SUGGESTED SOLUTION

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ANS.1.A)

As per Explanation 2A to section 9(1)(i), "significant economic presence" of a nonresident in India shall constitute "business connection" for attracting deemed accrual provisions in India.

"Significant Economic Presence" means-

(a) transaction in respect of any goods, services or property carried out by a non- resident in India including provision of download of data or software in India, if the aggregate of payments arising from such transaction or transactions during the previous year exceeds the prescribed amount; or

(b) systematic and continuous soliciting of business activities or engaging in interaction with such prescribed number of users in India through digital means. Further, the above transactions or activities shall constitute significant economic presence in India, whether or not,—

(i) the agreement for such transactions or activities is entered in India;

(ii) the non-resident has a residence or place of business in India; or

(iii) the non-resident renders services in India:

However, where a business connection is established by reason of significant economic presence in India, only so much of income as is attributable to the transactions or activities referred to in (a) or (b) above shall be deemed to accrue or arise in India.

This provision has been inserted in the Income-tax Act, 1961 in line with "BEPS Action Plan 1 Addressing the challenges of the digital economy" to take care of new business models such as digitized businesses, which do not require physical presence of itself or any agent in India. Such businesses can now be covered within the scope of section 9(1)(i). **(6 marks)**

ANS.1.B)

(i) Provision of scientific research services falls within the scope of international transaction under section 92B. Research & Co. and B Inc. are deemed to be associated enterprises as per section 92A(2), since B Inc. guarantees not less than 10% of the total borrowings of Research & Co. Since there is an international transaction between associated enterprises, transfer pricing provisions are attracted in this case.

(ii) Where the Assessing Officer has made a primary adjustment of ‘ 225 lakhs to the transfer price and the same has been accepted by Research & Co., secondary adjustment has to be made in the books of account. The excess money determined based on the primary adjustment has to be repatriated to India within 90 days from the date of order, failing which the same would be deemed as an advance and interest would be attracted at the one year marginal cost of fund lending rate of State Bank of India as on 1.4.2018 + 3.25%, since the international transaction has been denominated in Indian Rupees. In this case, since the excess money has not been repatriated within 90 days, the same would be deemed to be an advance made by Research & Co. to B Inc. and interest would be attracted @ 11.40% (8.15% + 3.25%). **(4 Marks)**

ANS.2.A)

Business profits of an enterprise can only be taxed by the Residence State. Right of Source State to tax business profits of an enterprise only arises if it carries on business through a Permanent Establishment (PE) situated in that State.

As per the approach under the OECD Model Convention, once a PE is proven, the Source State can tax only such profits as are attributable to the PE. The UN Model Convention amplifies this attribution principle by a <u>limited</u> Force of Attraction rule (FOA). The FOA rule implies that when a foreign enterprise sets up a PE in State of Source, it brings itself within the fiscal jurisdiction of that State (State of Source) to such a degree that profits that the enterprise derives from Source State of Source, whether through the PE or not, can be taxed by it (State of Source State).

As per Artic le 7 of the UN Model Convention, if the enterprise carries on business in the other Contracting State through a PE, the profits of the enterprise may be taxed in the other State but only so much of them as is attributable to:

(a) that PE;

(b) sales in that other State of goods or merchandise of the same or similar kind as those sold through that PE; or

(c) other business activities carried on in that other State of the same or similar kind as those effected through that PE. **(4 Marks)**

ANS.2.B)

(i) The issue under consideration in this case is whether consideration for supply of software embedded in hardware would tantamount to „royalty for attracting deemed accrual of income under section 9(1)(vi).

As per section 9(1)(vi), income by way of royalty payable by a person who is a non-resident would be deemed to accrue or arise in India, where the royalty is payable in respect of any right, property or information used or services utilized for the purposes of a business or profession carried on by such person in India or for the purposes of making or earning any income from any source in India.

For this purpose, „royalty includes transfer of all or any right for use or right to use a computer software irrespective of the medium through which such right is transferred.

The facts of the case are similar to the facts in CIT v. Alcatel Lucent Canada (2015) 372 ITR 476, wherein the above issue came up before the Delhi High Court. The Court observed that the software supply is an integral part of GSM mobile telephone system and is used by the cellular operators for providing cellular services to its customers. Where payment is made for hardware in which the software is embedded and the software does not have independent functional existence, no amount could be attributed as „royalty for software in terms of section 9(1)(vi).

In this case, since the software that was loaded on the hardware and embedded in the system does not have any independent existence, there could not be any independent use of such software. Therefore, the rationale of the Delhi High Court ruling can be applied to the case on hand. Accordingly, the action of the Assessing Officer in treating the consideration for supply of software embedded in hardware as royalty under section 9(1)(vi) is **not** correct. **(4 Marks)**

(ii) The Calcutta High Court in Indcom v. CIT (TDS)(2011) 335 ITR 485 has held that „match referee would not fall within the meaning of "sportsmen" to attract the provisions of section 115BBA. Therefore, although the payments made to non-resident „match referee are "income" which has accrued and arisen in India, the same are not taxable under the provisions of section 115BBA. They are subject to the normal rates of tax.

Particulars		**Rs.**
Tax@30% under section 115BB on winnings of Rs.25,000 from horse races		7,500
Tax on Rs.9,60,000 at the rates in force		
Upto Rs. 2,50,000	Nil	
2,50,001 – 5,00,000 @5%	12,500	
5,00,001 – 9,60,000 @ 20%	92,000	1,04,500
		1,12,000
Add: Health and Education cess @4%		4,480
Tax payable		**1,16,480**

(2 Marks)

ANS.3.A)

The above arrangement of splitting the investment through two subsidiaries appears to be with the intention of obtaining tax benefit under the treaty. Further, there appears to be no commercial substance in creating two subsidiaries as they do not change the economic condition of investor X Ltd. in any manner (i.e. on business risks or cash flow), and reveals a tainted element of abuse of tax laws. Hence, the arrangement can be treated as an impermissible avoidance arrangement by invoking GAAR. Consequently, treaty benefit would be denied by ignoring L Ltd. and M Ltd., the two subsidiaries, or by treating L Ltd. and M Ltd. as one and the same company for tax computation purposes. **(4 Marks)**

ANS.3.B)

(i) Principle of Contemporanea Expositio

A treatys terms are normally to be interpreted on the basis of their meaning at the time the treaty was concluded. However, this is not a universal principle.

In Abdul Razak A. Meman's (2005) 276 ITR 306, the AAR observed that "there can be little doubt that while interpreting treaties, regard should be had to material contemporanea expositio. This proposition is embodied in article 32 of the Vienna Convention and is also referred to in the decision of the Honble Supreme Court in K. P. Varghese v. ITO [1981] 131 ITR 597. **(3 Marks)**

(ii) Teleological Interpretation

In this approach the treaty is to be interpreted so as to facilitate the attainment of the aims and objectives of the treaty. This approach is also known as the „objects and purpose method.

In case of Union of India v. Azadi Bachao Andolan 263 ITR 706, the Supreme Court observed that "the principles adopted for interpretation of treaties are not the same as those in interpretation of statutory legislation. The interpretation of provisions of an international treaty, including one for double taxation relief, is that the treaties are entered into at a political level and have several considerations as their bases."

One instance is where the Apex Court agreed with the contention of the Appellant that "the preamble to the Indo-Mauritius DTAA recites that it is for „encouragement of mutual trade and investment and this aspect of the matter cannot be lost sight of while interpreting the treaty. **(3 Marks)**

ANS.4.A)

These new business models have created new tax challenges. The typical taxation issues relating to e-commerce are:

(1) the difficulty in characterizing the nature of payment and establishing a nexus or link between taxable transaction, activity and a taxing jurisdiction,

(2) the difficulty of locating the transaction, activity and identifying the taxpayer for income tax purposes.

The digital business, thus, challenges physical presence-based permanent establishment rules. If permanent establishment principles are to remain effective in the new economy, the fundamental PE components developed for the old economy i.e. place of business, location, and permanency must be reconciled with the new digital reality. **(4 Marks)**

ANS.4.B)

In case the Assessing Officer makes adjustment to arm's length price in an international transaction which results in increase in taxable income of the assessee, the following consequences shall follow:-

(1) No deduction under section 10AA or Chapter VI-A shall be allowed from the income so increased.

(2) No corresponding adjustment would be made to the total income of the other associated enterprise (in respect of payment made by the assessee from which tax has been deducted or is deductible at source) on account of increase in the total income of the assessee on the basis of the arm's length price so recomputed.

The remedies available to the assessee to dispute such an adjustment are:-

(1) In case the assessee is an eligible assessee under section 144C, he can file his objections to the variation made in the income within 30 days [of the receipt of draft order by him] to the Dispute Resolution Panel and Assessing Officer. Appeal against the order of the Assessing Officer in pursuance of the directions of the Dispute Resolution Panel can be made to the Income-tax Appellate Tribunal.

(2) In any other case, he can file an appeal under section 246A to the Commissioner (Appeals) against the order of the Assessing Officer within 30 days of the date of service of notice of demand.

(3) The assessee can opt to file an application for revision of order of the Assessing Officer under section 264 within one year from the date on which the order sought to be revised is communicated, provided the time limit for appeal to the Commissioner (Appeals) or the Income-tax Appellate Tribunal has expired or the assessee has waived the right of such an appeal. The eligibility conditions stipulated in section 264 should be fulfilled. **(6 Marks)**

Q.5)

1) d

2) a

3) a

4) c

5) a

6) a

7) b

8) b