Morison International

Q2, 2014
(Issue 8)

Global Tax Insights

CONTENTS

EDITORIAL

The well-attended Morison International Europe and North America (MIENA) conference, held 16–17 May in Dublin, Ireland, was a huge success. On the second day, the Tax Group had its breakout session, chaired by Dr Bernhard Madörin, which focussed on EU holding structures and VAT developments. The session concluded with a panel discussion on 'legal taxation versus materiality', which unanimously concluded that the taxes should be paid as per the legal situation and materiality has very little role to play as far as payment of taxes are concerned.

The OECD is continuing its good work on the base erosion and profit shifting (BEPS) project. Public consultations on hybrid mismatch arrangements and transfer pricing documentation were held in May 2014, and half of the action plans should be complete by the end of 2014.

This newsletter features an article on the transfer pricing comparability data and developing countries draft paper issued by the OECD. In the country focus section, we have a very informative article on the recent changes proposed in the UK Budget on taxation of employee stock ownership plans (ESOPs). The case law section deals with four cases. Two cases are from the Indian courts; the first deals with the issue of formation of an association of persons in case of consortium arrangements, the second deals with the issue of transfer pricing in the IT sector. The other two cases are from the European Court of Justice on VAT and accounting issue of 'true and fair view'.

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. Please email your suggestions to sachin@scvasudeva.com.

Happy reading!

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

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

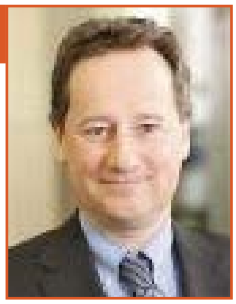
Voluntary tax arrangement for foreign trusts with Israel resident beneficiaries

On 9 March 2014, the Israel Tax Authority published rules regarding voluntary tax arrangements that will apply to trusts established by a foreign resident before 31 December 2013 wherein the beneficiary is a resident of Israel. Under the law that existed in Israel until 1 January 2014, revenue generated from assets belonging to a trust were not taxable in Israel for an unlimited period of time, except in cases where the beneficiary was involved in, or was influencing the activities of the trust and there was a distribution of funds to the beneficiaries.

The tax authorities noticed that taxpayers have misused the law by indirectly gifting assets to a resident in Israel through the trust route. This prompted the Israeli tax authorities to bring out the amendment that the income of such trusts will be taxable from 1 January 2014 onwards.

Under the provisions of the voluntary tax arrangement, the tax authorities have provided several categories where a different tax charge is determined (between one-third and two-thirds of taxable income) during the effective period. Alternatively, where it is not feasible to charge tax on the income of the trust, such trusts can pay tax at rates varying from 3% to 6%, calculated on the capital of the trust (instead of on the taxable income). Further, as part of the arrangement, the trust assets will be determined, in appropriate cases, on a new cost basis and will have a new purchase date.

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



Adjustments to tax at source

Switzerland is one of the few countries that basically do not deduct taxes directly from employees' wages. Rather, it trusts its citizens and leaves it up to them to self-declare their income and to pay the ensuing taxes. Strictly speaking, however, this applies only to Swiss citizens and foreign nationals with a category C residency permit. All other foreign nationals are taxed at source.

One of the large problems in Switzerland is how to deal with those taxed at source who move from one canton, to another during a calendar year. Under ordinary tax law, taxes are due where a taxpayer is resident at the end of the year – however, this does not apply for those who are taxed at source even if they have to subsequently file a tax return. Instead, the taxation period is split up, with each canton claiming tax for a part of the year. If identical splitting regulations were applied in all cantons, it would only lead to an increased administrative effort, but at least the end result could be deemed correct.

In reality, however, 25 cantons have simply split the annual income proportionally, according to the number of days, whereas Basel-Stadt has taken the actual day of payment of wages, additional income and deductions as the basis. In the case of a move from Basel-Stadt to Basel-Land, for example, this can lead, in breach of constitutional rights, to a double taxation of the same income. As this is rather complicated, many cantons have come up with a pragmatic solution. To simplify matters, these people are considered sole earners in these cantons and are taxed at source there according to their number of children, while occasionally additional requirements are to be applied for this solution. For example, the canton of Zurich only applies the sole earner tax rates if the international commuter's spouse earns a maximum of CHF 25,000 per year. In many cantons, it is also possible to file a simplified tax return (rate adjustment) and claim deductions for weekly commuter costs and allowances for pillar 3a and voluntary pension plan contributions. Until a few years ago Basel-Stadt completely refused to accept these deductions, but was then forced by the Federal Supreme Court to admit such a rate adjustment, at least in certain cases.

Now the administration has come up with a creative solution to enable them to be able to refuse those tax deductions to as many people as possible. First, the option of such a rate adjustment was restricted to EU citizens whose families live in the EU, as the judgement by Federal Supreme Court only found a breach of the Agreement with the EU on the Free Movement of Persons. And handing in a complete tax declaration is still not an option open to international commuters. Next, the terms 'quasi-resident' and 'assumption of perception' were created, and furthermore a completely arbitrary, but nevertheless formally legitimated, obstacle was erected: only the 'quasi-resident' marriage partner who is earning at least 90% of the family's income can claim tax deductions. Not only is this extremely difficult to prove with foreign tax assessments (as married couples are taxed separately in many countries), but even a small income earned by the spouse often means that the main earner can no longer comply with the 90% threshold, thus making any claims for deductions on Swiss taxes impossible.

Originally the number of children served as the basis for the tariff to tax at source, if their existence could be shown by whatever evidence was available. Some time ago both Basel cantons considerably tightened regulations in this respect, and since then, tax at source is wilfully tied to child allowance paid in Switzerland. Rather inconveniently, any employment by the spouse or partner in their home country – where the children also live – most often leads to child allowance being paid there. As a consequence, our international weekly commuter will now be taxed as if they had no children at all.

Early in 2014, in order to 'streamline the administrative process and to allow for the option of electronic filing', new tariffs for tax at source were introduced throughout the whole of Switzerland – which, incidentally, now means that the tariffs for tax at source for double-income families need to be applied for international weekly commuters as well. As a consequence, this leads, in some cases, to tax rises of over 60%.

Continued over

Meanwhile a silver lining has appeared on the horizon: the federal government has recognised the many complex problems with tax at source, and recently proposed new legislation to harmonise and optimise this tax. It proposes that the income threshold be lowered for compulsory and subsequent submission of the tax declaration, yet allows persons with an income below this threshold, on a voluntary basis, to still hand in their tax declaration. Additionally, persons taxed at source are now to be taxed for the whole year at their place of residence at the end of the year, which would mean that all the problems with split taxation periods – including increased administrative efforts and the risks of double taxation, as described above – would then cease to exist.

Unfortunately, the proposals also include keeping the status of 'quasi-residents', and it would also both cement the unfortunate 90% threshold and make it applicable throughout Switzerland, which in currently generous cantons like Basel-Landschaft would lead to a worsening of the position for those affected.

These draft proposals are undergoing the statutory consultation process, but will be clarified in the final rules.

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

UK Budget 2014

On 19 March 2014, the UK chancellor George Osborne delivered his budget to the UK Parliament which sets the tax rates/rules for the forthcoming tax year and onwards. Here, some key provisions are explained briefly.

Share options for internationally mobile employees
Currently, how an employee is taxed on the exercise of their option is dependent on their tax residence position at the time of grant. If they are a non-UK resident at the time of grant then no income tax arises on exercise even if they are a UK resident at the time of exercise of their option. On the other hand, if an employee is a UK resident at the time of the grant, s/he is technically liable to UK income tax on the whole share option gain (the difference between the shares' market value on exercise and the exercise price) on exercise, even if the employee ceases to be UK resident before the option vests or before it is exercised.

To counter this latter misalignment with OECD principles, HMRC has in the past allowed an apportionment of the share option gain to the period of UK duties if the employee exercised the option in a country with which the UK had a double tax treaty. Only the part attributed to the UK duties was liable to tax. This concession was of no help where the employee went to a country with which the UK does not have a double tax treaty, such as Brazil, or to countries such as South Africa where special expatriate regimes mean that the employee does not immediately become a tax resident. Those are the old rules, which will continue to apply until 6 April 2015.

The new measures in the Finance Bill 2014 introduce a new approach to taxation where an employee has been internationally mobile during the 'relevant period' of an award. The 'relevant period' is essentially the period between the grant of an option and when it 'vests' (becomes exercisable). The share option gain is treated as accruing evenly, day by day, across the relevant period with one of the following treatments:

1. Not taxable, as it relates to a period of non-residence in the UK in the relevant period where employment duties are wholly overseas;
2. Taxable in full, because it relates to a period of residence in the UK; or
3. Taxable to the extent it is remitted to the UK where the share option gain relates to duties performed abroad by a UK resident who is taxable on the remittance basis.

This new approach will have winners and losers. Employees holding vested options that were granted when they were a non-resident may wish to exercise them before 6 April 2015 to minimise UK tax bills. Conversely, employees granted options while resident and working in the UK, and who are now resident in countries with which the UK does not have a tax treaty (e.g. Brazil), may wish to delay exercising their option until after 5 April 2015 to gain the benefit of some of their share option gain being apportioned to non-UK periods such that it is not UK taxable.

Annual tax on enveloped dwellings (ATED) expanded
In April 2013, where a 'non-natural person' (any company irrespective of global location, a partnership with a UK partner or a collective investment scheme) owned a residential property valued at more than GBP 2 million, the ATED has been charged unless the owner qualified for one of the property business reliefs (property development, buy to let, etc.). Hand in hand, there was also a 15% increase to the stamp duty land tax (SDLT) rate for non-natural persons when they purchased a residential property worth over GBP 2 million. This was subject to the same reliefs for certain property businesses.

In an unexpected move, the Chancellor lowered the thresholds for the value of residential properties to be included in the scheme. From 1 April 2015, any residential property over GBP 1 million owned by a non-natural person will be within the ATED charge; this further lowers to GBP 500,000 from 1 April 2016. The Chancellor also announced the extension of the 15% SDLT band to be introduced immediately to any non-natural person purchasing a residential property for over GBP 500,000.

There will be a large number of companies and other non-natural entities holding residential investment properties who will now be caught by the lower limits. It is important to plan ahead to determine whether

Continued over

these structures can either be unwound or if there may be other ways to mitigate the impending charges. Further, even if someone qualifies for an ATED relief, ATED returns must be completed and filed by 30 April of each year – or, where a property has been purchased midway through the year, 30 days after the purchase. Penalties have been issued by HMRC for failure to comply.

Capital gains tax (CGT) for non-UK residents

The UK government is continuing its consultation in the imposing of CGT on non-UK residents. It previously announced details of the charge, but has yet to commit to a CGT rate or a method of collecting the tax. The new rules will apply to any residential property and not be limited to values (like ATED). It is likely that the tax will only affect gains after 1 April 2015 and will be withheld at the point of sale via solicitors/estate agents.

This does have wide implications for non-UK residents as it represents a large shift from the current policy of exemption, which has been in place for many years.

OECD UPDATE *Contributed by Sachin Vasudeva, S.C. Vasudeva & Co.*

Transfer Pricing Comparability Data and Developing Countries

The application of the arm's-length principle, requires that a comparison be made between the prices charged in controlled transactions, or the financial results of such transactions, and the prices set in or the financial results of similar transactions between independent enterprises in similar circumstances. This comparison is used to determine whether a transfer pricing adjustment is needed when computing the taxable profits of one or more of the associated enterprises.

The United Nations, *Practical Transfer Pricing Manual for Developing Countries* (2013; http://www.un.org/esa/ffd/documents/UN_Manual_TransferPricing.pdf) describes specific challenges for developing countries in paragraph 1.10.6:

It is often extremely difficult in practice, especially in some developing countries, to obtain adequate information to apply the arm's length principle for the following reasons:

1. There tend to be fewer organised operators in any given sector in developing countries; finding proper comparable data can be very difficult
2. The comparable information in developing countries may be incomplete and in a form which is difficult to analyse, as the resources and processes are not available. In the worst case, information about an independent enterprise may simply not exist. Databases relied on in transfer pricing analysis tend to focus on developed country data that may not be relevant to developing country markets (at least without resource and information-intensive adjustments), and in any event are usually very costly to access; and
3. Transition countries whose economies have just opened up, or are in the process of opening up may have, "first mover" companies who have come into existence in many of the sectors and areas hitherto unexploited or unexplored; in such cases there would be an inevitable lack of comparables.

Recognising the above difficulty, the G8 countries asked the OECD to find ways to address the concerns expressed by developing countries, on the quality and availability of the information on comparable transactions, that is needed to administer transfer pricing effectively. The OECD has come out with a draft discussion paper on this aspect.

The paper discusses four approaches for addressing the concern over the lack of data. The four approaches are:

1. Expanding access to data sources for comparables
2. More effective use of data sources for comparables
3. Approaches to reducing reliance on direct comparables
4. Advance pricing agreements and mutual agreement proceedings.

Expanding access to data sources for comparables

Commercial databases are a common source of information for comparables searches for transfer pricing purposes. However, such databases generally provide very limited financial data on companies in developing countries. The possible reasons for this could be the limited number of sizeable independent companies in those countries, or the absence of filing requirements.

The paper suggests that the major suppliers of the databases could be engaged to ensure that the reasons for the limited coverage of developing countries have been accurately identified and explore the steps that could be taken to improve developing country coverage and access.

More effective use of data sources for comparables

Once access to a commercial database has been acquired, its effective use requires a degree of skill and experience. If the search criteria are not appropriate, then the results may lead to selecting inappropriate comparables, which in turn would lead to incorrect results. It is possible that due to lack of proper knowledge, appropriate comparables may be excluded. The paper recommends that guidance or assistance be provided to developing countries, with regard to the effective use of commercial databases.

Continued over

In cases where domestic comparables are not available, the paper suggests that the search criteria may be expanded to include foreign comparables, or even making the foreign party as the tested party. The paper further points out that 'testing the foreign counterparty may also mitigate the risk, that the domestic party will only be allocated a routine return, without considering whether it should share in any residual return that may arise in the transaction'. Country experiences with these methods and guidance as to their application in practice may be useful to developing countries.

Approaches to reducing reliance on direct comparables

Both developing, and developed, countries may encounter the situation that no appropriate internal comparables or publicly available external comparables are identifiable. Nevertheless, transfer prices must still be set by taxpayers and audited by tax administrations. In such a situation, the paper suggests that consideration might then be given to alternative approaches that do not directly rely on comparables.

Other approaches include the use of safe harbour provisions, the profit-split method, and the application of economic analysis or value-chain analysis. Value-chain analysis would involve analysing the value added by business functions, within a multinational enterprise group, to allocate the value added to members of the group. The paper provides that a review of these and other potential alternative approaches and their application in practice may be useful to developing countries. Additional guidance or direct assistance could be provided to developing countries with regard to innovative techniques identified.

Advance pricing agreements and mutual agreement proceedings

Transfer pricing is not an exact science, but does require the exercise of judgment on the part of both the tax administration and the taxpayer. Another method for developing countries to deal with the issue of lack of comparability data, is to engage with the tax authorities through the advance pricing agreement (APA) mechanism. The paper provides that if the APA is offered on a bilateral basis, then the potential for double taxation or double non-taxation is also substantially reduced. The paper further provides that an APA programme requires access to skilled and experienced human resources, and therefore a review of country approaches and experiences with respect to APA programmes, particularly those of developed countries, may be useful to developing countries.

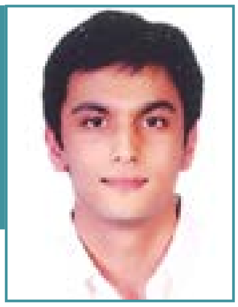
Conclusion

The work done by OECD is laudable, as some of the issues raised in the paper are very relevant. Comments to the paper were supposed to be sent to the OECD by 11 April 2014. It is expected that the OECD will soon release the final report, which will adequately address these concerns.

Linde AG, Linde Engineering Division v. Deputy Director of Income Tax

[2014] 44 Taxmann.com 244 Delhi

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



The Hon'ble Delhi High Court has recently held in the said case that a consortium does not result in an Association of Persons (AOP) unless there exists sufficient degree of joint action between consortium members, either in execution or in management of a project.

Facts of the case

A tender notice was floated inviting bids executing work (including undertaking all activities and rendering all services) for the design, engineering, procurement, construction, installation, commissioning and handing over of the plant for the Dual Feed Cracker and Associated Units of Dahej Petrochemical Complex, in accordance with the bid documents. The project was to be executed on a turnkey basis.

Linde AG (Linde) and Samsung Korea (Samsung) entered into a memorandum of understanding (MOU) whereby both parties agreed to form a consortium, for jointly submitting a bid to secure the contract for execution of the project. The said submitted proposal was accepted and notification of award was issued awarding the work of executing the project on a turnkey basis to the consortium.

Linde filed an application before the Assessing Officer, under section 197 of the Indian Income-tax Act, 1961, claiming that no portion of the amount payable to it (for supply of equipment, material and spares and for providing basic and detailed engineering services) was liable to be subjected to withholding tax under section 195 of the Act, as it was contended that the said transactions were performed and completed outside India and payments for the said transaction were also received outside India. It was contended that the amounts received/receivable by Linde for the said supplies and services were not chargeable to tax in India.

The Assessing Officer did not accept the plea of Linde and directed OPAL (the company making the payment) to withhold tax on amounts paid to Linde in terms of the contract.

Thereafter, Linde filed an application before the Authority for Advance Rulings (AAR) under section 245Q of the Act seeking advance ruling with regard to the status of Linde and Samsung as an association of persons, and also as to the tax liability of Linde in India in respect of income received/receivable under the contract.

The AAR held that the consortium of Linde and Samsung constitutes an 'association of persons' and noted that the notification of award was in the name of the consortium, not in the name of Linde and Samsung individually. The AAR further held that the liability of Linde and Samsung, for due performance of the contract, was joint and several, and that the contract was indivisible and could not be split up.

On this basis, the AAR concluded that income received/receivable by Linde for offshore supply of equipment, materials spares and for the offshore supply of drawings and designs relating thereto were taxable in India.

Aggrieved by the impugned ruling passed by the AAR, a writ petition was filed by Linde.

Contention of the assessee

The status of the consortium formed by Linde and Samsung was not that of an AOP, and as such the consortium was not liable to be assessed under the Act as an AOP. An AOP is one in which two or more persons join for a common purpose or common action (whether or not the same is formed with the object to produce income, profits or gains). In the present case, there is no element of the common action or common purpose.

Linde and Samsung had jointly submitted the bid in order to fulfil the criteria/conditions specified under the bid documents. The common object was to secure the contract; the consortium was formed only for this limited purpose, and each party was required to perform its specified portion of the contract separately. Both Linde and Samsung were responsible for their

Continued over

respective profits and liabilities and there was no sharing of risks, expenses or profits. There was also no sharing of assets or resources employed by each of them. The scope of the work to be performed under the contract by both parties was clearly demarcated and separately identified. It was submitted that in these facts, no joint management or joint action or common purpose in the performance of the contract could be inferred and hence, the consortium could not be assessed as an AOP.

The consideration received/receivable by Linde for supplying equipment, material and spares was not taxable in India, as the income arising/accruing from the transaction could not be deemed to accrue/arise in India.

The assessee, being a non-resident, would be chargeable to tax in India only in the event income accrues/arises in India or is deemed to accrue/arise in India. Therefore, the amount received/receivable by the assessee for the offshore supplies or offshore services were not liable to tax under the provisions of the Act, or under the double taxation avoidance agreement (DTAA) read with protocol between India and Germany.

In terms of the DTAA between India and Germany, Linde's income was taxable exclusively in Germany with respect to its global business income, except in cases where the petitioner carried on business through a permanent establishment in India, in which case the profits attributable to the permanent establishment would be taxable in India. In this regard, it was submitted by the assessee that the permanent establishment of Linde did not come into existence until the commencement of the installation stage, which was subsequent to Linde providing the basic and detailed engineering, drawings and offshore supply of equipment and material. The income from provision of offshore supplies and services had already accrued and arisen prior to Linde's permanent establishment coming into existence.

The entire consideration under the contract was paid/payable by OPAL to the members separately, not to the consortium. Thus, the notional inflow of funds in the hands of the consortium was also equal to the outflow in favour of the members; and in such case, no income would arise in the hands of the consortium.

Contention of the Revenue Authority

The consortium formed by Linde and Samsung constituted an AOP and income or profits received/receivable under the contract were liable to be assessed in the hands of the consortium as a separate person. The contract was entered by OPAL (the customer in India) with the consortium as one entity, which was described as the 'contractor' under the contract. The subsequent division of the work between the members of the consortium was not relevant. The contract was awarded to the consortium for the entire work, with the parties agreeing to be jointly and severally liable to OPAL for due performance of the contract. The contract provided for a lump sum consideration payable for execution of the entire contract, and as such the same was not divisible. The certificate of completion and acceptance of work was to be given to the consortium and not to individual members. Linde and Samsung had joined for the said common purpose of bidding and execution of the contract, and thus any income arising therefrom was assessable in their hands as an unregistered association, i.e., an AOP.

The project in the present case is a turnkey project and the contract is an integrated and indivisible contract. The offshore and the onshore transactions could not be segregated for the purposes of taxation and the contract had to be read as whole and indivisible. The offshore and onshore transactions are interlinked and the non-execution of one transaction/part would result in the breach or failure of the whole contract and the breach of any of the terms thereof would result in the breach of the entire contract and not just a particular obligation. Since the consideration of the whole work was receivable by the consortium and could not be segregated on the basis of the transactions/activities involved in execution of the contract, the whole income or profit received/receivable under the contract was taxable in India.

Linde had a direct subsidiary in India and the same was involved in pre-bidding negotiations. Thus, Linde had a permanent establishment in India even prior to the contract being signed.

The consortium was liable to be taxed as a tax resident entity in India, and to that extent the DTAA between India and Federal Republic of Germany did not apply.

Continued over

Decision of the Court

On issue of constitution of AOP

- An association can be considered as a separate taxable entity (i.e., an APO), if it exhibits the various essential features:

1. Two or more persons must constitute it;
2. The constituent members must have come together for a common purpose;
3. The association must move by common action and there must be some scheme of common management; and
4. The cooperation and association amongst the constituent members must not be perfunctory and/or merely in form. The association amongst members must be real and substantial, which is sufficient to treat the association as a separate homogenous taxable entity.

- Linde and Samsung had joined hands to bid for the contract in the form of a consortium; however, they were independent of each other and were responsible for their own deliverables under the contract, without reference to each other.
- The fact that Linde and Samsung agreed to be jointly and severally liable for due performance of the contract only indicated that they had accepted a contractual obligation towards a third party; the same would not by itself lead to a conclusion that the said members had formed an AOP.
- For applicability of an AOP, it is necessary that they should form a joint enterprise with a greater level of common management. Mere obligation to exchange information between independent agencies, for coordinating their independent tasks, would not result in an AOP.

On issue of taxability in India

- The contractual obligations of Linde were not limited to merely supplying equipment, but were for due performance of the entire contract. This would not necessarily imply that the entire income that was relatable to the contract could be deemed to have accrued or arisen in India.
- Merely because a project was a turnkey project would not necessarily imply that for the purposes of taxability, the entire contract had to be considered as an integrated one.
- In the facts of the present case, where the equipment and material were manufactured and procured outside India, the income attributable to the supply thereof could only be brought to tax if it was found that the said income arose through or from a business connection in India. However, in view of the decision of the Supreme Court in Ishikawajima-Harima Heavy Industries, it could not be concluded that the contract provided a 'business connection' in India and, accordingly, the offshore supplies could not be brought to tax under the Act.

EDITORIAL COMMENT

This is a landmark judgement of the Delhi High Court on the issue of whether a consortium constitutes an AOP or not. The Authority for Advance Ruling in the recent past had taken a stand that consortium leads to a formation of an AOP in India and as a result, the entire income including offshore supplies would get taxed in India. This decision reiterates that for the purpose of taxing the income in India; only the income attributable to the operations carried out in India is to be considered for the purposes of taxation in India.

Maersk Global Centres India Pvt. Ltd. v. ACIT

[2014] 161 TTJ 137 Mumbai

Contributed by Padmini Khare (top right) & Ravi Onkar (bottom right), B. K. Khare & Co.

Companies rendering back office support services cannot be classified into low-end business process outsourcing, (BPO) and high-end knowledge process outsourcing (KPO) services for comparability analysis but have to be classified based on the functions performed

Facts of the case

The taxpayer, an Indian company ('the Company') is a wholly owned subsidiary of Maersk GSC Holdings A/S. It is engaged in the business of shared service centre and rendered transaction processing, data entry, reconciliation of statements, audit of shipping documents and other similar support services. It also rendered other IT services such as process support, process optimisation and technical support services.

The Company applied Transactional Net Margin Method (TNMM) for determining the arm's length price (ALP) of the international transactions. The Company claimed that it is basically rendering low-end back office support services and therefore, selected the companies in the BPO sector as per set of comparables.

The Transfer Pricing Officer (TPO) rejected the transfer pricing study report submitted by the Company treating the same as unreliable and incorrect. The TPO, after analysing the nature of services provided by the Company, held that the services rendered by the Company are in the nature of knowledge process outsourcing (KPO) services, not low-end services. He accordingly rejected 12 out of 13 comparables selected by the Company since they were not in the KPO sector. After applying other filters, the TPO selected only one comparable as suggested by the Company and added six other comparables of his own. The TPO proposed a transfer pricing adjustment of Rs. 343.80 million on back office support services.

The Company had also rendered certain IT services to its associated enterprises (AEs). The TPO held that the same were in the nature of information technology-enabled services (ITES) and therefore, adopting the same basis and methodology, he finalised a set of 23 companies and proposed a transfer pricing adjustment of Rs. 11 million.

Aggrieved by the transfer pricing adjustments proposed by the TPO, the Company filed an objection before the Dispute Resolution Panel (DRP). During the DRP proceedings, the Company contended that it is engaged in providing low-end back office support services and not a high-end KPO. The Company's objections were partly considered by the DRP, in the light of functions performed, qualification and pay profile of the workforce employed by it. The DRP held that the Company could not be considered as a low-end service provider in the BPO sector or as a KPO at the high end of the spectrum. The taxpayer had also objected before the DRP on inclusion of certain comparables proposed by the TPO with high profitability. This objection of the Company was accepted by the DRP, observing that high and low margins both reflect the industry profitability, especially when they are acceptable on functional similarity.

- Against the aforesaid order of the DRP, the Company preferred an appeal before the Tribunal, who constituted the special bench to adjudicate the following two issues:
  1. Whether for the purpose of determining the ALP of international transactions of the Company, companies providing back office support services to their overseas associated enterprises and those performing KPO functions should be considered as comparable
  2. Whether, in the facts of the Company's case, companies earning abnormally high profit margins should be included in the list of comparable cases for the purpose of determining the ALP of an international transaction.

Contention of the Company

The Company placed reliance on the report of the National Skill Development Corporation (NSDC) on

Continued over

Human Resource and Skill Requirements in the IT and ITES Industry Sector and explained the basic and fundamental differences in the characteristics of BPO as compared to KPO. The Company further explained that services provided in KPO segment are high-end services for which the skill set required is entirely different from that required in BPO. No domain knowledge is required to render BPO services, whereas it is very much required to render KPO services.

The Central Board of Direct Taxes (CBDT), has introduced safe harbour rules that also recognise the distinction between KPO and BPO services. According to the Company, the services provided are akin to back office support services, i.e. BPO as contemplated in the said rules.

The taxpayer relied on the OECD guidelines, issued in July 2010, which explain the comparability standards to be applied when the transactional net margin method (TNMM) is used. The guidelines further explain that determining a reliable estimate of arm's length outcome requires flexibility and exercise of good judgment. A reasonable, and practical approach is expected to be adopted in order to ensure that the TNMM can afford a practical solution to otherwise insoluble transfer pricing problems.

On the second issue, the Company placed reliance on various judicial precedents, wherein the Tribunal had observed that comparable earnings from super-normal/abnormal profit companies should be excluded.

Contention of the Revenue

The activities of the Company lie somewhere between BPO and KPO. The taxpayer has itself selected BPO as well as KPO as comparables in its transfer pricing study, as the services rendered by it have some attributes of KPO.

The safe harbour rules are applicable to those taxpayers who exercise a valid option for application of safe harbour rules. The Company in the present case has not exercised the option; therefore, the safe harbour rules cannot be applied to it.

As there is a thin line of difference between BPO and KPO services, there is no need to make any distinction between BPO and KPO. The broad category of information technology enabled services (ITES), can be taken for the purpose of comparability analysis under TNMM.

On the issue of inclusion of high-margin companies, the income tax authorities contended that the Indian regulations adopt arithmetic means to work out the average profit margin of the comparables. The Indian regulation has recognised the extreme values for comparability and arithmetic mean is used as a measure of central tendency. Thus, merely because a company is earning abnormal profit, the same should not be rejected if it is otherwise comparable. The income tax authorities also relied on various judicial precedents backing its argument.

Decision of the Special Bench

On BPO v. KPO and transfer pricing methodology

- Even though there appears to be a difference between the services rendered by BPO and KPO, the line of difference is very thin. BPO services are generally referred to as the low-end services, while KPO services are referred to as high-end services. The range of services rendered by the ITES sector is so wide that a classification of all services either as low or high-end is virtually impossible. Accordingly, ITES for the purpose of TP study cannot be further classified as BPO and KPO services for the comparability analysis.
- Under the TNMM, functional similarity is more relevant than product similarity. It is not an intention of the Tribunal to dilute the standards of comparability just because the TNMM was being used. It explained that the comparability exercise can be split into two steps in order to attain a relatively equal degree of comparability. The first step is to select a list of potential comparables at the ITES sector level by applying the broad functionality test; the second step is to select comparables from this list that undertake similar functions to those carried out by the Company, to ensure close comparability.
- The services referred by the Company as 'IT services', such as process support, process optimisation and technical support, are not in the nature of low-end services. They do require special knowledge and domain expertise. However, the revenue from these services constitutes only about 10% of the total revenue of the Company. Similarly, other services – such as custom services study, contract drafting, audit functions and tender handling – cannot strictly be considered as low-end services. These services are incidental to the main services rendered.

Continued over

On inclusion of comparables with high margins

- Abnormally high margins should trigger further investigation and if it is found that such high-margin companies do not satisfy the comparability test or do not reflect the normal business condition, the said comparable cannot be included. On the other hand, if such a high-margin comparable reflects normal business conditions, then it should not be rejected solely on the basis of such an abnormally high profit margin.

EDITORIAL COMMENT

The Special Bench ruling has certainly provided much-needed clarity on the classification of ITES into BPO and KPO services. It has upheld the core transfer pricing principle of functional comparability and suggested a two-step approach for selection of comparables. This approach has once again placed significant emphasis on the need for detailed functional analysis, not only of the taxpayer itself, but each and every potential comparable company independently and not relying on the broad classification. Now, it is extremely critical for taxpayers to perform genuine and in-depth analysis of comparable companies and the process followed to identify potential comparables should be transparent, systematic and verifiable.

The said ruling also addresses the controversy and divergent views on inclusion of abnormal high-margin companies and explained how to deal with such abnormal high-margin comparables.

Minister Finansow v. MDDP Sp Z 00 Akademia Biznesu Sp Komandytowa (MDDP)

Court of Justice of the European Union Case C-319/12

Contributed by Nigel Eastaway, MHA MacIntyre Hudson

Input tax exemption, not excluded, where the educational services were provided by an organisation, with a profit-seeking motive, if the objects of the private organisation were similar to those governed by public law.

Facts of the case

The Academy, which is incorporated in Poland, organises specialised training courses and conferences in the field of education/training, including accountancy, taxation, finance, and personal development. These services were provided on a commercial basis with a view to profit. It was not registered as a school or educational institution under Polish law.

The VAT Directive (EC Council Directive 2006/112, Article 132 (1)(i)) provided that member states are exempt from VAT regarding the provision of children/young people's schools or university education as vocational training for bodies governed by public law. This exemption included the supply of allied goods and services.

Contentions of taxpayer

The taxpayer wanted to recover input VAT, since it was a commercial organisation and subject to VAT on its purchases. However if the Academy's purchases were exempt, then the VAT could not be recovered. It claimed that the exemption was contrary to articles 132 (1)(i), 133 and 134 of the VAT Directive.

Contentions of VAT Authorities

The Finance Ministry disagreed. The Polish Supreme Administrative Court referred to the Court of Justice of the European Union (CJEU) the question of whether the VAT Directive should be interpreted as denying VAT exemption to educational businesses provided on a commercial basis by bodies not governed by public law and, if so, whether the exemption provided by Polish law was incompatible with the VAT Directive so that the Academy could deduct input tax. The complication was that the Academy claimed that treating inputs as exempt under Polish law was incompatible with the VAT directive, and that the VAT could be recovered but there would be no output tax, in accordance with Polish law. Submissions were made to the CJEU by Greece, Poland, Portugal and the UK.

Decision of Advocate General (AG)

The AG held that the existence of a profit-making motive cannot preclude the tax exemption from VAT. However, they do preclude those provisions being implemented in such a way that no conditions at all are imposed in the case of private organisations.

The AG held that asymmetrical reliance on the VAT Directive is not possible: it is impossible to argue that input tax is deductible but output tax is not payable. MDDP was trying to argue that the input tax was deductible because the Polish Law was contrary to the VAT Directive but output tax was not payable because of the Polish Law.

Decision of the Court

The judgement at the CJEU was that the input tax exemption was not excluded where the educational services were provided by an organisation with a profit-seeking motive if the objects of the private organisation were similar to those governed by public law. Where the objects are not similar, the exemption should not apply.

'It is a central principle of the VAT system that, the right to deduct VAT levied on the purchase of input goods or services, pre-supposes that the expenditure incurred in acquiring them was a component of the cost of the output transactions that gave right to deduct'; 'It follows (from the case law) that Article 168 of the VAT Directive does not permit a taxable person both to benefit from the exemption, and to exercise the right to deduct tax'. The supplies were exempt, not zero-rated.

Continued over

If the organisation's objects are not 'similar to those of an educational body governed by public law, which is to be determined by the national court, the educational supplies by that taxable person will be subject to VAT and that person could then benefit from the right to deduct input VAT'.

EDITORIAL COMMENT

The decision emphasises that if transactions are exempt from VAT, then VAT paid as import tax is an expense and cannot be recovered. Accordingly, the corresponding supplies will also be exempt, such that a mismatch is not allowed. However, the rate of the VAT on fully taxable inputs does not need to match that of the outputs, which could be subject to tax at a different rate applicable to the goods or services supplied.

GIMLE v. Belgian State (C-322/12), 3 October 2013
Bloomsbury v. Belgian State (C-510/2), 6 March 2014

Court of Justice of the European Union

Contributed by Jonas Derycke, Van Havermaet Groenweghe

The Court of Justice of the European Union (CJEU) recently held twice that the accounting principle of the 'true and fair view' always requires the valuation of assets at their acquisition (or production) cost and not at higher fair market value. As a result, the approach of the Belgian tax authorities is incompatible with the 4th EU Company Law Directive.

Facts of the case ('GIMLE')

In 1998, two Swedish residents established a Belgian holding company. The day after incorporation, one of the Swedish founders sold his shares in the Swedish industrial company to the Belgian holding company for SEK 5,000, an amount that is also accounted for in the Belgian accounting records as the purchase price. About 1 month later, the Belgian holding company sold the Swedish shares to another Swedish company for SEK 17 million (about 3,400 times more). The Belgian holding company considered the significant capital gain on shares as tax exempt by virtue of article 192 of the Belgian Income Tax Code (BITC). [Note that under current tax legislation, the capital gain would be taxed at a rate of 25.75% in the case of a minimum 1-year holding period not being met.]

Contention of the Revenue

The Belgian tax authorities (BTA) argued that the true and fair view requirement of accounting law imposes an obligation on the Belgian holding company to value the shares at their fair market value at the time of the acquisition of the shares. The difference between the low purchase value and the substantially higher real value of the shares constitutes a taxable profit. Hereto the BTA, as in many other similar cases (including the Artwork Systems case), referred to the true and fair view principle (as comprised in article 2 of the 4th EU Company Law Directive, which forms the basis for European accounting rules) as well as a (highly debated) standard no. 126/17 of the Belgian Accounting Standards Board. The BTA therefore held that the true and fair view principle obliges companies to account assets at their real value (and not purchase value) if the fair market value is evidently higher than the purchase value.

Decision of the Brussels Court of Appeal

The Belgian holding company took the matter to court. The Higher Court of Brussels confirmed the principle of the valuation of assets, at their historical acquisition price and held that the true and fair view of the financial accounts, can also be attained by providing additional information in the notes to the financial accounts, without requiring valuation at the real value.

On 1 June 2012, the Court issued a request to the CJEU, whether the 4th EU Company Law Directive requires the valuation at fair market value of assets at the time of their acquisition in case the acquisition cost clearly does not reflect their real value, rather than simply to provide additional information in the notes to the annual accounts.

Decision of the European Court of Justice

The CJEU held on 3 October 2013 that the Directive does not allow a deviation from the principle of the valuation at acquisition price, even when it is manifestly lower than the real value.

- Guidance must be found, as far as possible, in the general rules listed in article 31 of the Directive – in particular the '*prudency principle*', which requires that only profits made at balance sheet date may be included in the annual accounts. If not, this would lead to the recognition of a profit that has not been made at balance sheet date.
- It is allowed to deviate from the Directive's provisions in exceptional cases where the application of a provision is incompatible with the true and fair view requirement. However, the undervaluation of assets as a result of the valuation at the historical acquisition cost in itself cannot be considered as such an exceptional case. This merely

Continued over

reflects the choice of the European legislator for the valuation of assets at historical cost price.

- The Court confirms that this conclusion may have an impact for tax purposes, in particular for countries that rely on annual accounts for the determination of the taxable profit. However, the Court reminds that the Directive does not preclude the member states to provide in deviating tax law for corrections to the effects of accounting regulations.

Confirmation by the European Court of Justice

On 6 March 2014, the Court confirmed this conclusion in a second case *(Bloomsbury v. Belgian State* C-510/2*)* of a gratuitous acquisition of shares ('for free'). As a result, no distinction is to be made between acquisitions at a manifestly lower price than the real market value and gratuitous acquisitions. Both should be accounted for at historical purchase price (nil, in the case at hand).

EDITORIAL COMMENT

Many non-resident individuals (mostly Scandinavians) tried to follow the above Belgian holding route in order to avoid local capital gains tax in their country of residence, but encountered the BTA on their way, with variable success depending on the exact pattern of facts.

These European Court judgments now provide certainty for both taxpayers and tax practitioners. Whenever assets are acquired at a price lower than their fair market value (or even gratuitously), valuation should always occur at historical cost, even when there are gratuitous motives for the transfer of the assets. Consequently, no (taxable) accounting profit may be recorded at the moment of the acquisition. It is anticipated that the BTA will soon align their position with this CJEU decision. In the meantime, the Belgian Accounting Standards Board has already erased their advice no. 126/17 from their website.

It should, however, be emphasised, that these judgments do not prevent the Belgian nor foreign tax authorities from challenging these types of transaction on other legal grounds, such as anti-abuse measures (e.g. if the transaction has only tax motives, and insufficient valid business reasons can be demonstrated) as well as failure to meet substance requirements.