision of the Tribunal and partly relied on the above commentary of the OECD in its decision rendered on 31.1.2011. The Court inter-alia, held that when the technical terms used in the DTAA are the same which appear in Section 9(1)(vi) of the Income Tax Act that defines royalty, for better understanding all these very terms, OECD commentary can always be relied upon.

3.3. Nimbus Sport International Pte Ltd Vs DDIT[12]:

Nimbus is an Indian group in media and entertainment with channels like Neo Sports, Neo Cricket. A company named Nimbus Sport International Pte Ltd was incorporated in Singapore. It was stated to be wholly managed from Singapore and not have a PE in India. It entered into an agreement with Prasar Bharati for telecasting of cricket events from February 2002 to October

[11] Asia Satellite Telecommunications Co Ltd Vs DIT [2011-TII-05-HC-DEL-INTL]
[12] 2011-TII-178-ITAT-DEL-INTL

2004. One of the issues involved in the case was the taxability of advertisement revenues paid by Indian advertisers- Coca Cola India Pvt Ltd, Seagram Manufacturing Ltd, Hero Honda etc. during the telecasting of matches played in Sri Lanka.

The Assessing Officer took the view that the taxpayer had a PE in India and the source of the receipts lay in India, the Indian team played in these matches that were broadcast internationally including in India. He adopted 20% of gross receipts from the advertisements and estimated 50% thereof as income attributable to the PE in India.

On appeal, the CITA observed that various companies in India like, Coca-Cola, Pepsico Food, LG Electronics etc. signed contracts with the assessee company for advertising their products and since the company provided advertisement to various companies located in India through live telecast which was viewed by customers in India, income arising from advertisement was taxable in India. He also held that the advertisement income was taxable u/s 9(1) of the Income Tax Act as the source of income was in India. Moreover, he held that Article-7(1) of DTAA between India and Singapore has incorporated the principle of "force of attraction" based on the UN Model. Accordingly, the CITA held that the assessee was also taxable under Article 7(1) of DTAA between India and Singapore because the assessee had carried out the core activities of advertisement business through fixed place PE in India.

On appeal, the Tribunal held that the contract was signed by the assessee at Singapore and all the activities relating to this contract were carried out from Singapore; there is no evidence on record that the management and control of the affairs of the company were situated in India, that merely because holding of one board meeting in India will not lead to a conclusion that during the year, the control and management of assessee's affairs was situated only in India; that the assessee's activities at Singapore demonstrated that the affairs of the company were wholly carried out at Singapore; that the residence of two non-residents directors in India will not make the company a resident in. The Tribunal held that the taxpayer did not have a PE in India, the matches were not played in India, the telecast of the matches was not in India and the indirect benefit which might have been derived by some of the Indian viewers could not be held to be incremental for Indian companies on assumption. The Tribunal held that the advertisement revenue had no attribution to India and in the absence of any PE in the traditional definition of the term, this revenue could not be taxed in India.

3.4. LG Electronics India Pvt Ltd Vs ACIT[13]:

Profit can be taken away from a country through myriad ways. Payment for purchases of goods and services is one obvious choice. Similar will be less than adequate compensation to the Indian company for sales or provision of services. In the absence of Transfer Pricing (TP) legislation in India, till the year 2001, not much attention has been paid to these aspects. The attitude of the court/tribunals that the assessee best knows its business also helped. However, with the passing of the TP legislation in India, many such transactions are coming to the notice of the tax department.

There are quite a few other ways which are not very obvious that have come to the knowledge of the Indian tax department in the course of the administration of the TP legislation.

One such less than obvious way is the exaggerated advertisement spends by the Indian subsidiaries of foreign MNCs. The advertisement and brand building expenses of MNCs in India has been on the rise. If these inure for the exclusive benefit of the Indian company, no one can have any quarrel with such spends which are normally tax deductible. However, when it is not the Indian subsidiary that is reaping the benefit, the issue of transfer pricing arises. In this regard, the case of LG electronics decided by the Special Bench of the Tribunal is informative.

L.G. Electronics Inc. is a Korean company, engaged in the business of manufacture, sale and distribution of electronic products and electrical appliances. L.G. Electronics India Pvt. Ltd. is a wholly owned subsidiary of LGK. In terms of a technical assistance and royalty agreement, LGI obtained a right to use the technical information, designs, etc. from the LGK for a royalty at the rate of 1%. The licensor allowed the licensee to use its brand name and trade marks to products manufactured in India during the validity period of the agreement.

One of the international transactions of the assessee was the contribution towards Global Cricket Sponsorship from its AE. The Transfer Pricing Officer (TPO) observed that the assessee had received contribution from its Associated Enterprise for the expenditure incurred on sponsorship of Global Cricket events. The quantum of contribution received was considered as a part contribution for the brand promotion carried out by the assessee on behalf of its foreign AE.

[13] 2013-TII-15-ITAT-DEL-SB-TP

The TPO observed that the Indian subsidiary's expenses on advertisement, marketing and promotion (AMP) was 3.85% of its sales whereas the same was 0.12% in the case of Videocon Appliances Ltd and and 2.66% for Whirlpool of India Ltd giving an average of 1.39%. He held that the Indian subsidiary was promoting LG brand owned by LG, Korea and should have been adequately compensated. Applying the Bright-Line Test, he held that the expenses up to 1.39% of the sales should be considered as having been incurred for the taxpayer's own business and the remaining 2.46% was on brand promotion of the foreign AE. The excess was proposed as a transfer pricing adjustment on account of AMP expenses for brand building. The AO passed order making additions, *inter alia,* of Rs 182.71 crore towards AMP expenses on brand building.

In a majority decision, the Special Bench of the Tribunal upheld the stand of the department although it remitted the matter to the lower authorities to work out the exact adjustments. The importance of the issue can be gauged from the fact that there were 22 interveners in the case including names like Cannon India, Maruti Suzuki, Star India, Sony India, Haier Appliances, Glaxo Smith Kline, Bausch & Lomb, Fujifilm, Haier Telecom, Daikin etc. The judgement of the Tribunal is under challenge in the Courts. However, the case demonstrates the modus of making the Indian subsidiaries pay for the brand promotion expenses of the parent company and thereby erode the tax base of India. The source country allows the deduction for the development or enhancement of the value of marketing intangibles. However, if it does not get the corresponding benefit of revenues that may be attributable to such efforts, its tax base will certainly shrink.

3.5. Perot Systems TSI India Ltd[14]:

Perot Systems TSI (India) Private Limited (PSTSI) is engaged in the business of designing and developing technology enabled business transformation solutions and providing business consulting, systems integration services and software solutions and services.

PSTSI extended two foreign currency loans to its associated enterprises, namely, HPS Global Systems (Bermuda) Limited (HPS Bermuda) and HPS Global Systems Hungary Liquidity Management LLC (HPS Hungary) worth USD 1.5 million and USD 4.6 million respectively.

[14] 2010-TII-03-ITAT-DEL-TP

During the assessment proceedings, the international transactions entered into by the assessee were referred for scrutiny to the TPO. The TPO held that the international transactions undertaken by PSTSI, in relation to the interest free loan were not at arm's length and undertook an upward adjustment to income for the relevant years.

PSTSI contended that income means real income and not fictitious interest income and since it had not earned any income, the same could not be taxed. It was further argued that Transfer Pricing document maintained clearly mentioned that these loans/advances are in the nature of quasi-equity and hence the transaction of granting interest free loan was at arm's length. The loan agreements mentioned that these were interest free loans and authorities had no right to re-write the transaction unless it is held that it was sham or bogus or entered into by the parties to avoid and evade taxes. It was pointed out that the loan had been duly granted by the approval of the RBI. The Income Tax Act, 1961 and OECD guidelines support the contention that the effect of government control/intervention should be considered while determining the arm's length price.

The TPO however held that no two persons in normal business situation would grant interest free loan to the other persons. On the taxpayer's appeal, the Tribunal held that there was no case for not providing or charging any interest and that if the contention that whenever interest free loan is granted to associated enterprises, there should not be any adjustment was accepted, it will tantamount to taking out such transactions from the realm of section 92(1) and section 92B of the IT Act.

The Tribunal pointed out that it was not the case that there was any technical problem that loan could not have been contributed as capital originally if it was actually meant to be capital contribution. The Tribunal approved the TPO's view that one of the AEs was situated in a tax haven and not charging of the interest by the assessee from the AEs, would result in higher income in the hands of the AEs, and the income of the assessee in India would reduce by the corresponding amount. Thus this would bring down the overall tax incidence of the group by shifting profit from Indian jurisdiction to Bermuda which is a tax haven with zero rate of tax on corporate profit; that this was a classic case of violation of transfer pricing norms where profits are shifted to tax havens or low tax regimes to bring down the aggregate tax incidence of a multinational group.

3.6. DCIT Vs Dr Reddy's Laboratories Ltd[15]:

The taxpayer was engaged business of manufacturing, trading and exporting of bulk drugs. To market its products in USA and Canada, it was required to get approval from the US Federal Drug Authority and the Therapeutic Product Program Authority in Canada by getting its products tested through certain Contract Research Organisations A report with the study findings was released to the assessee, which was then submitted to the regulatory authorities and if the regulatory authorities were satisfied, then the patents were registered.

The taxpayer made the following payments in two years:

	Amount paid during financial year	
Name of the CRO	**2001-02**	**2002-03**
M/s. Anapharm, Canada	2,84,74,878	16,06,42,979
M/s. MDS Pharma Services Canada	10,55,47,693	12,35,86,857
M/s. Applied Analytical Industries Inc. USA	3,19,32,665	1,54,21,361
M/s. Med Trials Inc., USA	-	42,48,928
TOTAL	**16,59,55,236**	**20,39,00,125**

No tax was deducted therefrom. It was claimed that these payments represented business profits in the hands of recipients and could not be taxed in India in the absence of a PE. The AO treated the receipts as fees for technical services. On appeal, however, on an analysis of the tax treaties, it was held that the income was in the nature of services and no knowledge was made available to the taxpayer and hence the amounts could not also be taxed as fees for technical services.

Thus, in the present scheme of distribution of taxing rights, India did not have a right to tax any part of the income although its tax base was eroded as the Indian taxpayer had to be given the benefit of the payment as business expenditure.

[15] 2013-TII-97-ITAT-HYD-INTL

3.7. ADIT Vs. WNS North America Inc[16]:

The taxpayer, a US based company, rendered marketing and management services to WNS Global Services Pvt. Ltd., its associated enterprise in India. In terms of a marketing and management services agreement with WNS India, it was entitled to receive fees at its cost plus 10 per cent mark up.

The taxpayer claimed that payment for rendering services outside India was not in the nature of 'Fees for Included services' as defined under Article 12 of the DTAA as the assessee had not made available any knowledge, experience or skills etc. to WNS India. Also, as its employees had visited India for providing managerial services, therefore WNS India constituted a service PE under Article 5(2)(1) of the tax treaty. Thus, a small portion of the total receipts was attributable to such service PE for managerial services rendered in India, and the assessee had offered this small amount as income for taxation under Article 7 of the DTAA.

The AO held that the assessee had rendered expertise and technical knowledge for conduct of business of WNS India. Therefore, the payment received on account of marketing and management services rendered by the assessee to WNS India represented 'Fees for Included Services' under Article 12(4)(b) of Indo-US DTAA. On appeal, the CITA decided the issue in favour of the taxpayer by following the decision of the Tribunal in the assessee's own case for the earlier assessment year.

On further appeal, the Tribunal held that the two essential conditions for applying the force of attraction rule are (i) the business activity carried on should be in the other State where the PE is situated (ii) the business activity carried on must be of the same or similar kind as those effected through PE. In the present case, the condition of business activity carried on in the other State where the PE is situated is not satisfied because the marketing and management services in question are provided by the assessee outside India and income of such services cannot be said to have accrued or arisen to the assessee or deemed to have accrued or arisen to assessee in India, the existence of service PE in India would not make it taxable under Article 7 of Indo-US DTAA.

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[16] 2013-TII-145-ITAT-MUM-INTL

The total amount involved in the case was Rs Rs.68,15,11,339/- which the Indian subsidiary paid and obtained deduction for. However, in the present scheme of taxation of services in terms of a treaty under the OECD model that does not allow the force of attraction, no tax could be levied.

3.8. Siemens Ltd Vs. CIT[17]:

In pursuance of its tender formalities with the Gujarat Energy Transmission Corporation Ltd and Maharashtra State Electricity Transmission Company Ltd, Siemens Ltd was required to obtain type-testing certificate of the circuit breakers manufactured by it. For this purpose it had sent the circuit breakers to be tested in the Laboratory of one "Pehla Testing Laboratory", Germany where the circuit breakers had to undergo destructive tests in the Laboratories. Once the circuit breakers pass through the test in the Laboratories, PTL gives a certificate for the quality of the product manufactured by assessee. The taxpayer was required to make payment to PTL, Germany for carrying out the type tests of the circuit breakers manufactured by the assessee in order to establish that the design and the product meets the requirement of the International Standards.

For the purpose of making remittance to PTL, the assessee moved an application u/s 195 (2) before the ADIT. It was argued that no income accrues or arises in India as all services were rendered outside India and the payment was made outside India; that the payment was in the nature of business income of Pehla Laboratory and since it did not had any PE in India, the same was not taxable in India as per the DTAA. It was further submitted that even as per the provisions of Explanation 2 to section 9(1)(vii), the payment did not fall in the nature and category of fees for technical services (FTS).

The AO however rejected the contentions on the ground that the type of the services provided by the Pehla Lab was of highly technical nature and the payment was definitely covered by section 9(1)(vii) and secondly, the Explanation 2 to section 9 provides that, where the income was deemed or accrued or arise in India, such income shall be included in the total income of the non-resident, whether or not the non-resident has a residence or place of business or business connection in India. He held that payment would qualify as FTS as per the DTAA between India

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[17] 2013-TII-34-ITAT-MUM-INTL

and Germany, as well as per section 9(1)(vii) and he directed the assessee to deduct the tax @ 10% on the gross amount of payment to be made to PTL.

The first appellate authority held in favour of the revenue. However, on further appeal, the Tribunal pointed out that if any person delivers any technical skills or services or make available any such services through aid of any machine, equipment or any kind of technology, then such a rendering of services can be inferred as “technical services”. In such a situation there is a constant human endeavour and the involvement of the human interface. On the contrary, if any technology or machine developed by human and put to operation automatically, wherein it operates without any much of human interface or intervention, then usage of such technology cannot per se be held as rendering of “technical services” by human skills. It is obvious that in such a situation some human involvement could be there but it is not a constant endeavour of the human in the process. Merely because certificates have been provided by the humans after a test is carried out in a Laboratory automatically by the machines, it cannot be held that services have been provided through the human skill.

Although the judgement is in the context of domestic law definition of technical fees, such fees cannot be taxed under the treaties as well considering the fact that treaty definition is narrower.

3.9. ITO Vs. Right Florists Pvt Ltd[18]:

Google’s tax practices in reducing its overall corporate tax liability is one of the important drivers for mobilizing public opinion in the west and the beginning of the BEPS project. Its public hearing before the UK PAC laid bare the oft repeated ‘double Irish Dutch Sandwich’ technique by which it managed to pay very little tax on its profits from the operational income in the UK and elsewhere in Europe. In India, we have had no enquiry about the revenue and taxes paid by various multinationals. However, that does not mean that India’s tax base is not eroded. In this connection, a case decided last year brings into focus the fact that in the absence of a change in the taxation rights of the source and residence countries, the source country tax base will continue to be eroded.

[18] 2013-TII-61-ITAT-KOL-INTL

Right Florists is a small florist in Kolkata. This small company had paid more than INR 30 Lakhs in a year to Google and Yahoo as online advertisement charges. If such is the magnitude of online advertisement from a small company, one can imagine how much Google and Yahoo will generate in the form of total advertisement revenue from India. The Indian company apparently made payments without deduction of tax at source. The question then arose about the allowability of the expenditure in the hands of the Indian company. The assessing authority held that there was no material to establish that these entities belonged to treaty countries and that the taxpayer should have obtained a prior authorization to remit money without deduction of tax at source and in default the sum involved could not be allowed as a deduction.

The question before the Tribunal was whether the amount in question could be taxed as business income or as royalty or as fees for technical services. The Tribunal found that the foreign companies did not have PE in India and that the amount could not be taxed as royalty. The Tribunal found that although technical services were rendered in the case, but in the absence of any human intervention, the same could not be taxed as fees for technical services. The Tribunal, while holding that a web site could not constitute a PE relied on the revised OECD model commentary and ignored India's official position on the said commentary that India did not agree with the OECD view. The logic of India's position was that servers can be placed anywhere thereby making taxation impossible. Moreover servers, by themselves are dumb instruments and can be useful only in conjunction with a website. The Tribunal, while deciding the issue in favour of the taxpayer also made the following observation: "Clearly*, conventional PE test fails in this virtual world even when a reasonable level of commercial activity is crossed by foreign enterprise. It is a policy decision that Government has to take as to whether it wants to reconcile to the fact that conventional PE model has outlived its utility as an instrument of invoking taxing rights upon reaching a reasonable level of commercial activity and that it does fringe neutrality as to the form of commercial presence i.e. physical presence or virtual presence, or whether it wants to take suitable remedial measures to protect its revenue base. Any inertia in this exercise can only be at the cost of tax certainty." (Emphasis added).*The case demonstrated that such kinds of erosion of tax base will not be prevented unless there is discussion on the larger issue of allocation of taxing rights between the countries.

3.10. Besix Kier Dabhol, SA Vs DDIT[19]

Besix Kier Dabhol is a Belgium based company whose sole business was carrying out a project for construction of fuel jetty near Dabhol. Its equity capital was divided in the ratio of 60:40 between two joint venture partners N V Besix SA, of Belgium and Kier International (Investment) Limited of the U.K. The assessee also borrowed from its shareholders in the same ratio as the equity share holding amount of Rs.57.09 crores from NV Basix SA and Rs.37.01 crores from Kier International. The loan was apparently borrowed by the Indian Permanent Establishment directly from the shareholders and was not routed through the head office. The assessee's equity capital was of Rs. 38.00 lacs and debt capital of Rs.9410 lacs. Thus, the debt equity ratio worked out is to 248:1. It paid interest of Rs. 5.73 crores on the borrowing.

The AO noted that the assessee company has no reserves, no provisions, no financial debts, no financial assets, no assets anywhere in the world except in India, that it had a debt equity ratio of 248: 1 whereas debt equity ratio of shareholder companies was not furnished and that the ratio of borrowings was the same as of the equity capital, and in view of these facts, he considered the interest as payment to self and disallowed the claim.

On appeal, the Tribunal held that a company and its shareholders have separate existence, that the contracts between a company and its shareholders are just as enforceable as contracts with any independent person, and that, therefore, interest paid to the shareholder can only be treated as interest paid to independent outside parties.

The Tribunal pointed out that the tax treatment being given to the equity capital and debt capital being fundamentally different, it is often more advantageous in international context to arrange financing of a company by loan rather than by equity. It does affect the legitimate tax revenues of the source country in which business is carried out because while dividends and interest are generally taxable at the same rate in the hands of the recipient in the source country, interest is tax deductible and that results in lower corporate taxes in respect of PE profits. These tax benefits could be further optimized by hybrid financing instruments such as profit participating loans, convertible loans or where instrument is treated as debt in the source country of the income and as equity in the residence country of the lender. That is how tax considerations at

[19] [2010-TII-158-ITAT-MUM-INTL]

times do result in a company being too thinly capitalized, financed by a disproportionate ratio of debts. In order to protect themselves against such erosion in their legitimate tax base, several tax jurisdictions enact 'thin capitalization rules'. The Tribunal finally held that in the absence of such a rule in India at the relevant time, the interest had to be allowed.

3.11. Dresser Rand India Pvt Ltd Vs. Addl CIT[20]

Dresser Rand India Pvt Ltd is a wholly owned subsidiary of Dresser Rand Co, USA. The Transfer Pricing Officer noticed that it had entered into a 'cost contribution agreement' with its parent company in terms of which (a) the assessee should compensate on an equitable basis for the expenses incurred by the holding company on its resources which are being shared with the assessee and other affiliates; (b) the allocation of the cost contribution to various affiliates of the Group depends on two allocation keys, i.e. based on number of headcount, and based on sales proportion ; (c) all the direct and indirect costs, including overheads and termination costs incurred by Dresser Rand Group Inc with respect to the resources shall be computed as cost contribution; and (d) the resources include strategy, administration, finance and treasury, tax and legal services. Asked by the TPO to explain the services rendered by Dresser Rand, for which assessee was to contribute costs, the assessee explained that the services included (i) human Resources services; (ii) legal services; (iii) treasury services; (iv) technical support services; (v) marketing services; (vi) global business oversight services; (vii) internal audit and controls; and (viii) other services such as provision for value added services, sharing for best practices for optimization of services, and safety procedures etc.

It was also explained by the assessee that the assessee had no facilities or manpower in order to handle the above fields, except for a three member team in the field of human resource services, and it was for this reason that it had to avail the services of the holding/parent company and the 'cost contribution' allocated by the Dresser Rand Group to the assessee, was justified. However, the TPO rejected the submissions of the assessee for the following reasons –

A. It was incorrect on the part of the assessee to assert that it did not have an audit department since (i) the assessee had two managers and executives in the field of accounts; (ii) the

[20] 2011-TII-101-ITAT-MUM-TP

salaries of these managers and executives in the field of accounts, amounting to Rs 11.65 lakhs, were included in the staff costs; and (iii) the assessee had also paid Rs 21.86 towards audit fees as evident from the profit and loss account.

B. While the assessee had incurred cost contribution allocation of USD 5, 03,660 towards treasury services, the assessee was in fact a cash rich company which did not need any loans or guarantees. The treasury services were thus not related to assessee's requirements.

C. While the assessee had claimed cost contribution allocation of USD 6,37,070 towards 'global business oversight', which were said to be towards 'guidance provided by the global leadership team for efficient management for India operations', the assessee had not furnished any precise details or evidence of the exact services received by the assessee. The TPO noted that the assessee's staff members also included several experts in the field of business management, production and marketing operations, and, as such, the assessee did not really need any services for global business oversight.

D. An analysis of sales, expenses and profitability of the assessee, raised doubts about the genuineness of the arrangement and the cost sharing agreement was an afterthought for the purpose of shifting profits. This conclusion was based on the observations (a) that normally as turnover increases, the ratio of overheads to sales should reduce, but this year, as a result of cost sharing arrangement, the ratio has gone up even as the turnover has gone up; (b) that operating costs in percentage terms, which should come down as a result of turnover increase, has increased this year; (c) the turnover of the assessee should have grown at an accelerated rate as a result of availing these services, but the growth rate has come down this year vis-à-vis the growth rate last year – 21.29% as against 33.07% last year; (d) overall profitability of the assessee should have increased with increase of turnover, but it has reduced from 13.72% to 13.31%.

The TPO thus held that there were no real services availed by the assessee from Dresser Rand US, under the cost contribution arrangement, and hence the payment of Rs. 10.055 crores, under the said arrangement, was not a genuine expenditure incurred for the purposes of business of the assessee and accordingly, the ALP of services availed by the assessee under the cost contribution arrangement was 'NIL'.

The TPO further observed that even if some services were actually availed by the assessee, the cost sharing on the basis of head count was a wholly unacceptable proposition and that cost sharing should be on the basis of actual services availed by the assessee. Moreover, if the assessee wanted to get such services in India, the expenses would be in terms of India employee cost and, therefore, the allocation of the parent company's expenses incurred in USA to an

Indian company on head count basis gave a totally distorted picture and results in excess allocation of such expenses to Indian company.

On appeal, the Tribunal held that-it is not for the revenue authorities to decide what is necessary for an assessee and what is not. An assessee may have any number of qualified accountants and management experts on his rolls, and yet he may decide to engage services of outside experts for auditing and management consultancy; it is not for the revenue officers to question assessee's wisdom in doing so. The Tribunal held that when evaluating the arm's length price of a service, it is wholly irrelevant as to whether the assessee benefits from it or not; the real question which is to be determined in such cases is whether the price of this service is what an independent enterprise would have paid for the same. The Tribunal observed that the assessee has given sufficient evidence of the services having been actually rendered to the assessee. There are contemporaneous evidences by way of exchange of emails, reports, guidance notes which show that the assessee received the services from the AE. In the present case, the costs have been shared at average of percentage of (i) head count to the total count and (ii) sales revenue to total revenue. The assessee's share of head count is 3.90% and of total revenue is 3.30%, and, accordingly, 3.50%, being average of these two parameters, is taken as the cost contribution ratio. The Tribunal found no infirmity in this contribution being taken as an arm's length contribution to the costs.

Section 4: Indian Perspective and Preparedness

The discussions in the earlier sections give broad indication of base erosion from India. The examples given in the earlier section would indicate that much of the time; India has not been able to tax the base eroding payments owing to the current state of play of the division of taxing rights between the source country (India) and the residence country following the OECD Model tax Convention. In a seminal paper titled *'Tax Base Erosion and Homeless Income: Collection at source is the linchpin,'* Bret Wells and Cym Lowell of the University of Houston charts the history of the development of the OECD model treaty and points out that the basic tax structure was premised on the belief that the colonial countries would be the source of capital and knowhow and the colonies were the passive suppler of low cost goods and services with very

little value addition.[21] The right to tax the residual income was with the home country and the source country was allowed to tax only the routine profits earned there and impose withholding taxes on certain types of payments like royalties and interest. The source country taxes could therefore be easily base eroded. India and other developing countries had no say in the development of such a model.

Therefore, when a new initiative has been taken by the G-20 of which India is a member, ideally the root of the problem of base erosion in the source countries- the allocation of taxing rights- should have been addressed. In fact the Los Cabos declaration mentioned: "We reiterate the need to prevent base erosion and profit shifting and we will follow with attention the ongoing work of the OECD in this area." However, the OECD action plan categorically says that relook at the allocation of taxing rights is not on its agenda. The G-20 having endorsed the OECD action plan, we limit our discussion to the action points as delineated by the OECD.

In the following table, an attempt has been made to summarise the viewpoint that India could take and alongside, there is a discussion of issues of preparedness where relevant. This is followed by a discussion on the administrative dimensions for preparing for effective implementation of the initiatives under the Action Plan.

Table 6: Indian Perspective and Preparedness on Action Points

Action Points	India's Perspective and Preparedness
1.Address tax challenges of digital economy Identify the main difficulties that the digital economy poses for the application of existing international tax rules and develop detailed options to address these difficulties, taking a holistic approach and considering both direct and indirect taxation. Issues to be examined include, but are not limited to, the ability of a company to have a significant digital presence in the economy of another country without being liable to taxation due to the lack of nexus under current international rules,	The Action Plan talks of a dedicated task force to study the issues. The task force will come out with a report by September 2014. Therefore, it is not possible to predict whether we are equipped to deal with the recommendations. India has had differences with the OECD in the area of e-commerce taxation earlier. In the late nineties, an issue was flagged that it is possible to do extensive business in a country without any physical presence. The 'fixed place of business', which is the cornerstone of the permanent establishment concept would be inapplicable in such cases. India appointed a high-powered committee to examine the taxation issues arising out of e-commerce.

[21] Available at : http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1888397&download=yes

• the attribution of value created from the generation of marketable location-relevant data through the use of digital products and services, • the characterisation of income derived from new business models, • the application of related source rules, • and how to ensure the effective collection of VAT/GST with respect to the cross-border supply of digital goods and services. Such work will require a thorough analysis of the various business models in this sector. -	The Committee was of the view that applying the existing principles and rules to e-commerce did not ensure certainty of tax burden and maintenance of the equilibrium in sharing of tax revenues between countries of residence and source. The Committee, therefore, was of the view that the concept of PE should be abandoned and a serious attempt should be made within OECD or the UN to find an alternative to the concept of PE. In this context, the committee endorsed the 'base erosion' approach suggested by Professor Doernberg for an equitable tax sharing between residence and source countries which involved application of a low withholding tax on all tax deductible payments to the foreign enterprise. The OECD had also come up with a Technical Advisory Group (TAG report) on the issue, "*Are the current treaty rules for taxing business profits appropriate for e-commerce*?" Having examined all the proposals including the one from India, the OECD ultimately concluded that the current rules were fine. At Para No 350 the Report concluded: *"As regards the various alternatives for fundamental changes that are discussed in section 4-B above, the TAG concluded that it would not be appropriate to embark on such changes at this time. Indeed, at this stage, e-commerce and other business models resulting from new communication technologies would not, by themselves, justify a dramatic departure from the current rules. Contrary to early predictions, there does not seem to be actual evidence that the communications efficiencies of the internet have caused any significant decrease to the tax revenues of capital importing countries.*" Although OECD now recognizes the problem, it is widely reported that there is a lot of resistance from certain OECD member countries to expand the scope of PE in the context of digital economy (see Sheppard (2013)). In the context of digital economy, the problems are likely to be compounded with the increasing resort to cloud technology. The OECD seems to have rejected proposals like the concept of virtual PE or the suggestions from the French in the Colin and Collin report. In this report, the authors suggested that a new definition of permanent establishment specifically introduced for the data-driven economy, should be based on the notion of users as co-creators of value.[22] It may be interesting to note that a Spanish court has recently used the concept of the virtual PE in the Dell case. In this case, the tax administration pointed out that Dell Products, Ireland sold goods in Spain through a website dedicated to the Spanish

[22] See http://www.redressement-productif.gouv.fr/rapport-sur-fiscalite-secteur-numerique

	market and the Spanish affiliate Dell Spain employed people to translate the website, review the contents and administered the site. It also owned the .es domain name. Thus in the facts of the case the Irish company did not have any physical presence in Spain. The server that hosted the website was not located in Spain. There were no employees of the Irish company in Spain. Nevertheless, the Court held that there was a PE in Spain. As for the OECD prescription that a website per se does not constitute a PE, the Court referred to the observations of Spain: " … Spain and Portugal do not consider that physical presence is a requirement for a permanent establishment to exist in the context of e-commerce, and therefore, they also consider that, in some circumstances, an enterprise carrying on business in a State through a web site could be treated as having a permanent establishment in that State…" India had earlier stated its disagreement with the OECD commentary on the issue by stating its position. In the absence of a satisfactory outcome, we may continue with our position.
2.Neutralise hybrid mismatches Develop model treaty provisions and recommendations regarding the design of domestic rules to neutralise the effect (e.g., double non-taxation, double deduction, long-term deferral) of hybrid instruments and entities. This may include: (i) changes to the OECD Model Tax Convention to ensure that hybrid instruments and entities (as well as dual resident entities) are not used to obtain the benefits of treaties unduly; (ii) domestic law provisions that prevent exemption or non-recognition for payments that are deductible by the payer; (iii) domestic law provisions that deny a deduction for a payment that is not includible in income by the recipient (and is not subject to taxation under controlled foreign company (CFC) or similar rules); (iv) domestic law provisions that deny a deduction for a payment that is also deductible in another jurisdiction; and (v) where necessary, guidance on co-ordination or tie-breaker rules if more than one country seeks to apply such rules to a transaction or structure. Special attention should be given to the interaction between possible	Hybrid mismatch may not be a special problem for India. However, the Action Plan talks of change in treaty rules and also recommendations relating to design in domestic law including in CFC rules. What contours the change in the OECD model Convention will take is not yet known. Over all, the thrust of the changes seems to be beneficial. As far as changes in domestic law are concerned, for example in denying deduction for a payment that is not includible in income by the recipient, it is certainly a good idea. However, we need to change the provisions of section 90(2) in order to benefit from any such proposed rule. This is because of the fact that section 90(2) as is presently drafted implies that a taxpayer can pick and choose between a treaty provision and a domestic law provision relating to the same issue depending on which provision is more beneficial to him. In such a situation, unless the treaty provision is simultaneously changed, a change in the domestic law does not solve the problem. It may therefore be considered whether to bring back the provision as suggested in the original DTC to the effect: "For the purposes of determining the relationship between a provision of a treaty and this Code,- (a) neither the treaty nor the Code shall have a preferential status by reason of its being a treaty or law; and (b) the provision which is later in time shall prevail." The later in time principle prevails in most countries including the USA.

changes to domestic law and the provisions of the OECD Model Tax Convention. This work will be co-ordinated with the work on interest expense deduction limitations, the work on CFC rules, and the work on treaty shopping.	
3.Strengthen CFC rules Develop recommendations regarding the design of controlled foreign corporation rules. This work will be co-ordinated with other work as necessary.	As far as CFC rules are concerned, in India we do not have CFC rules as yet although the same has been proposed in the DTC. One point to be noted is that OECD obviously finds the CFC rules of its member countries inadequate to deal with the perceived abuses. Therefore, the proposed CFC in the DTC may have to be further modified.
4.Limit base erosion via interest deductions and other equivalent financial payments Develop recommendations regarding best practices in the design of rules to prevent base erosion through the use of interest expense, for example through the use of related-party and third-party debt to achieve excessive interest deductions or to finance the production of exempt or deferred income, and other financial payments that are economically equivalent to interest payments. The work will evaluate the effectiveness of different types of limitations. In connection with and in support of the foregoing work, transfer pricing guidance will also be developed regarding the pricing of related party financial transactions, including financial and performance guarantees, derivatives (including internal derivatives used in intra-bank dealings), and captive and other insurance arrangements. The work will be co-ordinated with the work on	The expected outputs here are the recommendations regarding the design of domestic rules and changes to the transfer pricing guidelines. Unlike in most of the OECD countries, in India we still do not have thin capitalization rules as yet. In fact, in one case, the Tribunal has pointed out the lack of such rules in the domestic law and allowed exaggerated interest claims. Transfer pricing rules can take care of excessive claims in the case of related parties. Nevertheless, it is desirable to have thin capitalization rules in the statute.

hybrids and CFC rules.	
5. Countering harmful tax practices more effectively Revamp the work on harmful tax practices with a priority on improving transparency, including compulsory spontaneous exchange on rulings related to preferential regimes, and on requiring substantial activity for any preferential regime. It will take a holistic approach to evaluate preferential tax regimes in the BEPS context. It will engage with non-OECD members on the basis of the existing framework and consider revisions or additions to the existing framework.	While the idea of reviewing preferential regimes is welcome, care should be taken as mentioned in the separate note **(Appendix A).**
6. Prevent treaty abuse Develop model treaty provisions and recommendations regarding the design of domestic rules to prevent the granting of treaty benefits in inappropriate circumstances. Work will also be done to clarify that tax treaties are not intended to be used to generate double non-taxation and to identify the tax policy considerations that, in general, countries should consider before deciding to enter into a tax treaty with another country. The work will be co-ordinated with the work on hybrids.	The OECD may come up with a model LOB clause. In India, recent treaties mostly have LOB clauses. But these differ wildly. If the OECD suggestion is suitable for India, we may adopt the same in our model for future negotiations. However, the existing treaties need to be revisited. Since these are existing treaties, the multilateral solution envisaged in Action point 15 may not be sufficient. The OECD is also likely to come out with recommendations relating to GAAR in domestic laws. We have GAAR in our Act but the same is kept in abeyance till 2016.
7.Prevent artificial avoidance of PE status Develop changes to the definition of PE to prevent the artificial avoidance of PE status in relation to BEPS, including through the use of commissionaire arrangements and the specific activity exemptions. Work on these issues will also address related profit attribution issues.	The OECD work in this area is limited to commissionaire arrangement and some changes in preparatory and auxiliary exception to PE. The commissionaire arrangement is important for civil law countries and arises out of some adverse court cases. It is not an important issue for India. As for restricting the preparatory and auxiliary exemption to creation of PE, the same is welcome, as we have lost many cases relating to Liaison Offices when such offices actually participate quite substantially in the economic activities in

	the country. At the same time, we need to review our domestic law provision contained in Explanation 1(b) to Section 9(1) that gives exemption to operations confined to purchase of goods in India for the purpose of export. As for the most substantial aspect of change in the rules of PE, OECD is unlikely to expand the scope of PE. Therefore, India should continue with its position stated on the OECD Model. India's participation in the BEPS project should not be taken as its acquiescence of the OECD model on this important area.
8.Transfer Pricing: intangibles Develop rules to prevent BEPS by moving intangibles among group members. This will involve:	
(i)adopting a broad and clearly delineated definition of intangibles;	(i) One has to see what exactly the OECD comes up with. In the Indian context, the Finance Act, 2012 has already taken a wide definition of intangible property in section 92B (2). These include –marketing related intangibles, technology related intangibles, artistic related intangible, data processing related intangibles, engineering related intangibles, customer related intangibles, contract related intangibles, human related intangibles, location related intangibles, goodwill related intangibles, methods, programmes, systems, procedures, campaigns, surveys, studies, forecasts, estimates, customer lists, technical data etc. Whether OECD accepts the same or not has to be watched.
(ii)ensuring that profits associated with the transfer and use of intangibles are appropriately allocated in accordance with (rather than divorced from) value creation;	(ii) This is an important suggestion and should be welcomed. However, what is value creation has not been defined in the action plan. As pointed out by Sol Picciotto, Emeritus Professor of Law on Transfer Pricing, Lancaster University and a view that resonates with the views of big market economies like India and China, "A firm's know-how develops organically and incrementally through its activities as a whole. Although basic research may be carried out in laboratories and research centres, the successful application of the knowledge produced depends to a great extent on the development stages in which saleable products are designed, tested, adapted and marketed. These stages are indeed generally more time-consuming and expensive than the primary research stage. They also involve repeated cycles of interaction involving many of the firm's employees, not only those normally considered to be engaged

	in research and development, but also those involved in production and marketing.”.[23] Adequate return therefore needs to be given to such markets. There are judicial precedents in India upholding value creation in respect marketing intangibles through incurring of advertisement, marketing and publicity expenses
(iii)developing transfer pricing rules or special measures for transfers of hard-to-value intangibles; and	(iii) Ideally, the ALP concept should be abandoned in favour of formulary apportionment. However, this is unlikely to be accepted by the OECD. In fact, in India also the ALP is the standard for Transfer Pricing Analysis. In this context, it is interesting to note that the OECD talks of taking special measures “either within or beyond the arm’s length principle” may be required with respect to intangible assets, risk and over-capitalisation. Assuming that a solution outside of the ALP concept is agreed in a particular situation, we may need to change the relevant law.
(iv) updating the guidance on cost contribution arrangements	(iv)Cost contribution arrangements entered into by MNC group with centralization of functions in some group companies and other companies being made to pay for the same are routine. While the expense may be legitimate in some cases, the internal arrangements leave scope for manipulation and base eroding payments. OECD has so far insisted on respecting self -serving agreements. Courts and tribunal in India has also relied on the OECD Transfer Pricing Guidelines in cases to give relief to the taxpayers.
9. Transfer Pricing: risk and capital Develop rules to prevent BEPS by transferring risks among, or allocating excessive capital to, group members. This will involve adopting transfer pricing rules or special measures to ensure that inappropriate returns will not accrue to an entity solely because it has contractually assumed risks or has provided capital. The rules to be developed will also require alignment of returns with value creation. This work will be co-ordinated with the work on interest expense	Contractually assumed risk has been observed in India in the following activities: - High-end R&D - Financial Guarantee or Letter of Comfort given by holding companies to its group companies - Performance Guarantee by an Indian Company for the performance of overseas group company entering into the contract Indian Courts are generally reluctant to ignore contractual rights. Many a times the Tribunal has relied on the OECD’s earlier insistence on respecting such rights. How the courts will react to any change in this area remains to be seen. Mere change in the commentary is unlikely to persuade the Courts in India to ignore contractual rights.

[23] Response to OECD Revised Discussion Draft on Transfer Pricing Aspects Of Intangibles available at: http://www.oecd.org/ctp/transfer-pricing/beps-monitoring-group-intangibles.pdf

deductions and other financial payments.	
10. Transfer Pricing: other high-risk transactions Develop rules to prevent BEPS by engaging in transactions which would not, or would only very rarely, occur between third parties. This will involve adopting transfer pricing rules or special measures to: (i) clarify the circumstances in which transactions can be recharacterised; (ii) clarify the application of transfer pricing methods, in particular profit splits, in the context of global value chains; and (iii) provide protection against common types of base eroding payments, such as management fees and head office expenses.	More guidance is required about this action point. The proposed GAAR permits recharacterisation of transactions in certain circumstances. Transfer pricing involving unique intangibles in an MNC's value chain is a problem area and in the absence of a formulary apportionment option, profit split is a viable option. In India also management fees and head office expenses have been found to be base eroding. In fact, the Indian Income Tax already contains a limitation of head office expenses in section 44C which restricts such payment to 5% of adjusted total income. However, the provision has been somewhat diluted by judgements from Tribunal to the effect that if the expenses are exclusively incurred for the permanent establishment, then no disallowance can be made. Based on the actual recommendations, it may be necessary to relook at the provision. Management fees have been held to be taxable under the domestic law as fees for technical services within the meaning of the term given in Section 9(1)(vii). However, it escapes taxation since under the treaty provisions in most of the cases, it cannot be brought within the definition of such term. Typically in India, information relating to the Indian taxpayer entity is submitted. However, the MNCs are reluctant to share detailed information regarding their associated enterprises and global operations. If the current Plan is implemented, the OECD may, by way of specific legislation/guidance, require taxpayers to submit information on the entire value chain, including information relating to entities in various jurisdictions.
11. **Establish Methodologies to Collect and Analyse Data on BEPS and the Actions to Address It.** Develop recommendations regarding indicators of the scale and economic impact of BEPS and ensure that tools	This is an important action point. In the Indian context, lack of data makes any analysis extremely difficult. The information system in place in the department has been designed for

are available to monitor and evaluate the effectiveness and economic impact of the actions taken to address BEPS on an ongoing basis. This will involve developing an economic analysis of the scale and impact of BEPS (including spillover effects across countries) and actions to address it. The work will also involve assessing a range of existing data sources, identifying new types of data that should be collected, and developing methodologies based on both aggregate (e.g. FDI and balance of payments data) and micro-level data (e.g. from financial statements and tax returns), taking into consideration the need to respect taxpayer confidentiality and the administrative costs for tax administrations and businesses	monitoring and aiding assessment and other functions of the department and is not designed to address policy-related questions. In the present context, for instance, an assessment of the extent of fund flows under various heads and the destination of such flows could have provided vital information for analysis, but was not readily available with the department. Analysis of economic impact of BEPS can only follow once the fiscal impact of BEPS can be identified or assessed.
12 Require Taxpayers to Disclose Their Aggressive Tax Planning Arrangements. Develop recommendations regarding the design of mandatory disclosure rules for aggressive or abusive transactions, arrangements, or structures, taking into consideration the administrative costs for tax administrations and businesses and drawing on experiences of the increasing number of countries that have such rules. The work will use a modular design allowing for maximum consistency but allowing for country specific needs and risks. One focus will be international tax schemes, where the work will explore using a wide definition of "tax benefit" in order to capture such transactions. The work will be co-ordinated with the work on co-operative compliance. It will also involve designing and putting in place enhanced models of information sharing for international	What exactly is aggressive tax planning arrangement needs to be seen. Depending on the recommendation, such disclosure may be in the income tax return or in some kind of special return. India has experience in such area and appropriate rules can be put in place easily.

tax schemes between tax administrations.	
13. Re-examine transfer pricing documentation Develop rules regarding transfer pricing documentation to enhance transparency for tax administration, taking into consideration the compliance costs for business. The rules to be developed will include a requirement that MNE's provide all relevant governments with needed information on their global allocation of the income, economic activity and taxes paid among countries according to a common template.	Country by country reporting is essentially a tool for risk assessment by the countries concerned. It is a valuable tool for the tax administration and should be welcomed. On 30/1/2014, OECD has also released draft guidance on Transfer Pricing documentation and country by country reporting and has sought comments by 23rd February, 2014. One of the questions asked by OECD in the draft is whether the reported data should be based on entities or countries. As pointed out by civil society group, entities can trade in many places and hence what is important is what happens in a particular country. Another question is whether data should be top down or bottom up. Again, local data will already be with tax authorities, the reporting should be top down so that meaningful comparison can be done by the tax authorities.[24]
14. Make Dispute Resolution more effective Develop solutions to address obstacles that prevent countries from solving treaty-related disputes under MAP, including the absence of arbitration provisions in most treaties and the fact that access to MAP and arbitration may be denied in certain cases.	While speedy resolution of disputes is welcome, India should be wary of introducing compulsory arbitration in MAP. See separate note in **Appendix B**.
15. Multilateral Instrument Analyse the tax and public international law issues related to the development of a multilateral instrument to enable jurisdictions that wish to do so to implement measures developed in the course of the work on BEPS and amend bilateral tax treaties. On the basis of this analysis, interested Parties will develop a multilateral instrument designed to provide an innovative approach to international tax matters, reflecting the rapidly evolving nature of the	This is a good idea and perhaps will eliminate the need to renegotiate all the existing treaties. But, it will need the other treat partners to also agree to sign the multilateral pact. We have had issues with renegotiating treaties with Mauritius and Cyprus. While OECD has achieved remarkable success in the area of exchange of information, that is mostly because of the threat of sanctions in the form of being branded as uncooperative jurisdiction. In the absence of any such sanctions, it is doubtful whether all the partner countries will be on board. In the Indian context, the exact relationship between a tax treaty, the proposed multilateral treaty and the domestic law

[24] http://www.taxresearch.org.uk/Blog/2014/01/31/country-by-country-reporting-is-open-for-discussion/

global economy and the need to adapt quickly to this evolution.	needs to be sorted out.

Administrative Initiatives

OECD BEPS report indicate that gaps in the national tax regimes of different countries as also the interaction between the tax regimes and the treaties create opportunities that are exploited by multinationals. Hopefully, the final report will put in place some policy prescriptions to minimize such opportunities.

However, the policies are to be implemented on ground. Therefore, it is necessary to examine whether we are administratively prepared for the challenge. Some limited discussion that we had with the officers of the department indicate that this is not an insurmountable problem although concentrated attention needs to be given to the area of international taxation.

Although transfer pricing adjustments have increased in India, it is still relatively new and lot more emphasis needs to be given to this area. For this purpose, deployment of more trained manpower will be necessary. Similarly, the Directorate of international tax also needs to be strengthened. In this connection, it is interesting to note that best brains from the private sector are normally deployed in the transfer pricing since the stakes involved are extremely high.

Prem Sikka of the Essex University points out: "Tax authorities lack the resources to combat the tax avoidance industry. Ernst & Young alone employs over 900 professionals to sell transfer pricing schemes. The US tax authorities employ about 500 full-time inspectors to pursue transfer pricing issues and Kenya can only afford between three and five tax investigators for the whole country"[25] While India may fare better than Kenya, it has to be admitted that the capacity of Indian administration is also severely limited. In all, there are roughly 50 Transfer Pricing Officers all over the country. This needs to be increased at least 10 times in the near term.

Transfer pricing disputes are also increasing phenomenally. Government of India has put in quite a few measures with a view to reducing disputes. One such is the introduction of the process of Advance Pricing Arrangement. However, there are overall only 5 people manning this directorate. Again, the strength needs to be increased manifold. The Income Tax Department is

[25] Shifting profits across borders by Prem Sikka available at :
http://www.theguardian.com/commentisfree/2009/feb/11/taxavoidance-tax

carrying out its cadre restructuring. It is hoped that these aspects will be taken care of while doing the exercise.

Apart from augmenting the strength of the directorates, it has also to be ensured that the officers posted here get adequate training. This is also necessary to ensure that consistent stand is taken by the officers across different offices. It is the experience that in a number of cases inconsistent stances are taken by different officers. While this might not be a serious problem in the domestic scenario, in the area of international taxation and transfer pricing, the orders of our officers are now scrutinized all over the world and a certain standard needs to be maintained. The officers posted here should also be encouraged to attend international conferences and trainings.

International taxation and transfer pricing are specialized subjects and it takes at least 2/3 years for the officers to pick up the nuances. However, there are frequent transfers. A minimum tenure of three to four years should be kept for the officers posted here. The department can think of other measures to attract the best brains including offering some special pay, if the rules permit.

One area which will require attention is the state of computerization in the department. Although the department has ambitious plans in this regard, it has to see whether it is geared up to tackle the challenges that will be posed by the added responsibility of automatic exchange of information that has devolved on it as a result of the commitment given under the various agreements that India has signed. Automatic exchange of information will help India in getting information. But, that information has to be processed in a meaningful way. For that necessary processing power has to be acquired. Automatic information also entails responsibility taken up by India to supply information to the treaty partners in a timely manner. Again the information has to be collected preferably online from banks and other institutions and the same has to be processed and then transmitted to the treaty partners. It is therefore necessary to examine holistically the requirements of the department and see whether it is prepared to meet the challenges in an effective manner.

Section 5: Will Investment and Growth in India be Adversely Affected

Given the dependence of the Indian economy on foreign capital inflows and the need for sustained growth, a significant concern for the economy is whether, measures taken to address

issues of base erosion and profit shifting would reduce the attractiveness of the Indian economy or for that matter any developing economy as an investment destination. The answer to this question would depend on the contours of the international taxation regime subsequent to the conclusion of the present initiative. Very broadly, if all the countries in the world agree to undertake all the measures that are agreed upon, then the total tax incidence on business would increase, and assuming taxes have less of a roll to play in the new regime, the investment decisions would be more closely aligned with or determined by all the non-tax factors that are argued to influence investment decisions. There is a considerably amount of literature on the determinants of investment decisions, both in the context of Foreign Direct Investment and in domestic investment across states within a country. While taxes do emerge as one indicator for the attractiveness of a particular destination for investment purposes, existing literature suggests that infrastructure, size and growth of market and extent of openness of the economy are important determinants of the quantum of FDI in a jurisdiction. While most of the studies have used number of telephone connections per 1000 population as the proxy for the quality of infrastructure, even in the cases where alternative variables like infrastructure index or installed electricity generation capacity are used, the results suggest a positive relation between infrastructure and FDI. The other important variable considered by these studies is the size of the market. There are two alternative ways in which the size of the market is sought to be measured – by the size of per capita GDP and the rate of growth of per capita or total GDP. These variables in most cases turn out to be significant determinants of the quantum of FDI in the country. It is interesting to note the difference between the use of level and the growth variable. While the former relates the actual size of the economy, the latter conveys information on the functioning of the economy as well, since higher growth would indicate that there are fewer hurdles to investment and growth in the economy. The other variable which emerges fairly consistently is extent of openness of the economy. Once again most of the studies indicate a positive relation between the extent of openness measured as the ratio of trade to GDP and the size of FDI inflows. These results suggest that economic factors other than taxation are important determinants of the size of FDI inflows. Within an open economy, this would also suggest that FDI outflows too would be driven by similar factors in choosing choice of location. The issues of concern therefore remain concentrated on measures to improve infrastructure and growth in the economy.

Table 7: Impact of Key Economic Variables on FDI inflows

Determinant	Country/countries for analysis	Proxy used	Method	Effect	Author(s) (year)
Infrastructure	16 SSA countries	Telephones per 1000 inhabitants	Multivariate Regression	0	Cleeve (2008)
	12 MENA; 24 Developing countries	Telephones per 1000 inhabitants	Multivariate Regression	0	Mohamed and Sidiropoulos (2010)
	44 countries	Telephones per 1000 inhabitants	Panel Regression	Positive	Biswas (2002)
	Developed, emerging and African countries	Telephones per 1000 inhabitants	Panel Regression	Positive	Jordaan(2004)
	22 SSA countries	Telephones per 1000 inhabitants	Panel Regression	Positive	Asiedu (2006)
	SSA	Telephones per 1000 inhabitants	Panel Regression	Positive	Ancharaz (2003)
	14 South African Development Community	Telephones per 1000 inhabitants	Multivariate Regression	Positive	Mhlanga et al. (2010)
	14 South African Development Community	Number of landline and mobile subscribers per 1000 inhabitants	Multivariate Regression	Positive	Mhlanga et al. (2010)
	44 countries	Installed net electricity generation	Panel Regression	Positive	Biswas (2002)
	6 South East European Countries	capacity per capita	Panel Regression	Negative	Botrić and Škuflić (2006)
	BRICS	Infrastructure index	Panel Regression	Positive	Vijayakumar et al. (2010)
Market size	80 DCs	GNP per capita	Multivariate Regression	Positive	Schneider and Frey (1985)
	Baden-Wurttemberg, Catalunya and Lombardia	GDP per capita	LSDV	Positive	Artige and Nicolini (2006)
	22 SSA countries		Panel regression	Positive	Asiedu (2006)
	Belarus	GDP	Multivariate regression	Positive	Pärletun (2008)
	16 SSA countries	GDP per capita	Multivariate Regression	Positive	Cleeve (2008)
	6 South East European Countries	Number of inhabitants	Panel Regression	Negative	Botrić and Škuflić (2006)
	6 South East European	GDP	Panel Regression	Positive	Botrić and Škuflić (2006)

Determinant	Country/countries for analysis	Proxy used	Method	Effect	Author(s) (year)
	Countries				
	Baden-Wurttemberg, Catalunya and Lombardia	GDP per capita	LSDV	Positive	Artige and Nicolini (2006)
	38 countries	GDP per capita	Panel regression	0	Demirhan and Masca(2008)
	12 MENA; 24 Developing countries	Number of inhabitants	Panel regression	Positive	Mohamed and Sidiropoulos (2010)
	BRICS	Industrial Production Index	Panel regression	Positive	Vijayakumar et al. (2010)
	14 South African Development Community	GNP per capita	Multivariate Regression	Positive	Mhlanga et al. (2010)
Market Growth	80 DCs	GDP growth rate	Multivariate Regression	Positive	Schneider and Frey (1985)
	80 DCs	Real GNP growth rate	Multivariate Regression	Positive	Schneider and Frey (1985)
	SSA countries	GDP growth rate		0	Ancharaz(2003)
	non SSA countries	GDP growth rate		Positive	Ancharaz(2003)
	16 SSA countries	GDP growth rate	Multivariate Regression	Positive	Cleeve (2008)
	38 countries	growth of GDP per capita	Panel regression	positive	Demirhan and Masca(2008)
	12 MENA; 24 Developing countries	Real GDP growth rate	Panel regression	Positive	Mohamed and Sidiropoulos (2010)
	BRICS	Industrial Production Index	Panel regression	0	Vijayakumar et al. (2010)
	14 South African Development Community	GDP growth rate	Multivariate Regression	0	Mhlanga et al. (2010)
Openness	6 South East European Countries	Exports plus imports by GDP	Panel Regression	Positive	Botrić and Škuflić (2006)
	22 SSA countries	Openness index by ICRG	Panel Regression	Positive	Asiedu (2006)
	Belarus	Exports plus imports by GDP	Multivariate regression	Positive	Pärletun (2008)
	38 countries	Exports plus imports by GDP	Panel regression	positive	Demirhan and Masca(2008)
	16 SSA countries	Exports plus imports by GDP	Multivariate regression	Positive	Cleeve (2008)
	14 SADC	Exports plus	Multivariate	Positive	Mhlanga et al.

Determinant	Country/countries for analysis	Proxy used	Method	Effect	Author(s) (year)
		imports by GDP	regression		(2010)
	12 MENA; 24 DCs	Exports plus imports by GDP	Panel Regression	0	Mohamed and Sidiropoulos (2010)
	BRICS	Exports plus imports by GDP	Panel Regression	0	Vijayakumar et al. (2010)

In the alternative and more likely scenario, that only some of the countries in the world agree to undertake all the measures agreed to upon in the G20, or even if they agree the decisions are phased out over a long period, then the consequences would depend on the relative strengthens of these economies, which once again would take the discussion back to other economic variables discussed above. On the other hand, it is necessary to increase the tax GDP ratio of India so that taxes gathered can be properly used to finance the physical and social infrastructures that are more important determinants for investment flows. Viewed from that perspective tax base erosion is a serious problem for India and should be tackled whether in tandem with the OECD or even independently of others.

Section 6: Concluding Comments

The discussion in this paper highlights some evidence to support the notion that there is base erosion in India. On the specific action points listed in the OECD's Action Plan, a perspective from India's stand point has been presented along with a brief discussion on the steps needed to prepare for complying with likely proposed measures. A natural question that emerges from such a discussion is what are the likely consequences of such reform initiatives. From existing literature, it is fairly clear that while taxes are one important factor in determining location for FDI decisions, there are a host of other factors which influence this decision. Key among them are size and rate of growth of the domestic market and infrastructure. Some studies even suggest that the negative impact of taxes is mitigated to a large extent by public investments in infrastructure. Given the large size of the Indian economy, it is therefore expected that inflows to India would not vanish. Provided the investments do not change substantially, it would be expected that the revenue flows to the government too would increase, since the effort is to stem base erosion and profit shifting.

While welcoming the OECD's action plan, it is important to keep in perspective the fact that OECD is essentially a forum for rich countries. It is unrealistic for us to expect OECD to change its orientation and focus on issues which do not benefit its members. The interests of capital exporting countries will differ from those of capital importing countries. The OECD will therefore focus on only those issues where there is some convergence in the interests of developed and developing countries. When these interests clash, it is unlikely that OECD will come to the rescue of the developing world. Therefore, we should not expect any paradigm shift from this project.

OECD will also like the rules that it formulates to be the standard model that will apply to all. It is with this end in view that it has possibly engaged BRICS and brought Indonesia and Saudi Arabia on board. If these countries also agree on the basic philosophy of the OECD model, then that becomes the world standard and everybody else will be required to/expected to follow. India's interests and the interests of the developing world do not coincide with the interests of the OECD countries. Therefore, while supporting the BEPS project, India in conjunction with other BRICs should make it amply clear that these countries should continue to oppose this basic philosophy of the OECD model which gives the taxing rights of the important sources of income to the capital exporting countries while the source countries get only the rights to tax routine income. Two such incomes on which the OECD view is different from the India's stated position are discussed below.

Under the OECD MC, the right of taxation of royalties is given exclusively to the country of residence with no right for the country of source. The UN model gives a secondary right to the country of source. In all of India's treaties, India has retained this secondary right whereas the OECD countries have tried to remove the same. Thus, under USA-UK tax treaty or USA-Japan tax treaty, there is no withholding tax for royalties. As a part of the process of becoming observer at the OECD CFA when India was asked to state its positions on the OECD model its commentaries, India obviously reserved its position on the same.

Similar is the case for taxation of services. As is well known, India puts a lot of emphasis on this aspect. India has a fee for technical services clause both in its domestic law as also in most of its treaties. OECD model obviously does not have it while the UN is deliberating on the issue. There is also a service PE clause in most of India's new treaties. UN model allows for service PE while

the OECD model in its commentary, has recently given an option to its members to have such a clause. The scope of the same is restricted in the OECD model. India does not agree with the OECD model and its commentaries and has stated its position.

Following from such differences, it is clear that the OECD Model and its commentaries cannot be binding on India and in the discussions on the Actions Points, it is important for India to maintain this position of independence/difference from the OECD position on issues which protect its revenues.

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Appendix A

Countering Harmful Tax Practices

Action no. 5 talks of countering harmful tax practices more effectively, taking into account transparency and substance. It talks of carrying forward the 1998 OECD initiative on curbing harmful tax practices leading to the race to the bottom amongst states. The 1998 initiative was targeted against tax havens and preferential tax regimes granted by OECD member states. Such preferential regimes within the OECD countries were to be eliminated. As for tax havens, the work involved identifying the tax havens and making them commit to transparency and exchange of information. Initially there was also talk of imposing sanctions against non-cooperative regimes which was not really followed up.

This time around, the action plan talks of harmful tax practices generally. The review of such regimes will not only be of the OECD countries but of the G-20 countries as well and perhaps subsequently to other countries.

While action against dubious practices adopted by tax havens to attract headquarters of companies to these jurisdictions that cause base erosion from the source countries are certainly welcome, there needs to be clarity on the kind of regimes that are being targeted here. The action plan talks of across the board corporate tax reduction on certain types of income, such as income from financial activities or from the provision of intangibles. Again, it is not clear if these are the only types of income that will be considered. Moreover, reduction in corporate tax rates seems to be a sovereign decision of the countries concerned and may not be subject to scrutiny.

Many developing countries including India give incentives for investment. Of course, there is substantial activity in such areas as a result. Similar is the case of the Special Economic Zones where investors including multinationals set up their activities. It has to be ensured that such provisions do not come under any restrictions.

The action plan talks of compulsory spontaneous exchange on ruling related to preferential regimes. It is not clear who will give such rulings. The idea of exchange of information about the rulings is welcome since the affected countries, if they so desire, will be in a position to take action. To be effective though, the kind of action to be taken also needs to be coordinated, particularly in the treaty context. If a holding company structure set up in a treaty country is found to be harmful, it needs to be specified what action can be taken by the partner country without necessarily rescinding the treaty.

Appendix B

Compulsory Arbitration

Action 14 of the BEPS project mentions about the need to address obstacles that prevent countries from solving treaty related disputes under MAP, including absence of arbitration provision in most treaties and the fact that access to MAP and arbitration may be denied in some cases.

This action plan is not related to the basic theme of base erosion and profit shifting. The rationale of its inclusion in the action plan is not very clear. Apparently, this was included at the instance of powerful businesses.

It may be noted that the idea of compulsory arbitration in cases where competent authorities are unable to reach an agreement within a specified time period has been on the agenda of the OECD for some time. In the 2010 version of the OECD Model, a new paragraph 5 was incorporated in Article 25 relation to Mutual Agreement Procedure, which states that where Competent Authorities are unable to reach an agreement on an issue within two years of submission of a request, the unresolved issue shall be submitted to arbitration if the taxpayer so requests. The Commentary then gives the methodology of the arbitration process.

As compared to the OECD model, the UN model did mention the possibility of arbitration but it was left to the states concerned to consider the same. However, the business community has been putting pressure on having such a provision. Settlement of tax disputed through compulsory arbitration has been one of the demands of the multinationals, represented by the international Chamber of Commerce. In fact even in 1995, the ICC submitted its representation to the United National Committee of Tax Experts. Commenting on the Mutual Agreement Procedure, ICC submitted: "The ICC is not satisfied with the mutual agreement procedure as now set out in both the OECD Model and the UN Model. The procedure required significant changes in order to achieve fair and equitable treatment of all parties involved. In particular, the tax authorities should be required to reach agreement on a solution (e.g. by way of arbitration) and the taxpayer's involvement should be guaranteed by provisions that allow him to participate in the process and to approach the tax authorities of both countries." Thus, ICC wanted compulsory arbitration and also the involvement of the taxpayers in the process.

However, the UN Model till 2001 did not contain any provisions for arbitration. In the commentary, it was merely mentioned that it has been suggested that the Contracting States may provide an arbitration clause through which controversies concerning the interpretation and application of the Convention may be resolved. After the incorporation of the provision relating to arbitration in the OECD model in 2010, there was pressure for the adoption of the same in the UN Model as well. However, it is well known that developing countries are wary of the

arbitration process and no consensus could be reached on the issue even after elaborate discussions. Finally, in the 2011 UN Model, two versions of Article 25 relating to Mutual Agreement Procedure has been proposed. It is not exactly known whether all the developing countries were against the proposal or not but the fact that there are two versions shows that there was no consensus. Version 25A is without compulsory arbitration clause while version 25B contains such a clause. However, there are some minor differences even in version 25B as compared to the OECD model. Thus, the period after which arbitration sets in is 3 years as compared to 2 years in the OECD Model. Secondly, unlike the OECD Model, it is the Competent Authority that sets it in motion. And, unlike in the OECD Model, the Competent Authorities are allowed to depart from the arbitration decision if they agree to do so within six months after the decision has been communicated to them.

Under the OECD model, each of the parties nominates an arbitrator who then nominate a third one who will function as the chair. In case, they are not in a position to do so within one month of finalization of the terms of reference, the Director CTPA will nominate the Chair. The costs are to be borne by the two states. The OECD commentary also allows the taxpayer to participate in the arbitration proceedings either directly or through representative.

Under the OECD Model, although the taxpayer initiates the arbitration process, the arbitration order is not ultimately binding on it.

These aspects of the arbitration process have come in for criticism from commentators.[26] The UN Model, 2011, while having some differences, also more or less follows the OECD Model in the details. Here instead of the Director, CTPA, the Chairman of the group of experts will nominate the Chair.

Allison Christians argues that the primary significance of the arbitration process is the naming of the experts and the elevation of these private sector individuals to de facto decision making position in matters of state-to-state tax revenue allocations. She adds: "This privatization of international tax lawmaking should make everyone wary, but it should be especially troubling to developing countries, since experts seem all too often to be identified solely in the developed world." Commenting on the importance of the selection of arbitrators, Allison points out: "As one arbitration expert put it, just as "location, location, location" comprise the three key elements in sustainable real estate value, so it has been observed that "arbitrator, arbitrator, arbitrator" endure as the most critical factors in the integrity of any arbitration."

A look at the literature on arbitration in other contexts shows that there is cause of worry. In the Indian context, the arbitration case in White Industries Australia Limited and the Republic of India is worth remembering. Very briefly, in this case, White Industries had entered into an

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[26] For example- Comments on the OECD proposal for secret and mandatory arbitration of international tax disputes- Michael J. McIntyre available at : http://faculty.law.wayne.edu/McIntyre/text/mcintyre_articles/Treaties/McIntyre_OECD_Arbitration_Proposal.pdf

agreement with the public sector Coal India for supply of equipment and knowhow for an open caset mine. The agreement allowed for bonus for White Industries for exceeding the production target or penalty for default. Subsequently a dispute arose and Coal India encashed a bank guarantee by way of penalty. In the arbitration proceedings that ensued in ICC, White Industries won although there was a dissenting note by Justice Jeevan Reddy from India. Coal India wanted the award to be set aside and applied to the Calcutta High Court and there was protracted litigation and the matter was pending before the Supreme Court. In the circumstances, White Industries brought a complaint against India for the alleged violation of the of the provisions of the India-Australia BIPA. The arbitration proceedings under the UNCITRAL rules took place in London and the arbitrators, although did not find merit in the other charges of White Industries, nevertheless held that the India judicial system's inability to deal with White's jurisdictional claims for over nine years, and the Indian Supreme Court's inability to head the White's jurisdictional appeal for over five years amounted to undue delay and constituted a breach of India's voluntarily assumed obligation of providing White with "effective means" of asserting claims and enforcing rights. The arbitration Tribunal awarded compensation to be paid by the Government of India.

As Allison Christians points out, "The determination of the arbiters is the resolution of the case. That is not to say that experts from developed countries will always and necessarily make decisions that favour developed countries; the opposite could be true, despite the UN's stated fears. But a look at the literature in other contexts suggests that there is cause for worry – at the very least, there is cause for being vigilant about the structure that is being adopted for states to allocate revenues cooperatively going forward. This is especially true in cases involving things like transfer pricing in which disputes are regularly likely to hit the big and hotly contested issues of international tax policy."[27]

[27] Allison Christians (2012),"Putting Arbitration on the MAP: Thoughts on the New UN Model Tax Convention", Tax Notes, April 27.