

ELECTIVE PAPER 6C: INTERNATIONAL TAXATION

SOLUTION TO CASE STUDY 5

I. ANSWERS TO MCQs (Most appropriate answers)

1. (c)
2. (b)
3. (b)
4. (d)
5. (d)
6. (b)
7. (b)
8. (a)
9. (c)
10. (b)

II. ANSWERS TO DESCRIPTIVE QUESTIONS

Answer to Q.1:

First stage: Professionals have been hired in India for preparing a report over a period of two months. Based on the contents of the report, it is possible to take a view that the work done by the professionals is merely preparatory and auxiliary in nature. Once the activities are preparatory and auxiliary in nature, the activities cannot be classified as triggering a PE implication for Athena Ltd. in India as per Article 5(4) of the India-Country A DTAA. In any case, at this stage, there is no revenue generation to trigger the concept of PE.

Second stage: Article 5(6) of the DTAA with Country A does not expressly provide for exclusivity of relationship with the principal as a test of agent's dependence. However, "exclusive" relationship with the principal is a relevant factor, although not entirely determinative, in ascertaining an agent's independence. In this case, considering that Shyam is an agent exclusively for Athena Ltd., it is possible to take a view that he is a dependent agent. As per Article 5(5) of the DTAA with Country A, a dependent agent in India would constitute a PE for Athena Ltd. only if it is shown that he has the authority to conclude contracts in the name of Athena Ltd. In this case, it can be seen that the role of the agent does not extend to concluding contracts on behalf of the principal. Here, the agent can only engage in preliminary negotiations with the final say being reserved exclusively for Athena Ltd. alone. Further, he has to identify potential customers and sell the products at the initial offer price which is also decided by the Board of Athena Ltd. Due to these reasons, the agent in India does not constitute a PE for Athena Ltd.

Third stage: The traditional meaning and understanding of a fixed place PE connotes a physical space which is at the disposal of the non-resident enterprise and through which the latter conducts its business. With respect to a website, it has been held that it is merely a software. In the absence of the server supporting the website being located in India (here, it is in Cayman Islands), there can be no PE liability for Athena Ltd. The server, through which business is carried on, is located in Cayman Islands, a no tax jurisdiction, and not in India.

Furthermore, a warehouse in India would not constitute a PE as per Article 5(4) of the India-Country A DTAA.

Fourth stage – In this stage, Athena Ltd. sets up a branch in Mumbai, which constitutes a PE in India as per Article 5(1)/(2) of the India-Country A DTAA. Accordingly, profits of Athena Ltd. as are attributable to the PE in India would be liable to tax in India.

Answer to Q.2(a):

- (i) The rise of e-commerce has led to an emergence of digital economy. Physical locations of the servers of such digital businesses were considered to establish the tax jurisdiction in which the profits of digital businesses could be taxed. Servers were, therefore, placed in tax efficient jurisdictions, even though the main income generation and customers were from other jurisdictions.

In the third stage, the business in India is to be carried on through the website hosted on the server located in Cayman islands, which is a no tax jurisdiction. In fact, the server located in Cayman islands carries on the entire set of operations. A website consists of data and programmes in digitised form which is stored on a server of the internet service provider. On the other hand, a permanent establishment, as the name itself suggests, is a fixed place of some permanence from where a business is carried on. Therefore, existence of a website in India would not constitute a permanent establishment.

However, the server is a system which carries out activities initiated by an end-user's computer. In this case, Athena Ltd. itself owns and operates the server and the business is carried on through the server, it could be construed to be a permanent establishment. However, the server is located in Cayman islands, which is a no tax jurisdiction. Location of the server owned and operated by Athena Ltd., which constitutes a PE in

this case, in a no tax jurisdiction may be viewed as a strategy adopted by Athena Ltd. to avoid tax in India, considering the fact that Athena Ltd. is a Country A based company, its Board of Directors are residents of Country B and it wishes to expand its market in India. However, it has chosen to locate the server through which it carries on business in a fourth place, namely, Cayman islands, which is a no tax jurisdiction. This may be viewed as a strategy adopted by Athena Ltd. to avoid tax in India in the third stage.

- (ii) Owing to the 'intangibility' attached to the digital model of business, tax authorities often face challenges in rightly bringing to tax the profits earned from a digital business.

Action Plan 1 of the BEPS project was developed by the OECD which outlines the methods and principles based on which physical and digital economies can be taxed at par.

The OECD recommends the following options to address the challenges of the digital economy -

- Modifying the existing Permanent Establishment (PE) rule to provide whether an enterprise engaged in fully de-materialized digital activities would constitute a PE, if it maintained a significant digital presence in another country's economy.
- A virtual fixed place of business PE in the concept of PE i.e., creation of a PE when the enterprise maintains a website on a server of another enterprise located in a jurisdiction and carries on business through that website
- Imposition of a final withholding tax on certain payments for digital goods or services provided by a foreign e-commerce provider or imposition of a equalisation levy on consideration for certain digital transactions received by a non-resident from a resident or from a non-resident having PE in other contracting state.

Answer to Q.2(b)

The process of determination of POEM is primarily based on the fact as to whether or not the company is engaged in active business outside India.

A company shall be said to be engaged in "active business outside India"

- if the passive income is not more than 50% of its total income; **and**
- less than 50% of its total assets are situated in India; **and**
- less than 50% of total number of employees are situated in India or are resident in India; **and**
- the payroll expenses incurred on such employees is less than 50% of its total payroll expenditure.

Passive income is the aggregate of, -

- (i) income from the transactions where both the purchase and sale of goods is from/to its associated enterprises; and
- (ii) income by way of royalty, dividend, capital gains, interest or rental income;

(1)	(2)	(3)	(4)	(5)	(6)
Particulars	Country A	Country B	India	Total	% of (4) to total in (5)
Value of assets	Rs.400 lakhs	Rs.100 lakhs	Rs.210 lakhs	Rs.710 lakhs	29.58%
Number of employees	30	10	20	60	33.33%
Payroll expenses on employees	Rs.160 lakhs	Rs.35 lakhs	Rs.65 lakhs	260	25.00%

It can be seen that the value of assets in India is only 29.58% of the total assets of the company, the number of employees in India is only 33.33% of the total number of employees and the payroll expenses incurred on such employees is only 25% of its total payroll expenditure. Thus, three out of four conditions for active business outside India are met. However, the passive income test has also to be met for active business to be outside India.

Passive income = income from transactions where both purchases and sales are from/to associated enterprises + total income by way of dividend and interest = Rs.110 lakhs + Rs.35 lakhs = Rs.145 lakhs

Percentage of passive income to total income = $145/250 \times 100 = 58\%$

In this case, the passive income is more than 50% of the company's total income. Hence, the passive income test has failed, consequent to which the company cannot be said to have active business outside India.

Answer to Q.3:

- (a) Equalisation levy@6% is attracted on the amount of consideration for specified services received or receivable by a non-resident not having PE in India from a resident in India who carries on business or profession or from a non-resident having PE in India. Specified services include online advertisement and any provision for digital advertising space or any other facility or service for the purpose of online advertisement.

In this case, Google Inc is a non-resident not having PE in India. It receives consideration of Rs.30 lakhs from Athena Ltd., a non-resident having PE in India, for online advertisement services provided by it. Hence, equalization levy@6% on Rs.30 lakhs is attracted in the hands of Google Inc.

In the hands of Athena Ltd., the amount of Rs.30 lakhs paid to Google Inc. would be allowable as business expenditure, provided equalization levy has been deducted at source.

- (b) Athena Ltd. is liable to deduct equalization levy of Rs.1.80 lakhs from the amount of Rs.30 lakhs payable to Google Inc. In case it fails to so deduct equalization levy, it shall, notwithstanding such failure, be liable to pay the levy to the credit of the Central Government by 7th April, 2018. Further, penalty of an amount equal to Rs.1.80 lakhs would be attracted for failure to deduct equalization levy. Also, disallowance of the expenditure of Rs.30 lakhs would be attracted under section 40(a)(ib) while computing business income of Athena Ltd.
- (c) Section 10(50) of the Income-tax Act, 1961 exempts income arising from providing specified service of online advertisement, which are subject to equalization levy, from income-tax.