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Holding Companies – Key trends and substance requirements

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Tax morality vs. Tax legality

Parameters	Whether legal?	Whether moral?
Tax planning	☐	☐
Tax avoidance	☐	✗
Tax evasion	✗	✗
Aggressive tax planning	☐	Depends

Organization of Economic Co-operation and Development ('OECD') - Glossary of tax terms:

- Tax planning; Arrangement of a person's business and /or private affairs in order to minimize tax liability;
- Tax avoidance; arrangement of a taxpayer's affairs that is intended to reduce his tax liability and that although the arrangement could be strictly legal it is usually in contradiction with the intent of the law it purports to follow. Cf. evasion;
- Tax evasion; illegal arrangements where liability to tax is hidden or ignored, i.e. the taxpayer pays less tax than he is legally obligated to pay by hiding income or information from the tax authorities.

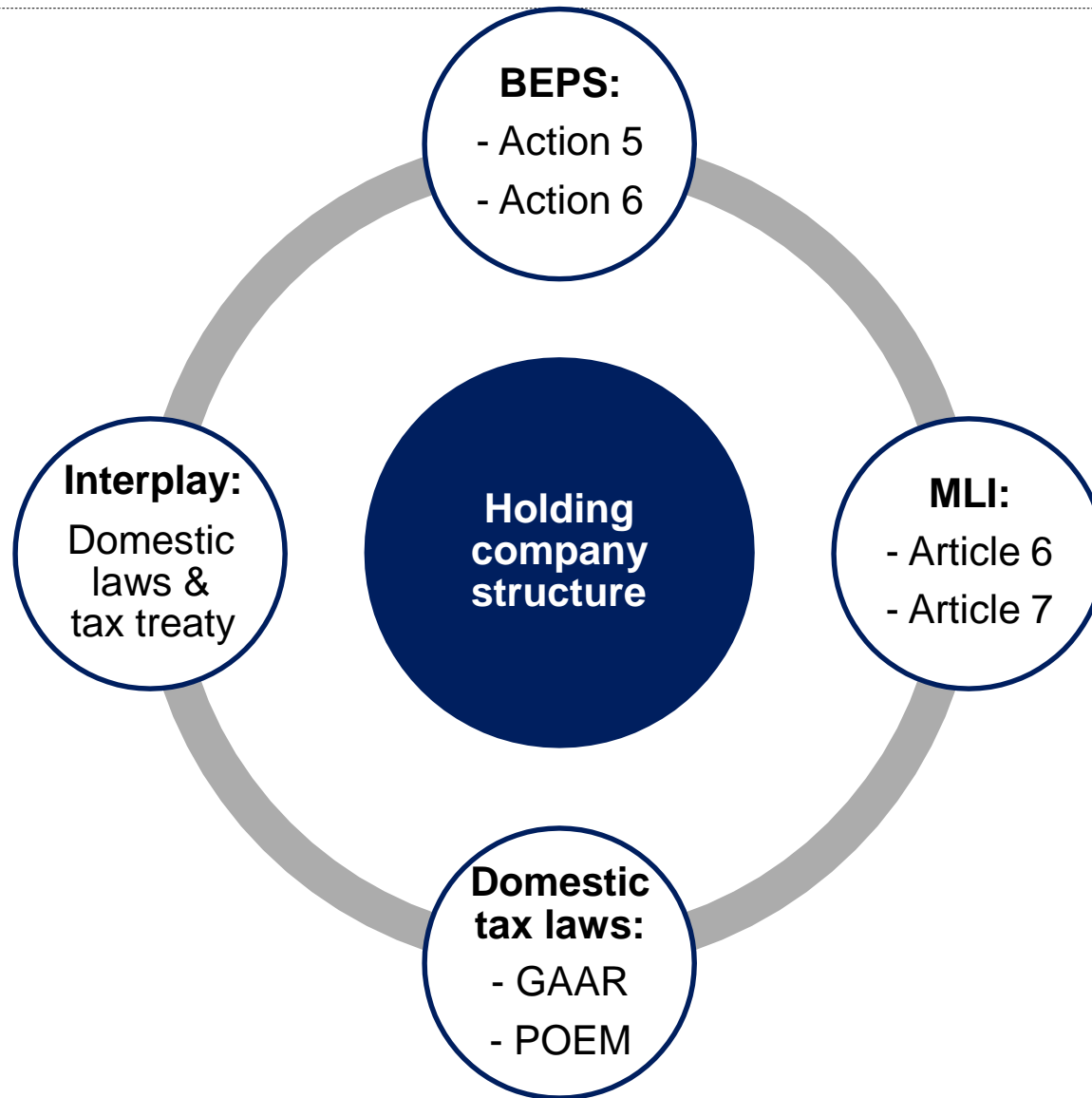
Concept of substance over form

- An age-old concept in tax laws;
- Consideration to real purpose / intention of the transaction;
- Definition as per Black's Law Dictionary:

Term	Meaning
Substance	<i>The essence of something; the essential quality of something as compared to form</i>
Form	<i>The out shape or structure of something as distinguished from its substance or matter</i>

- Prevalence of economic or social reality over the literal wording of legal provisions.

Relevance of substance for holding company structures



Base Erosion and Profit Shifting measures

Base Erosion and Profit Shifting ('BEPS')

- Tax planning strategies that intend to exploit gaps and mismatches in tax laws to shift profits to a low / no tax jurisdiction;
- Measure to tackle BEPS – OECD & G20 released 15 action plans in year 2015;
- Three key pillars of BEPS:
 - **Introducing coherence** in domestic rules that affect cross border activities
 - **Reinforcing substance** requirements in the existing international standards
 - **Improving transparency** as well as certainty
- BEPS minimum standards:

Action 5
Harmful tax practices

Action 6
Prevention of treaty abuse

Action 13
Country-by-Country Reporting

Action 14
Mutual Agreement Procedure

15 actions built on 3 pillars



15 Actions around 3 Main Pillars

Coherence

Hybrid financial
Arrangements (2)

CFC Rules (3)

Interest
Deductions (4)

Harmful
Practices (5)

Substance

Preventing Tax Treaty
Abuse (6)

Avoidance of
PE Status (7)

TP Aspects of Intangibles
(8)

TP Risks and
Capital (9)

TP High Risk
Transactions (10)

Digital Economy (1)

Multilateral Instrument (IS)

Transparency and Certainty

Measuring BEPS (11)

Disclosure
Rules (12)

IP Documentation
(13)

Dispute
Resolution (14)

Source: <https://www.slideshare.net/OECDtax/beps-webcast-8-launch-of-the-2015-final-reports>

Action 5: Harmful tax practices

- Comprises of work three key areas:

Assessment of
preferential tax
regimes

Transparency
framework

Substantial
activity
requirement

- Preferential tax regime; taxpayer intends to get taxed in a country (say no or low tax jurisdiction) instead of the country where actual activity has taken place;
- Provides for two approaches :
 - substantial activity for any preferential regime; and
 - improvising transparency in relation to ruling.
- Provides for methodologies to arrive at substantial activities with respect to IP regimes; value creation approach, transfer pricing approach and nexus approach;

Action 5: Harmful tax practices (Cont...)

- Substantial activity for non-IP regime:

Headquarters

Distribution and
service centre

Financing and
leasing

Fund
management
services

Banking and
insurance

Shipping

Holding
company

Action 5: Harmful tax practices (Cont...)

- **Holding company regime:**

Type of holding company	Meaning
Holding equity participation; earns only dividend and capital gains income	<ul style="list-style-type: none"> • At least require the companies to adhere to corporate law filing; • Encourage to have substance into holding investments; • Should have human resource and premises; help mitigate possibility of 'letter box' companies benefiting from such regime.
Hold variety of assets and earn different types of incomes - interest, royalty, rent, etc.	<p>Interest or rental income:</p> <ul style="list-style-type: none"> • Core income-generating activities could be – agreeing terms, identifying and acquiring assets to be leased, setting the terms / duration of the agreement; <p>Royalty income:</p> <ul style="list-style-type: none"> • Engage in actual activities and incurred actual expenditure.

Action 6: Prevention of Treaty abuse

- Intends to address Treaty shopping arrangements;
- Recognizes that interpretative rules such as economic substance, substance over form, etc. – adopted by various countries to address abuse of domestic laws as well as Treaties;
- Requires jurisdictions to include two elements in their tax Treaties:

Principal purpose test ('PPT') only; or

Preamble to include an
express statement on non-
taxation



PPT and simplified or detailed LOB; or

A detailed LOB provision supplemented by
anti-conduit rule

Multilateral Instrument

Multilateral Instrument ('MLI')

- Designed to ensure swift implementation of tax treaty related measures arising from BEPS project
- MLI modifies the operation of existing tax treaties between parties -
 - None of the bilateral double tax treaties will actually be amended;
 - MLI will have to be read along with tax treaty.
- Part III of MLI deals with treaty abuse – includes minimum standards (Article 6 & 7);
- **Article 6: Purpose of a Covered Tax Agreement** - Covered tax agreements to be modified to include the following preamble text:

“Intending to eliminate double taxation with respect to the taxes covered by this agreement without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance (including through treaty-shopping arrangements aimed at obtaining reliefs provided in this agreement for the indirect benefit of residents of third jurisdictions).”

MLI (Cont...)

- **Article 7: Prevention of treaty abuse**
 - PPT being minimum standard under Action 6 – provided as default option.
 - Article 7(1) of the MLI provides as under:

“Notwithstanding any provisions of a Covered Tax Agreement, a benefit under the Covered Tax Agreement shall not be granted in respect of an item of income or capital if it is reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining that benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit, unless it is established that granting that benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of the Covered Tax Agreement”

Under MLI, India along with PPT has opted for simplified LOB provisions.

Indian domestic tax measures

Indian domestic tax measures

- Place of Effective Management provisions introduced; Applicable from April 1, 2016;
- General Anti-Avoidance Rule introduced vide Finance Act, 2012;
- MLI:

Particulars	Period / date
India deposited the ratified instrument with OECD depository	June 25, 2019
Date of entry into force (first day following the expiry of period of three calendar months from the date of deposit)	October 1, 2019
Date of entry into effect with respect to 22 treaty partners who deposited the ratified instrument on or before June 30, 2019 (withholding tax and all other tax purposes)	Financial year 2020 – 21 onwards

Source <https://pib.gov.in/newsite/PrintRelease.aspx?relid=191125>:

- Preamble of Indian CTAs to stand modified in line with Article 6(1) of the MLI;
- Along with PPT, India has opted for SLOB.

Residence of a foreign company - *Place of effective management ('POEM') provisions*

- As per section 6 of the Income Tax Act, 1961 ('the Act'), company said to be resident in India if:
 - It is an Indian Company;
 - It's place of effective management is in India.
- POEM; a place where key management and commercial decisions that are necessary for the conduct of the business of an entity as a whole are, in substance **made**;

Residence of a foreign company - *POEM provisions (Cont...)*

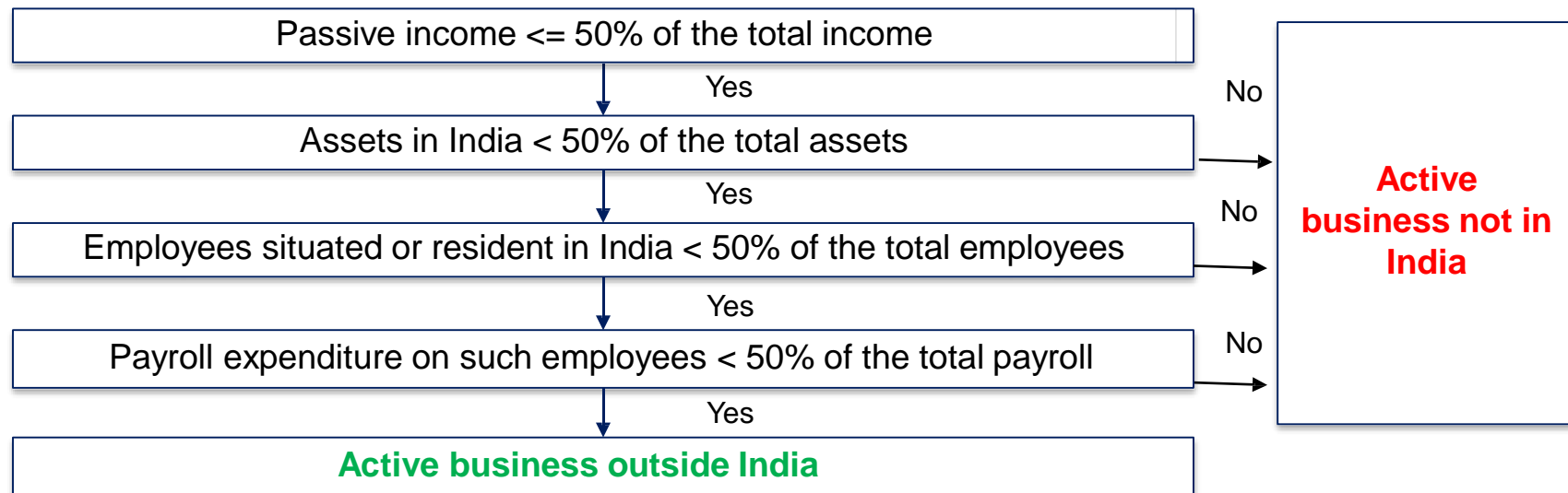
Relevant Terms	Meaning
Key	Key personnel who actually manage the company ought to be considered.
Management decisions	Place from where important management decisions are taken is to be considered.
Commercial decisions	Place where the key management takes important commercial decisions is the place where POEM is situated.
Conduct of the business of an entity as a whole	Different offices of an entity taking commercial and operational decisions restricted to its own area of work shall not determine POEM.
In substance	Actual, real decision making supported by conduct as against mere recording of them in documents.

- CBDT Circular 6 of 2017, dated January 24, 2017 – provides for guiding principles to determine POEM;
- The process of determining POEM would depend on the place where the company is engaged in 'active business' and conduct of the Board of the entity;

Residence of a foreign company - POEM provisions (Cont...)

In case engaged	POEM implications
In 'active business outside India'	POEM presumed to be outside India – if majority of board meetings held outside India
In 'active business in India'	Further tests given in guiding principles to be tested

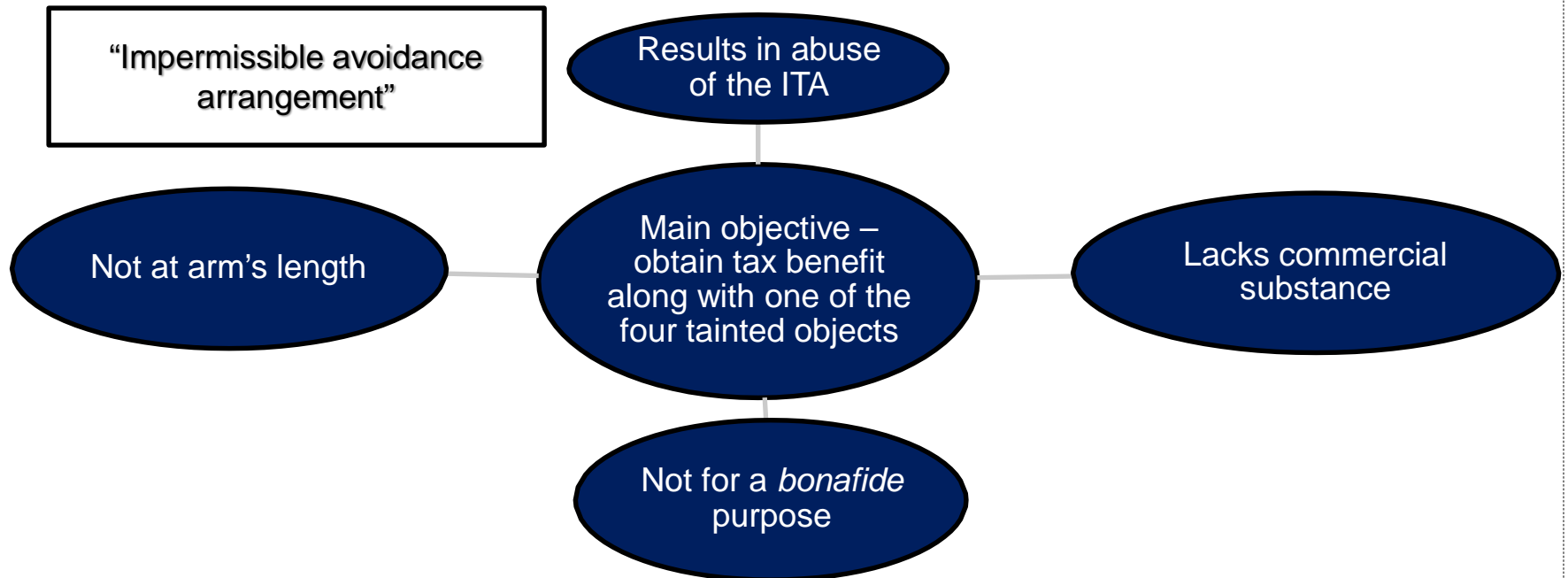
- For ease of understanding, the term 'active business outside India' has been presented as under:



- Circular 8 of 2017, dated February 23, 2017 – POEM provisions to not apply if turnover does not exceed threshold of INR 50 crores.

General Anti-Avoidance Rule ('GAAR')

- Introduced vide Finance Act 2012. Applicability deferred and came into effect from April 1, 2017;
- GAAR gets triggered when taxpayer enters into 'impermissible avoidance agreement';



Indirect transfer provisions

- Clarificatory amendment vide Finance Act, 2012; Insertion of *Explanation 5* to section 9(1)(i) of the Act;
- Asset / capital asset being share / interest in a company or entity registered or incorporated outside India; deemed to have been situated in India; if share / interest **derives value substantially** from assets located in India;
- Substantial value derived from assets located in India if:
 - Fair market value ('FMV') of Indian asset on specified date exceeds INR 10 crores; and
 - Represents at least 50% of the value of assets owned by the foreign entity;
- Exemption to small shareholders to small shareholders holding 5% or less of the total voting power/ share capital, in the foreign corporation or entity directly / indirectly holding the Indian assets.

Indirect transfer provisions | Points for consideration

- Value as on specified asset:
 - Last date of accounting period preceding the date of transfer; **or**
 - date of transfer if the book value of the investee entity on the date of transfer exceeds 15% of the book value as on the accounting period date
- Rule 11UB provides for valuation of assets mechanism;
- Rule 11UC provides for income attributable to assets located in India.

Interplay of domestic tax laws and tax-treaty

Interplay – domestic tax laws and tax treaty

- GAAR interplay with BEPS initiatives;
- GAAR interplay with PPT;
- GAAR interplay with POEM provision;
- POEM provisions, GAAR and BEPS initiatives

GAAR interplay with PPT

- GAAR to be invoked if the main purpose is to obtain tax benefit; PPT could be invoked if one of the principal purposes to obtain treaty benefits;
- Threshold limit for invoking GAAR provisions – INR 3 crores of aggregate tax benefit; no threshold limit for invoking PPT;
- Income arising from investments prior to April 1, 2017 grandfathered under GAAR provisions; No grandfathering available under PPT.

Tax planning vs. Tax evasion | Landmark judgements

- **CTO vs. McDowell and Co. Ltd. [1985] 154 ITR 148 (SC):**
 - *“Tax planning may be legitimate, provided it is within the framework of the law”*
 - *“Colorable devices cannot be a part of tax planning and it is wrong to encourage the belief that it is honorable to avoid payment of tax by resorting to dubious methods”*
- **Union of India vs. Azadi Bachao Andolan [2003] 263 ITR 706 (SC):**
 - *“Many developed countries tolerate or encourage treaty shopping, even if it is unintended, improper or unjustified, for other non-tax reasons, unless it leads to a significant loss of tax revenues”*
- **Vodafone International Holdings B.V. vs. Union of India [2012] 341 ITR 1 (SC):**
 - Transaction between two non-resident companies (having no presence in India) in relation to shares of an overseas company having an Indian subsidiary; transaction not taxable in India
 - Reviewed principle laid down in case of IRC vs. His Grace The Duke of Westminster [1936] A.C.1;19 TC 490; SC reiterated the said principle that every tax-payer entitled to arrange his affairs so as to reduce the tax liability.

EU Anti-Tax Avoidance Directive

Anti-Tax Avoidance Directive ('ATAD') | An overview

- EU adopted anti-avoidance measures; ATAD I & II;
- Most of the rules to apply from January 1, 2019;
- Rules with respect to following areas:

Limitation on deductibility of interest

Business exit taxation

General anti-abuse rule

CFC rules

Rules to tackle hybrid mismatches

ATAD | An overview (Cont...)

Rules of ATAD	Particulars
Limitation on deductibility of interest	<ul style="list-style-type: none"> • Deductible up to 30% of EBITDA; • Exceptions: <ul style="list-style-type: none"> ○ Up to EUR 3 million ○ When issuer is not a member of a corporate group • Options provided for: <ul style="list-style-type: none"> ○ Group exclusion provisions and ○ Carryforward and carryback of disallowed interest
Business exit taxation	<p>Transactions considered as sale of assets:</p> <ul style="list-style-type: none"> • Transfer to PE in Member state or 3rd country • Transfer from PE to HO, or other PE • Transfer of taxpayer residence to Member state or 3rd country; excluding assets connected to PE in first state • Transfer of business from PE to Member state
General anti-abuse rule	<p>Tax authorities may ignore non-genuine arrangements if one of main purpose / main purpose is to obtain tax advantage</p>

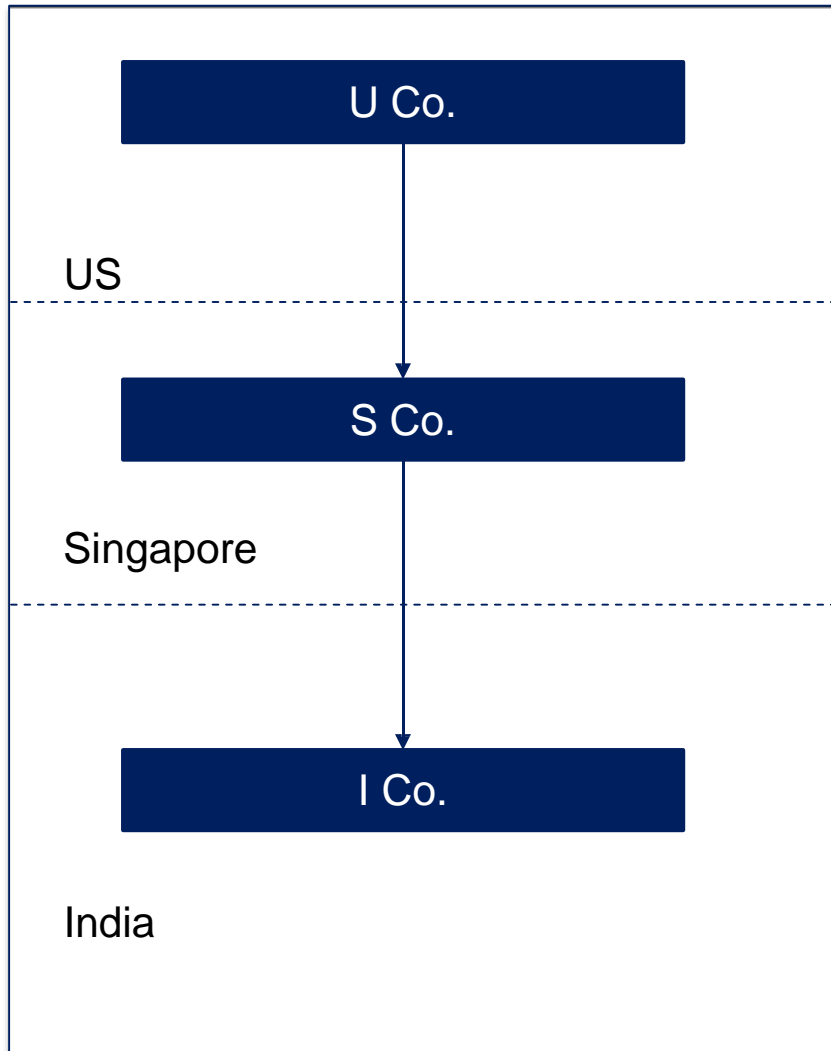
ATAD | An overview (Cont..)

Rules of ATAD	Particulars	
CFC rules	<ul style="list-style-type: none"> • CFC exists when: <ul style="list-style-type: none"> ○ Part 1: more than 50% of voting rights / interest in profits is held directly / indirectly by shareholder alone / with AE's ○ Part 2: actual tax paid at rate lower than 50% or less of the rate applicable in the parent country • Income of CFC included in tax base of parent country in 2 situations • Exceptions have been provided to CFC rules 	
Rules to tackle hybrid mismatches	In case of double deduction	Deduction can be taken in jurisdiction of the issuer of the instrument
	In case of deduction and non-inclusion	Payment is non-deductible in jurisdiction of the issuer

Impact on India inbound and outbound structures

Case study (Cont...)

Case study 1A: India inbound direct transfer – treaty provisions



Facts:

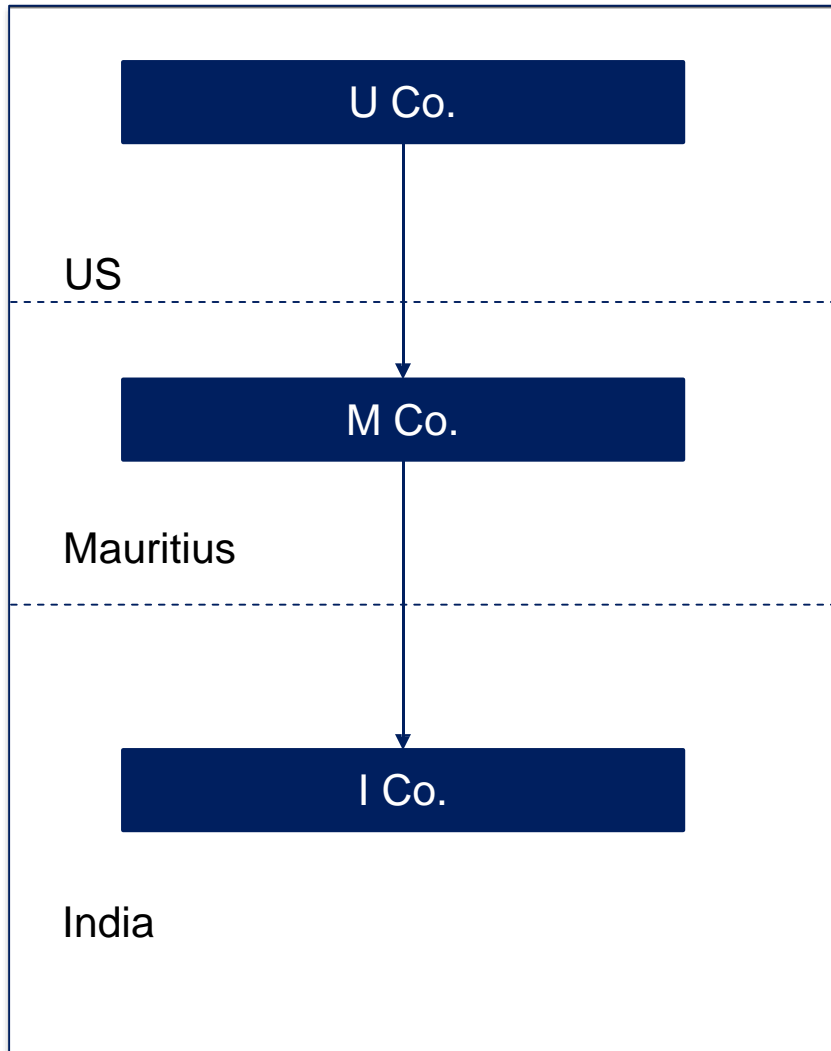
- U Co. is the ultimate holding company;
- S Co. is a company incorporated in Singapore – principal activity to make investments;
- S Co. acts as holding co. for investments in I Co. in India (Made post April 1, 2017);
- S Co. sold shares of I Co. to NR;
- POEM of S Co. is not in India;
- S Co. meets the expenditure threshold provided under Article 24A of DTAA (SGD 2,00,000).

Points for deliberation – In MLI regime:

- Capital gains taxation – Section 9 of the Act and Article 13 of the India – Singapore DTAA;
- GAAR, LOB & PPT.

Case study (Cont...)

Case study 1B: India inbound indirect transfer – treaty provisions



Facts:

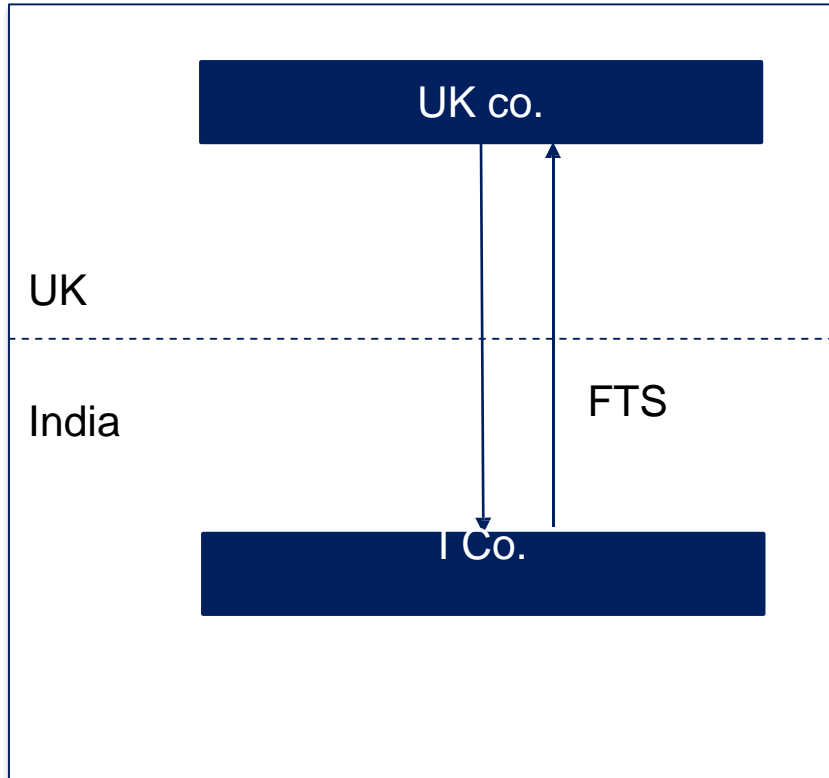
- U Co. is the ultimate holding company;
- M Co. is a company incorporated in Mauritius – principal activity to make investments;
- M Co. acts as holding co. for investments in S Co. in India (Made post April 1, 2017);
- U Co. sold shares of M Co. to NR;
- POEM of U Co. is not in India.

Points for deliberation:

- Capital gains taxation – Section 9 of the Act and Article 13 of the India – Mauritius DTAA;
- GAAR, LOB
- MLI – PPT – not applicable as Mauritius has not notified India.

Case study (Cont...)

Case study 2: India inbound structure – POEM provisions



Facts:

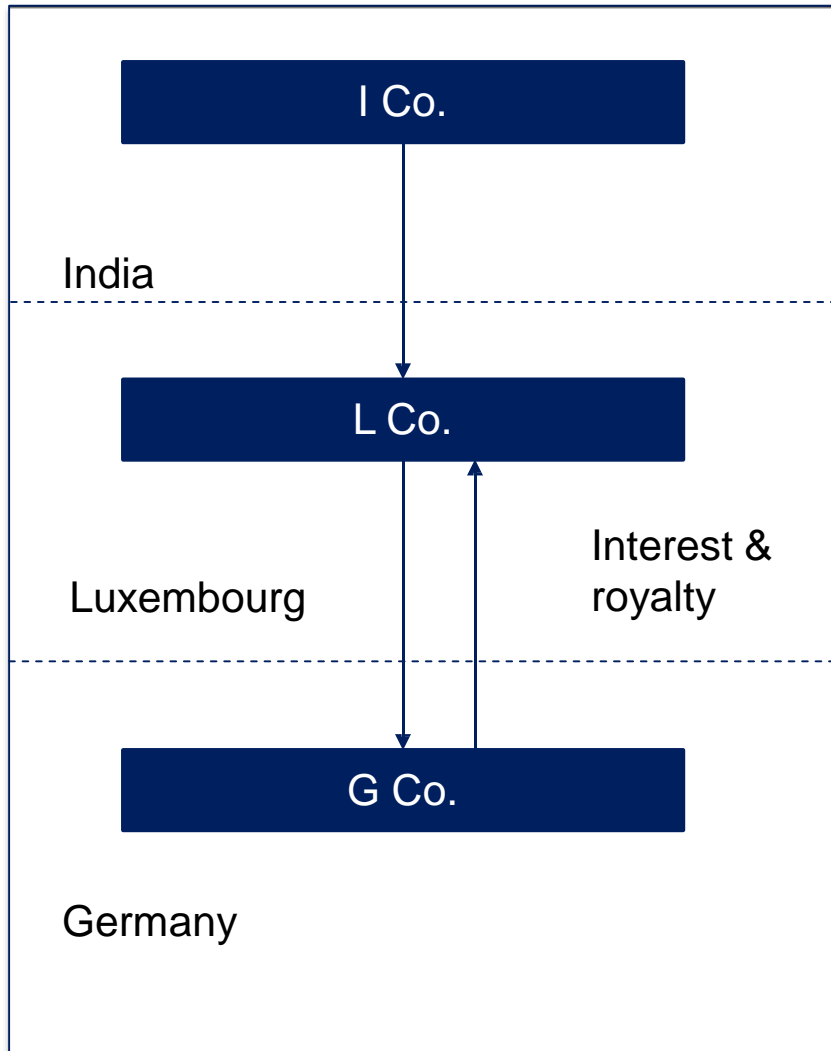
- UK Co., a company incorporated in UK, has a wholly owned subsidiary I Co. in India;
- UK Co. provides technical services to the Indian subsidiary, for which I Co. pays FTS
- Make available benefit under Article 13(4)(c) of DTAA available;
- UK Co. is engaged in 'active business outside India';
- 3 out of 5 directors of UK Co. are Indian tax residents;
- Board meeting are conducted by way of video conferencing.

Issues:

- a) Would UK Co.'s POEM be treated to be in India?
- b) In case POEM is determined in India – availability of treaty benefits under MLI regime.

Case study (Cont...)

Case study 3: Outbound structure – MLI & ATAD



Facts:

- I Co., a company incorporated in India, has a wholly owned subsidiary L Co. in Luxembourg;
- L Co. has a step-down subsidiary G Co. in Germany;
- L Co. holds the intangibles exploited by G Co. for which G Co. pays royalty;
- L Co. advanced loan to G Co., for which G Co. pays interest;
- L Co's POEM is likely to be ascertained in India.

Points for deliberation:

- POEM implications in India (including DTAA & MLI);
- ATAD:
 - CFC;
 - Interest limitation;
 - GAAR.

Key takeaways

Key takeaways

- Substance over form;
- Commercial substance vs. legal form;
- Transactions and arrangements to be backed by actual conduct;
- IP regime vs. non-IP regime;
- Critical factors to be considered while setting up / restructuring their business activities:
 - Business ecosystem – for instance, logistics and warehousing facilities, availability of skilled labor, reliable legal system, political stability, etc.;
 - Legal form of entity;
 - Operational and compliance cost;
 - Ease of doing business;
 - Customer focus;
 - Investor perception.

Thank you

For any questions, please contact
Uday Ved, Chartered Accountant