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Global Tax Insights

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EDITORIAL

Recently, the Indian government has decided to withdraw the conciliation talks with Vodafone over a INR 11,200 crore (US$ 1.8 billion) tax dispute in respect of a transaction consummated in 2007 that gave Vodafone an entry into the Indian market. Other multinational enterprises such as Nokia, IBM and Shell are also in the firing line of the Indian tax authorities. The demands raised on these companies are pursuant to transfer pricing audits that have been conducted by the tax authorities. Whether these tax demands are legitimate or not will be decided by the judiciary in due course, but the stand taken by the tax authorities in India has nevertheless made investors jittery. The position taken by tax authorities is, however, not unique to India. As mentioned in my previous editorial, authorities across the world will be taking an aggressive stand in transfer pricing audits; in some jurisdictions, this is already underway.

Continuing the work on base erosion and profit shifting (BEPS), the OECD has released a discussion draft outlining its proposals on information that multinationals may be required to disclose to the tax authorities. The draft suggests maintenance of a 'master file' containing standardised information for all multinational group members and a 'local file' that would provide specific/material information related to the transactions of a local taxpayer. In addition, a country-by-country matrix of key financial information would also need to be established. If approved, this would require significant documentation to be maintained by the multinational companies.

This edition of the newsletter, besides the updates from various countries, incorporates three very important judgements. The first decision is that of the US Court, which disregarded the multi-tier structure and held that the loan transaction was in essence dividend which was duly taxable. The second case law, from the Delhi High Court, reiterates the principle of international tax law that merely having a subsidiary in another jurisdiction does not constitute a permanent establishment in that jurisdiction. The third case law is from the Court in Israel, which pierced the corporate veil and decided in favour of the tax authorities.

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

Happy reading!

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

BELGIUM *Contributed by Gert De Greeve, Van Havermaet Groenweghe*

Notional interest deduction (NID) amended

Belgian corporate tax law contains a tax deduction based on the equity of companies. This aims to encourage the financing of companies through equity, which will trigger a fiscal deduction similar to the deduction of interest paid on loans. The deduction applies to all companies (Belgian or foreign) that are subject to the common corporate tax regime. Both national (Belgian) and international companies can take advantage of this tax deduction. The NID rate for tax year 2014 is 2.742% (3.242% for SMEs).

Act of 21 December 2013

The NID is based on the accounting equity shown in the balance sheet of the non-consolidated annual accounts for the preceding financial year. However, for companies with a permanent establishment established or real property located in a country with which Belgium has signed a double taxation agreement under which income of the foreign permanent establishment or real property is exempt from tax in Belgium, Belgian law previously excluded the application of the NID as far as the accounting net assets of the foreign establishment were concerned. In other words, the NID was only applied as far as 'Belgian equity' or 'foreign non-treaty equity' was concerned.

The European Court of Justice (ECJ) ruled on 4 July 2013 that this refusal to apply the NID to a foreign permanent establishment's net assets is a violation of the freedom of establishment (case C-350/11). The Act of 21 December 2013 therefore provides an amendment to the NID legislation:

- Foreign permanent establishments (located in a treaty country) are no longer excluded from the NID calculation basis
- However, the NID must be reduced
  - If it concerns a permanent establishment located in the European Economic Area (EEA): the lower amount of (i) the result of the foreign permanent establishment or real estate and (ii) the net asset value of the permanent establishment or real estate multiplied by the NID rate; or
  - If it concerns a permanent establishment or real estate located in a treaty country outside of the EEA: the net asset value of the permanent establishment or real estate multiplied by the NID rate.

This means that a Belgian company with a loss-making permanent establishment no longer loses the benefit of the NID calculated on the net asset value of the permanent establishment based in the EEA.

Example 1

A Belgian company realises:

- Belgian profits of 100, the NID related to the Belgian assets amounts to 25
- There is an EEA permanent establishment with a profit of 60 and net assets resulting in NID of 50.

In this case, the total NID would amount to 75. However, in the second step, the NID would be reduced by 50 resulting ultimately in a Belgian taxable basis of 100 and a NID of 25.

Example 2

If with the same figures, the NID related to the permanent establishment's net assets amounts to 70, the total NID would amount to 95, but would only be reduced by 60 (the branch result). In such a case, the Belgian taxable basis would amount to 100 and the NID to 35.

CZECH REPUBLIC *Contributed by Lukas Eisenwort, NSG Morison*

Trust funds

On 1 January 2014, a new Civil Code came into force that introduces a new legal entity: 'trust funds'.

Trust funds: legal aspects

Every trust fund must have a settler, trustee, and beneficiary/ies. The essence of the trust fund lies in appropriating a part of the settler's property into the trust fund. At the time of appropriating the property into the trust fund, the property no longer belongs to the settlor. The property transferred into the trust fund is managed by the trustee (who is usually paid for this activity), and the benefits coming out of the property in the trust fund accrue to the beneficiary. The property nevertheless does not belong to the trustee, nor to the beneficiary, as it is owned by the trust. Importantly, there is complete flexibility in terms of how the trust can be managed and setting conditions for beneficiaries in order to get the benefits from the trust.

Trust funds: tax aspects

The act of putting the property into the trust fund is not taxed (only when the property includes a Czech real estate, in which case the real estate transfer tax must be paid). The trust fund must pay income tax and VAT, in the same way that companies do, when conducting business. The trust fund is required by law to keep accounts. The fund income is taxed, but with notable exemptions:

- If the settlor is/was a family member of the beneficiary, then the benefits from the property given into the trust fund are exempt from tax
- If the trust fund was founded at the time of the death of the settler, then all benefits from the property given into the trust fund are exempt.

The benefits from any property not given into the trust fund by the settlor (i.e. the profit of the trust fund) are taxed by the withholding tax (in case of an individual beneficiary).

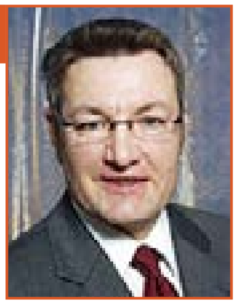
Examples of how to use the trust fund

For Czech individuals, trust funds can be used in many ways, including:

- Transfers from generation to generation
- Charity
- Property protection.

Any foreign individual can use the Czech trust fund in the same way. For example, an entrepreneur who puts all their companies under a Czech holding company, having obtained Czech tax residency for ≥1 year, can put the holding company into the trust fund and through the trust deed define how the property will be distributed to their followers. If the followers are family members and are also Czech tax residents (at least in the year they receive the benefits), then there will be no taxation on the transfer of property.

GERMANY *Contributed by Werner Buennagel, Morison Frankfurt AG*



New regulation of the documentation requirements for intra-community supplies

In order to have their supplies exempted from VAT, German exporters must prove to the German tax authorities that either they or their customers have transported the delivered goods to another EU country. With effect from 1 January 2014, German regulations concerning the evidence of intra-community supplies have changed. The new regulations require the proof by a duplicate of the invoice and purchaser's confirmation *(Gelangensbestätigung)* that the delivered goods have reached another EU country.

The *Gelangensbestätigung* is not required for every individual delivery. In case of permanent supply agreements, the sales for each quarter can be summarised in one confirmation. The *Gelangensbestätigung*, which can be transmitted electronically, must contain the following information:

- Name and address of purchaser
- Quantity and commercial description of goods delivered
- Place and month of delivery destination (must specify city/municipality, not just country); this is also valid for chain supplies
- Issue date of the invoice
- Signature of purchaser, or of their agent (not required in case of electronic transmission, as long as the transmission clearly started at the purchaser's/agent's area of disposition).

No specific form is prescribed for the *Gelangensbestätigung*, which may include several documents showing the required information; but useful templates are published by the Federal Ministry of Finance, which are also available in English or French.

Alternative certifications

In certain cases, instead of the *Gelangensbestätigung*, there is an option to provide any one of seven other certifications acceptable to the authorities:

1. Shipment documents

Proof of dispatch by the supplier or by the customer can be provided by a shipment document, especially the way bill, the bill of lading or duplicate copies of both documents.

2. Freight forwarder confirmation concerning an already completed transport (case 1)

In case of dispatch by the supplier or by the customer, the proof can also be provided by a confirmation from the freight forwarder ('white confirmation'). As the month of the transport must be indicated, this confirmation can only be issued after delivery. The freight forwarder must sign to certify possession of the purchaser's confirmation concerning receipt of the delivered goods (i.e. confirming receipt of the Gelangensbestätigung).

3. Freight forwarder confirmation of an intended transport (case 2)

If dispatch is arranged by the purchaser, there is no need to indicate the month of delivery, as proof can be provided by the supplier who confirms the freight forwarder carrying the goods to another EU country.

4. Track-and-trace

If the supplier or the purchaser arranges dispatch by courier, evidence of this can be supplied by a track-and-trace journal, which must prove the entire history of the transport in a transparent manner, including the month and destination of the final delivery. A signature is not required. The journal can be archived electronically or filed as a hard copy.

5. Sending by postal mail

For postal mailings (for which track-and-trace journals are not provided), in case of dispatch by the supplier or purchaser, the proof consists of confirmation of receipt of the postal service together with a proof of payment for the delivery.

6. Vehicle registration

In case of delivery of a motor vehicle transported by the purchaser, registration of the vehicle in the country of destination is accepted as proof of delivery.

7. Special issues

Alternative evidence is admitted also if the community transit procedure is used, as well as for goods that are subject to excise taxes.

INDIA *Contributed by Karan Jain, S.C. Vasudeva & Co.*

Cyprus blacklisted for not providing tax-related data

As of 1 November 2013, the central government has specified Cyprus as a 'notified jurisdictional area' for the purpose of Section 94A of the Income Tax Act, 1961 ('the Act'). As a result, India has blacklisted Cyprus for not cooperating on sharing information on suspected tax evaders. Following this new step, every payment currently made to any person in Cyprus will suffer a withholding tax rate of whichever is the *highest* of the following:

- 30%; or
- Rate prescribed under the Act; or
- Rate prescribed under the Double Taxation Avoidance Agreement.

In addition to the above, as per the provisions of the said section of the Act, all parties to the transaction with a person in Cyprus shall be deemed to be associated enterprises and the transaction shall be treated as an international transaction resulting in application of transfer pricing regulations, including maintenance of transfer pricing documentation. If any sum is received from a person located in Cyprus, then the onus is on the assessee to satisfactorily explain the source of such money in the hands of such person or in the hands of the beneficial owner; in case of failure to do so, the amount shall be deemed to be the income of the assessee.

No deduction in respect of any payment made to any financial institution in Cyprus would be allowed unless the assessee furnishes an authorisation, allowing for seeking relevant information from the said financial institution. In addition, no deduction in respect of any other expenditure or allowance arising from the transaction with a person located in Cyprus would be allowed unless the assessee maintains and furnishes the prescribed information.

ISRAEL *Contributed by Ariel Zitnitski, Zitnitski Weinstein & Co.*

Double taxation treaty between Israel and Malta

A double taxation treaty between Israel and Malta ('the Treaty'), ratified in Israel, has come into effect as of 1 January 2014. Accordingly, acquisition or holding, directly or indirectly, by an Israel resident (individual or company) in a company that is a resident of Malta shall henceforth not be considered as an aggressive tax planning that would require reporting to the authorities. Other important aspects of the Treaty are explained below.

Passive income tax

The Treaty stipulates the withholding tax rates for the following passive income, subject to fulfilment of conditions and exclusions set out in the relevant sections of the Treaty:

Dividend – The Treaty distinguishes between dividend received by a resident of Israel and dividend received by a resident of Malta:

- In case of a Malta resident company receiving dividends, the Israeli withholding tax will be at the maximum tax rate of 15%. If the recipient of the dividend is a Maltese, holding ≥10% of the share capital of the company distributing the dividend, then there will be no withholding tax
- In case of a resident of Israel who receives dividend from a Maltese company, the Treaty provides a withholding tax at a limited rate. However, as per the internal law today in Malta, there is no withholding tax upon dividend distribution to a non-resident.

Interest – the Treaty sets withholding tax at a maximum rate of 5% of the country of origin. However, as per the domestic law in Malta, there is no withholding tax when paying interest to a non-resident.

Royalties – the Treaty provides the exclusive right of tax to the country of residence. Even in this case, the domestic law in Malta provides for exemption from withholding tax at source.

The Treaty also provides for an Article with respect to extensive information exchange between tax authorities of the two countries. According to this Article, the Israeli Tax Authorities can obtain information about the revenue generated by the residents of Israel and Malta, including information held by banks or other financial institutions in Malta.

SINGAPORE *Contributed by Esther Mok, Paul Wan & Co.*

Singapore Budget 2014

On 21 February 2014, the Singapore Deputy Prime Minister and Finance Minister Tharman Shanmugaratnam unveiled the 2014 Budget in Parliament.

As in past years, this Budget also provides further measures to enhance some existing benefits. A key step this year is the introduction of the 'Pioneer Generation Package', aimed at recognising the contributions of all first-generation Singaporeans born on/before 1949.

Other key measures include:

Corporate and business

- Extension and enhancements to the Productivity and Innovative Credit (PIC) Scheme
- Introducing PIC+ for SMEs and extension of PIC benefits to training individuals under centralised hiring arrangements
- Refining conditions for PIC cash payout
- Extension of research and development (R&D) tax deductions
- Extending and refining the Writing Down Allowance (WDA) scheme and tax deduction for registration costs of the Intellectual Property scheme
- Extending and enhancing of the Land Intensification Allowance (LIA)
- Waiver of withholding tax requirements for payments made to Singapore branches
- Increasing foreign worker levies for construction workers
- Special Employment Credit (SEC) and Temporary Employment Credit (TEC) incentives.

Individuals and household businesses

- Enhancing parent and handicapped parent/spouse/sibling/child reliefs
- Removing transfers of deductions between spouses and tax relief for non-Singapore tax resident individuals holding Singapore citizenship
- Enhancing healthcare affordability such as Medishield Life, specialist outpatient clinics subsidies, Medisave top-ups, etc
- Supporting students of lower- and middle-income households higher learning bursaries
- One-off cash bonus and U-save vouchers
- One-off service and conservancy charge rebates.

Others

- Redefining basis of charging stamp duty on leases; land premiums and purchase of property; and share transfers and mortgages
- Legislating a review date on Approved Building Project (ABP) scheme
- Extending vehicle tax rebates under the existing Carbon Emissions-based Vehicle Scheme (CEVS) and Green Vehicle Rebate Scheme (GVRS)
- Raising tobacco and liquor excise duties and betting duties.

As for the property market, it has currently shown signs of stabilising after large increases in demand and prices in recent years. The Minister felt that it is too early to ease any cooling measures imposed in the past. However, the government will continue to monitor it and adjust when necessary in the coming quarters. Overall, this year's Budget is close to a balance Budget. It aims to share the fruits of economic growth with Singaporeans, particularly to honour the pioneer generation and help households with rising costs.

SPAIN *Contributed by Ignasi Contreras, Morison AC, S.L.P.*

The new Spanish law to encourage entrepreneur activity

In September 2013, Law 14/2013 on the support and internationalisation of entrepreneurs came into force. The Law aims at supporting the entrepreneur and business activity, to facilitate development, growth, and internationalisation and to encourage an entrepreneurial culture/environment that favours economic activity.

The Law introduces new categories for investor and entrepreneur permits processed by the *Unidad de Grandes Empresas* (UGE; Special Unit of Large Companies), relaxes qualifying criteria and reduces processing times for existing categories of work and residence permits. The UGE also provides expedited immigration processing for large businesses in Spain, reducing processing times, removing the requirement for a labour market search and allowing simultaneous submission of dependent visa applications.

This Law contains (in Section 2.2) important developments in the scope of immigration law that are reflected in the regulation of certain situations in which, for reasons of economic interest, it aims at facilitating and speeding up the granting of visas and residency permits for nationals of countries that do not belong to the European Union or the European Economic Area, in order to attract investment and talent to Spain.

The applicants will be those who can demonstrate that they are:

- Investors of significant economic or general interest sums of money
- Entrepreneurs engaged in innovative activities with a special economic interest, which particularly focus on job creation
- Highly qualified professionals
- Investigators
- Employees that relocate to Spain within a framework of labour or professional relations, or for reasons of vocational training, for the entire duration of the relocation.

The provisions of this section do not apply to those citizens that are members of the European Union or to those foreigners who are beneficiaries of the rights of the EU free movement and residence.

Investors

Foreigners who intend to enter Spanish territory in order to carry out a significant capital investment may apply for a residence permit or, where applicable, a residence permit for investors.

In this case, specifically, they must meet one of the following criteria:

- Take on Spanish public debt amounting to at least €2 million, or invest a minimum of €1 million in shares or quotas in Spanish companies or bank deposits in Spanish banks
- The acquisition of real estate located in Spain with a net investment value of at least €500,000 per applicant
- A business project to be developed in Spain that must be considered as of 'general interest'. To be considered 'of general interest', a business must:
  - Create new jobs
  - Carry out an investment with a relevant socio-economic impact in the geographical area in which the investor will develop the activity
  - Make a significant contribution to scientific and/or technological innovation.

Any investment made by a foreign company located abroad (except in a tax haven) where the foreign investor has control of the company will also be considered a significant investment.

The extended stay visa, valid throughout all Spanish territories, will be granted by the Spanish Ministry of Foreign Affairs for a 1-year period. Individuals holding an extended stay visa may also apply for a residency permit for investors, valid for 2 years and renewable thereafter.

Continued over

Entrepreneurs

Foreign entrepreneurs may apply for a visa to stay in Spain for a period of 1 year for the purpose of developing an entrepreneurial activity – defined as an innovative project with special economic interest, particularly in terms of job creation.

Highly qualified professionals

Companies located in Spain that need to hire foreigners may apply for a residence authorisation for highly qualified professionals as managers or when the company meets the legal requirements.

Companies that require incorporation of a foreigner into their organisation in Spain to establish an employment or professional relationship must prove one of the following assumptions:

- Average staff of >250 employees registered with the Spanish Social Security
- Annual turnover of at least €50 million in Spain; or volume of equity over €43 million
- Have received an average of at least €1 million annual foreign investment in the 3 years prior to the application
- Companies with investor stock abroad valued at a minimum of €3 million
- In case of small and medium-sized companies, it will be necessary to belong to a strategic sector.

Additionally, graduates and postgraduates of renowned universities and business schools are also included as eligible applicants.

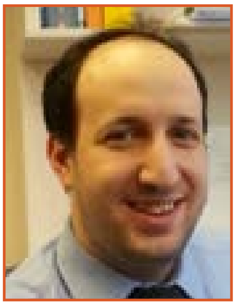
Intra-company transfers

The definition of an intra-company transferee has been broadened to include not only an employee with an employment contract, but also an employee with a professional relationship or service contract with the Spanish entity. Only 3 months (down from 9 months) of previous experience with the sending entity is required.

The Spanish government, via the Council of Ministers, has described the aim of this Law as being to support entrepreneurs and facilitate the implementation of international projects in Spain.

The entrepreneur Law supposes a very important change for the procedures regarding qualification for personal immigration, bringing Spain in line with other EU countries in terms of both anticipated increase in number of immigrants and streamlining of the relevant bureaucracy.

UK *Contributed by Tom Byng (top right) & Ricky Noimark (bottom right), MHA MacIntyre Hudson*



R&D tax relief

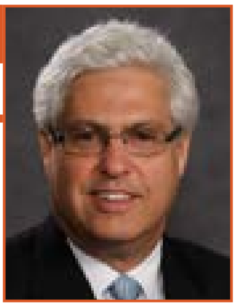
This relief has been in existence since 2000, but since 2010 the benefits have been substantially increased, and for every £1,000 spent on R&D by SMEs there can now be an additional tax saving of up to £300 for profitable companies, or a £248 cash payment from the UK tax authority (HMRC) if loss making.

For larger companies (>500 employees in the group), the benefits are lower. However, from April 2013, the benefit can be accounted for within operating profit (i.e. it will increase the accounting profit, as it will be accounted for as a reduction in the R&D expenditure in the income statement) rather than in the tax charge – as well as increasing the benefit to profitable companies (to 7.7%), it will make the relief more visible to the board and shareholders, and will also provide for a 7.7% cash refund for non-taxpaying companies.

These benefits reduce the cost of carrying out R&D in the UK but they are still very much under-claimed, due to both a lack of awareness and the misconception claiming is difficult. HMRC have dramatically improved their processes to streamline claims. R&D includes any project that aims to achieve an advance in science or technology through the resolution of scientific or technological uncertainties, i.e. something that is new and difficult. The definition is therefore very broad, and is likely to encompass some element of the work undertaken not just by every technology company but also by a number of business in almost every other sector (e.g., it can include new processes or product lines). Any company not claiming is missing out on funding that may be benefiting its competitors.

There is also the potential for double benefits across international borders, using another country's R&D schemes. As an example, using Dutch staff carrying out R&D for a UK company (as part of a UK R&D project), in for example a Dutch branch or subsidiary, it may be possible to claim R&D relief on the salaries of these staff under the local scheme. If this cost is then recharged to the UK company, it will be possible to claim R&D relief in the UK on these same costs. The double benefits of R&D are country- and fact-specific, but in certain situations substantial benefits can be achieved.

USA *Contributed by Paul Bercovici, Marks Paneth LLP*



Foreign Account Tax Compliance Act (FATCA): A (very basic) primer

Background

The Foreign Account Tax Compliance Act (FATCA) is designed to discourage offshore tax evasion by US persons by requiring foreign financial institutions (FFIs) to report certain information to the Internal Revenue Service (IRS) regarding their US account holders, or else be subject to a US withholding tax on certain US-source items of income payable to them. FATCA also imposes certain tax return disclosure obligations on US taxpayers who own offshore assets, including the obligation to file IRS Form 8938 with their annual US federal income tax returns.

Application of FATCA to FFIs

For FATCA purposes, the term FFI includes, among others, foreign banks, brokers, insurance companies, mutual funds, hedge funds and private equity funds. FATCA requires FFIs to report to the IRS certain information about financial accounts held by US taxpayers or by foreign entities in which US taxpayers hold a substantial ownership interest. FFIs that fail to provide the required information face significant US withholding taxes on US-source income payable to them, including withholding on proceeds of stock sales.

FATCA also generally requires FFIs to withhold 30% on certain US connected payments to 'recalcitrant account holders' – defined as one that fails to provide:

- The information required to determine whether the account is a US account
- The information required to be reported by the FFI; or
- A waiver of a foreign law that would otherwise prevent reporting by the FFI.

Intergovernmental agreements

The Treasury Department has entered into a number of intergovernmental agreements with foreign governments that determine the provision of information regarding US account holders.

FFIs in jurisdictions that have signed Model 1 intergovernmental agreements must report the information about US accounts to their respective governments, which then exchange the information with the IRS automatically. FFIs in jurisdictions that have signed Model 2 intergovernmental agreements must register and report information directly to the IRS. The >500-page final FATCA regulations issued in January 2013 coordinate the obligations on FFIs under the intergovernmental agreements and the regulations.

Application of FATCA to individuals

As noted above, FATCA also requires certain US taxpayers holding foreign financial assets with an aggregate value that exceeds certain thresholds to report certain information about those foreign financial assets on IRS Form 8938, which is filed with their annual federal income tax returns. The obligation to file Form 8938 is separate and distinct from the obligation to file the Report of Foreign Bank and Financial Accounts (commonly referred to as the FBAR). As FFIs increasingly report information regarding US account holders, the likelihood of US taxpayers being tripped up by neglecting to file Form 8938 will become greater, as will the likelihood of incurring costly penalties for such failure.

BARNES GROUP, INC. AND SUBSIDIARIES v. COMMISSIONER OF INTERNAL REVENUE [2013]

33 taxmann.com 201 (United States Tax Court)

Contributed by Divya Bhargava, S.C. Vasudeva & Co.

The transactions of loan carried through multi-tier subsidiaries and complex financial structure were held as dividend by US Tax Court.

Facts of the case

The taxpayer, a US corporation (Barnes), was engaged in a manufacturing and distribution business and operated both domestically and overseas. As a result of several business acquisitions, Barnes had significant company debt. At the same time, Barnes's one subsidiary in Singapore, Associated Spring – Asia PTE Ltd. (ASA), held a substantial amount of cash and was generating cash in excess of its operating needs. A dividend or loan of this excess cash to the taxpayer would trigger a significant federal tax liability. It was therefore decided to implement a 'reinvestment plan' that included the following events:

- Forming a subsidiary in Bermuda with the funds of the Barnes and ASA
- Forming a subsidiary in Delaware with the funds of the Barnes and its newly formed subsidiary in Bermuda
- The newly formed Delaware subsidiary got the funds from Bermuda Subsidiary, in exchange of issue of shares, which was lent to the Barnes; and
- ASA borrowed funds from a Singaporean bank that travelled further from Bermuda and Delaware to Barnes in the form of borrowings.

As a result of the above plan, the accumulated foreign profits of ASA, for which Barnes had not been previously taxed, returned to the Barnes indirectly. If the transfer had been directly to Barnes, it would clearly have been taxable.

Further under Sections 951 and 956 of the Code, a US shareholder of a controlled foreign corporation is taxed on its pro rata share of the controlled foreign corporation's earnings that are invested in US property, including stock of a US corporation. Section 956(a) of the Code limits the amount taxable to the US shareholder (Barnes) to the controlled foreign corporation's (Bermuda) adjusted basis in US property (Delaware's stock). Barnes relied on Revenue Ruling 74-503, which stated that when two corporations exchange their own stock, their basis in the stock received is $0. Therefore, Bermuda could transfer US$ 62 million worth of foreign currency, representing a portion of ASA's accumulated profits, to Delaware without triggering US income tax.

Contention of Revenue

Revenue argued that the principle of substance over form should be applied to this case and the reinvestment plan should be categorised as dividend in the hands of Barnes.

Decision of the United States Tax Court

- The Court rejected Barnes' reliance on the Revenue Ruling on the contention that Barnes' facts were considerably different from those in the Revenue Ruling
- One of the primary reasons why Barnes wanted ASA's excess cash was to pay off Barnes' high-interest debt
- Barnes, ASA, Bermuda, and Delaware contracted to undertake a series of transactions that resulted in a substantial amount of money from three entities with earnings and profits being transferred back to the USA without any tax consequences
- US corporations are ordinarily taxed under Section 11 on their worldwide income. However, the income of a foreign subsidiary of a US corporation generally is not subject to US tax, if the income is earned outside the USA and not repatriated as a dividend. Some domestic corporations, therefore, choose to keep a foreign subsidiary's earnings abroad in order to defer US tax until the money is repatriated

Continued over

- The US Tax Court held that the newly formed subsidiaries in Bermuda and Delaware did not have a valid business purpose, and that the various intermediate steps of the reinvestment plan are properly collapsed into a single transaction under the interdependence test of the step transaction doctrine. The interdependence test analyses whether the intervening steps are so interdependent that the legal relations created by one step would have been fruitless without completion of the later steps. This is one of three alternative tests that, if satisfied, invoke the step transaction doctrine, under which a particular step in a transaction is disregarded for tax purposes if the taxpayer would have achieved its objective more directly, but instead included the step for the purpose of tax avoidance
- The US Tax Court further held that the Singaporean subsidiary transferred a substantial amount of cash to the US corporation through the reinvestment plan, and that the US corporation failed to show that it had returned any of the funds
- Therefore, the US Tax Court concluded that the reinvestment plan had resulted in substantial taxable dividend payments from the Singaporean subsidiary to the US corporation.

EDITORIAL COMMENT

The principle of 'substance over form' is a well-recognised concept in taxation laws. The US Tax Court has rightly applied the above principle and disregarded the complex structures formed by Barnes to avoid its tax liability. This decision may have implications for other structured transactions.

DIT v. E FUNDS IT SOLUTIONS

Vasudeva & Co. 42 Taxmann.Com 50 (Delhi High Court) (2014)

Contributed by Aditi Gupta, S.C.

Indian subsidiary of a foreign company providing back office support operations does not constitute a permanent establishment (PE) in India.

Facts of the case

The assessees are the companies incorporated in USA: e-Fund Corporation (e-Fund Corp.) and e -Fund IT Solutions Group Inc., USA (e-Fund Inc.). e-Fund Corp. was the ultimate holding company of e-Fund India, a company incorporated and resident of India, and also of e-Fund Inc.

e-Fund Inc. and e-Fund Corp. have entered into a contract with their clients for providing certain IT-enabled services that were either assigned or subcontracted to e-Fund India for execution. e-Fund India performed back office operations in respect of the ATM management services, electronic payments, decision support services, risk management and professional services rendered by the assessees.

Contention of the Assessing Officer

The Assessing Officer contended that from the functions performed, assets used and risks assumed (FAR analysis) by the assessee and e-Fund India, it was clear that e-Fund India lacked the appropriate software and database to supply IT-enabled services independently, and that these were made available free of charge by the assessee to e-Fund India. It was also held that e-Fund India did not bear any significant risk, as the ultimate responsibility lay with the assessee. It was also noted that the sales team of the assessee undertook marketing efforts for its affiliates, including e-Fund India.

It was accordingly held that the entire activities of the assessee in India were carried out by e-Fund India (an agent), and that the said agent had not been remunerated on an arm's-length basis. It was therefore held that the assessee had a PE in India in respect of back office operation and software development services being carried out by its subsidiary. It was also held that the assessee's income was liable to tax in India in respect of operations performed by the subsidiary company on its behalf.

The Commissioner (Appeals) and Delhi Bench of the Income Tax Appellate Tribunal upheld the order of Assessing Officer. Aggrieved by the order of Tribunal, the assessee filed an appeal before the Hon'ble High Court.

Decision of the High Court

A subsidiary per se does not form a PE
A subsidiary constitutes an independent legal entity for the purpose of taxation. A holding or subsidiary company by itself would not become the PE of each other. As per Article 5(6) of the India–US tax treaty ('the Treaty'), the company, which controls or is controlled and carries on business in the other state by itself, would not constitute a PE of the other company. A subsidiary can become a PE of the holding/controlling company or the related company, if it satisfies the requirements of other paragraphs of Article 5, notwithstanding and negating the protection provided under Article 5(6), which recognises the legal independence of the two entities for tax purposes.

Fixed-place PE [Article 5(1)]
There was no material to hold that the assessee (1) had a fixed place of business in India through which business of enterprise was wholly or partly carried on and (2) had right to use any of the premises belonging to e-Fund India. Accordingly, Article 5(1) of the Treaty cannot be invoked to constitute a PE in India. Further, even if the foreign entities have saved and reduced their expenditure by transferring business or back office operations to the Indian subsidiary, it would not by itself create a fixed place or location PE.

The fact that the subsidiary company was carrying on core activities as performed by the foreign assessee does not create a fixed-place PE. If an enterprise enters into contracts, assigns or subcontracts works or renders services to a third party on behalf of the principal, this

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by itself would not lead to a subsidiary becoming a PE unless the relevant requirements of Article 5 are satisfied.

Further, as the assessees did not have any branch office or factory or workshop in India, the mere fact that they had a subsidiary in India did not itself create a fixed-place PE within the meaning of Article 5(2)(b)–(k) of the Treaty.

The High Court relied on the Supreme Court's decision in the case of Morgan Stanley, where it was observed that back office operations by the Indian subsidiary to the parent to support the main office functions do not satisfy the second requirement of Article 5(1) of the Treaty – i.e., carrying on of business in India through such fixed place. The Indian subsidiary was in fact merely supporting the front operations of the principal company and therefore there was no fixed-place PE.

Service PE

Article 5(2)(i) and (k) of the treaty defines a 'service PE': sub-clause (i) requires furnishing of services within the second contracting state by a foreign enterprise through its employees or other personnel. But a PE is created only if activities of that nature continue for a period or periods aggregating >90 days in a 12-month period, or under clause (ii) services are performed within that state for a related enterprise. For application of clause (ii), no time period stipulation is postulated. Sub-clause (i) would apply only if the foreign enterprise or the two assessees had performed services in India through their employees or personnel – i.e., personnel engaged or appointed by the foreign assessee. The employees and other personnel must be of the non-resident assessee to create a service PE.

Employees of e-Fund India were their employees, i.e. employees of an Indian entity, not of the assessees. The employees of e-fund India did not become other personnel of the assessee. The words 'employees and other personnel' under Article 5 of the Treaty must be read along with the words 'through' and 'furnishing of services' by the foreign enterprise within India.

Thus, the employees and other personnel must be non-resident to create a service PE. The High Court relied on the Supreme Court decision in the case of Morgan Stanley and held that merely because the non-resident assessee, to protect its interests by ensuring quality and confidentiality, has sent its employees to provide stewardship services, this does not make the Indian subsidiary (or another entity) a PE of the non-resident company, even if the employees of the non-resident taxpayer were taken on deputation.

Article 5(3) and its overriding effect and consequences

Article 5(3) of the Treaty is a non-obstante provision that overrides Articles 5(1) and (2) of the Treaty. While analysing whether taxpayer has a PE, first and foremost, Article 5(1) or (2) should be applicable; but if the activities fall under Article 5(3), then a PE cannot be created for imposing tax in the second state.

The Tribunal was not correct in applying Article 5(3) that all activities performed and undertaken by the Indian subsidiary and that their employees would create a PE in India because the activities of e-Fund India were not preparatory or auxiliary in character – i.e., the activities are not satisfying the conditions of Article 5(3). Article 5(3) is not a positive provision but a negative list; it does not specify what creates a PE, but rather indicates which activities do not create a PE.

Agency PE

A subsidiary by itself cannot be considered to be a dependent agent PE of the principal. However, a subsidiary may become dependent or an independent PE agent provided the tests as specified in Article 5(4) and (5) are satisfied. It was not the case of the Tax Department that e-Fund India was authorised and habitually exercised authority to conclude contracts, or was maintaining stock or merchandise from which it delivered goods or merchandise on behalf of the assessee or secured orders on behalf of the assessee. Therefore, the conditions and requirements of Article 5(4)(a)–(c) are not satisfied. Consequently, there was no agency PE of the taxpayer in India.

Business connection

Considering the facts of the case, it was held that there was a business connection of the assessee in India, because e-Fund India was providing information and details to the assessee in the USA for the purpose of entering into contracts with third parties and subsequently the said contracts were performed fully or partly by e-Fund India as an assignee or sub-contractee. Looking at the nature of the said transactions and the manner in which contracts were executed, and where the assessee had assumed and agreed to third-party claims and risks, a business connection was established.

However, even when business connection under Section 9(1)(i) of the Income Tax Act, 1961 stands established, the provision does not seek to bring to tax

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all profits of the non-resident. Only income reasonably attributed to operations carried out in India can be taxed under the Act. Real and intimate connection must exist between operations carried out in India; and only business by the non-resident outside India, and profits of business outside India attributed to operations carried out in India, can be subjected to tax. This is clear from the explanation to Section 9(1)(i) and only such income operations carried out in India have to be attributed and taxed.

This would have entailed an intrusive and exhaustive exercise into each contract executed by e-Fund India and on involvement of the assessee and E-Fund India. In the present case, attributions of profit to business connection has not been undertaken/applied keeping in mind the aforesaid stipulation, but by applying Article 7 of the Treaty, as the Treaty was more beneficial to the assessee.

On the basis of the above principles, the Hon'ble Delhi High Court held that having subsidiary in India itself does not create a PE in India. Further, on the issue of profit attribution, the High Court held that the activities, which were not undertaken by e-Fund India and the assets of the assessees located outside India, cannot be taken into account or attributed for earning income of the assessees. Since proper income was declared and taxed in the hands of e-Fund India, nothing remains to be attributed or taxed in the hands of the assessees.

EDITORIAL COMMENT

Taxability of foreign companies having subsidiaries for back office support operations in India has been a subject matter of debate before the courts. The Supreme Court in the case of Morgan Stanley dealt with this issue and held that back office functions performed by the Indian company were preparatory and auxiliary in nature, and therefore did not constitute a fixed-place PE.

This is a welcome ruling and lays down a very important principle that 'having a subsidiary in India itself does not create a PE in India'. A subsidiary can become a PE of the holding/controlling company or the related company, if it satisfies the requirements Article 5 of the tax treaty. Furthermore, merely because the non-resident taxpayer, to protect its interests by ensuring quality and confidentiality, has sent its employees to provide stewardship services, will not make the Indian subsidiary, or another entity, a PE of the non-resident company, even if the employees of the non-resident assessees were taken on deputation.

JANCO WEISS HOLDING LTD. v. TAX ASSESSOR OF HOLON [APPEAL CASE NO. 1090-06]

Contributed by Ariel Zitnitski, Zitnitski Weinstein & Co.

Sale of shares of a company registered in Israel taxable in Israel.

Facts of the case

Janco Weiss Holdings 1996 Ltd ('the appellant') was incorporated in 1996 in Israel. The appellant held shares of Sabra Salads Food Industries (1985) Ltd, which owned, among other things, a manufacturing plant for marketing refrigerated salads. In May 1998, the appellant purchased a building in Brussels. In 1999 the appellant changed its place of registration to Luxembourg, and in September 1999 further changed its registration to Belgium. In July 2000, the appellant sold its shares in Sabra Salads to a third party. In a report for tax year 2000 filed in Israel, the appellant did not report the capital gain from the sale of Sabra Salads.

Contention of the tax authorities

The Israeli tax authorities (ITA; 'the respondent') argued that the taxpayer (the appellant) was a resident of Israel and therefore the capital gain is taxable in Israel. Alternatively, the ITA argued that the appellant's registration in Belgium must be seen as an artificial transaction (as mentioned in Section 86 of Israeli tax law).

Contention of the taxpayer

The appellant argued in its tax appeal that the company was a resident of Belgium and, in accordance with Belgian tax law and as per the tax treaty between Israel and Belgium, the profit from the sale of Sabra Salads is taxable in Belgium only and not in Israel.

Decision of the Court

The Court cited a large number of parameters and concluded that despite the existence of the external characteristics that may indicate the place of management abroad, the in-depth examination of the parameters indicated that the administrative apparatus established abroad lacked substance. Also, in essence, the appellant is Mr Janco, a resident of Israel, and the decision-making process remained largely in his hands.

The Court laid down important parameters and observed the following:

- *The identity of the shareholders* – in this case, the shareholders were both residents of Israel, who lived in Israel
- *Place of decision-making* – the residency of the appellant, by virtue of control and management, is not determined by performing a specific action (however important it may be), but must be seen over a period of time
- *The appellant Board of Directors' decisions* – not of real substance, as the decision to sell shares of Sabra Salads submitted by Mr Janco was without the involvement of the directors of the Belgian company
- *Approval of transactions* – transactions over 50,000 Belgian francs required confirmation from Mr Janco – a relatively insignificant amount, considering the volume of business and expenses of the appellant
- *Distinction between professional activities and real management* – it was held that the directors in Belgium were professionals, and were in substance 'directors for rent'
- *Distinction between strategic policy versus current business management* – in this case, members of the Belgian company did not oversee and conduct the strategic and ongoing aspects of managing the business
- *Authorised signatory at the bank account* – the shareholders maintained Mr Janco as an authorised signatory on the bank account, which confirmed his control of the company accounts and his managerial involvement.

Based on the above, the Court concluded that the management of the Belgium company was situated in Israel and that the gain was taxable.

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EDITORIAL COMMENT

The issue regarding where the control and management of a company is situated is a vexed one. The general rule is that control and management lies wherever the Board of Directors meet to take decisions. However, where the actual decision-making is being exercised by a person other than the Board, so that the Board lacks substance, the Courts have pierced the veil and have decided contrary to the general principle, as has been done in the instant case.