INTRODUCTION TO INTERNATIONAL TAX

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AWARDED Superbrands UAE'S CHOICE 2018

OBJECTIVE

Getting familiar with key international tax concepts…..

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NEED FOR RATIONAL CROSS BORDER TAXATION

Source State

Residence state

Both States have the right to tax!!!

Challenge for each state

- **Allocation of taxing rights**
  - **DTAA**
- **Base protection**
  - **Withholding tax**
  - **Transfer pricing**

DTAAs

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DTAA – CHARACTERISTICS

- Treaties are signed by two national jurisdictions to regulate matters concerning taxes
- Taxpayer is not a party to a tax treaty
- Treaty represents understanding as to rights and obligations of respective country
  - to forego its right to tax,
  - to limit scope or rate of taxation,
  - to grant credit of tax paid directly or indirectly in other jurisdiction/s etc.

MODELS USED TO NEGOTIATE TREATIES

OECD MTC

- Entered into between developed nations with comparable tax systems and objectives
- Follows Residence principle
- Lays emphasis on the right of state of residence to tax (e.g. excludes taxation on services in the name of service PE)
- India not member; Observer status

UN MTC

- Entered into between developing or less developed nations
- Focus on attracting investments into such developing countries
- More emphasis on Source principle
- Income should be taxed where it arises
- Most of India's tax treaties are based on this model

US has a Model Convention and Commentary to form basis for its Treaties

BRINGING A TREATY TO LIFE

Negotiation of a treaty → **Drafting of the articles** → **Signing** → **Ratification** → **Notification** → **Coming into effect**

Entry into Force refers to date of later of the notifications by each contracting state informing the other State of completion of procedures required by its law for bringing the Treaty into force.

Ratification: Confirmation by each contracting state, that the constitutional requirements for implementation of the treaty fulfilled

Notification: Date of publishing in the Official Gazette to notify general public (after Entry into force).

Coming into effect: The period as specified in the treaty once the treaty is notified

TYPICAL CONTENTS OF A DTAA

SCOPE PROVISIONS

ANTI-AVOIDANCE

ELIMINATION OF DOUBLE TAXATION

KEY PROVISIONS – IMPACTING MNCs

1. Article 4 – Residency
2. Article 7 – Business Profits

   Article 5 – Permanent Establishments
3. Article 10 – Dividends
4. Article 11 – Interest
5. Article 12 - Royalties & Fees for Technical Services
6. Article 13 - Capital gains
7. Article 21 - Other income

DEFINITION PROVISIONS

SUBSTANTIVE PROVISIONS

MISC. PROVISIONS

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KEY PROVISIONS IMPACTING MNCS – RESIDENCY

Residence rule	▶ A person should be resident of one of the contracting states in order to invoke the provisions of a tax treaty
Determination of residence	▶ A person is a resident of a country if he is liable to tax in the country by virtue of his domicile, residence, citizenship, place of management, place of incorporation, or any other criterion of a similar nature
Tie breaker	▶ When a person qualifies as resident of both countries, the tie breaker test needs to be applied to determine the residential status in favour of one country in order to apply the provisions of the treaty

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KEY PROVISIONS IMPACTING MNCS – BUSINESS PROFITS

Business Profits → Taxable in Source State if **PE** is formed → How is a PE constituted?

PE Constitution

- Fixed place of business
- Construction/ installation/ supervisory activities
- Services provided through employees or other personnel
- Operations carried out by agent

- PE is hypothesized as a separate taxpayer
- Non-resident entity to pay tax in Source State
- Book-keeping and compliance requirements
- Profit attribution

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KEY PROVISIONS IMPACTING MNCS – CAPITAL GAINS

Capital gains

- Typically, taxing rights with Source State
- In certain cases, exclusive rights provided to Residence State
- Historically, major avenue of treaty shopping
- India-Mauritius treaty

Incorporation of safeguards/ anti-abuse provisions on account of aggressive tax planning

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KEY PROVISIONS IMPACTING MNCS – OTHERS

Instrument driven

- Dividends
- Interest

Activity driven

- Royalty
- Fees for technical services

- Typically tackled through withholding tax provisions → domestic tax law of Source State
- Treaty vs Domestic Law – whichever is more beneficial to taxpayer applies

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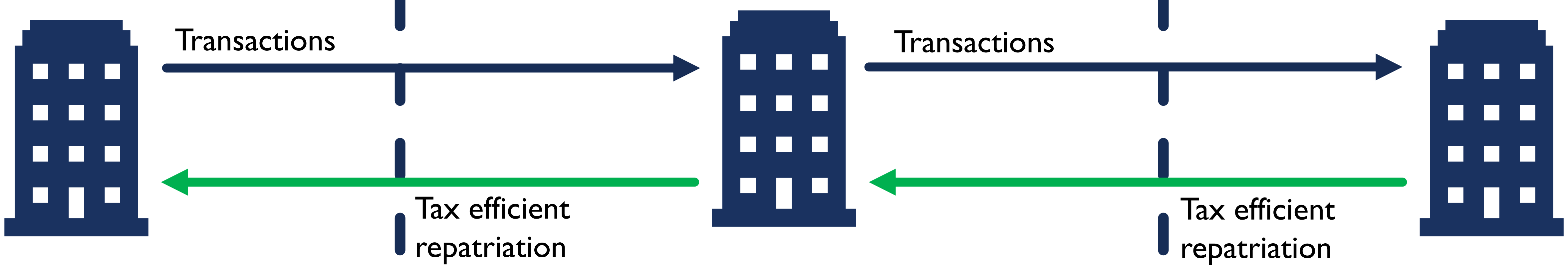
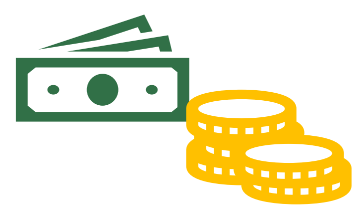
TREATY SHOPPING

Original Residence State	Tax Friendly State	Source State
	Typically has a favorable domestic tax regime and a vast treaty network	

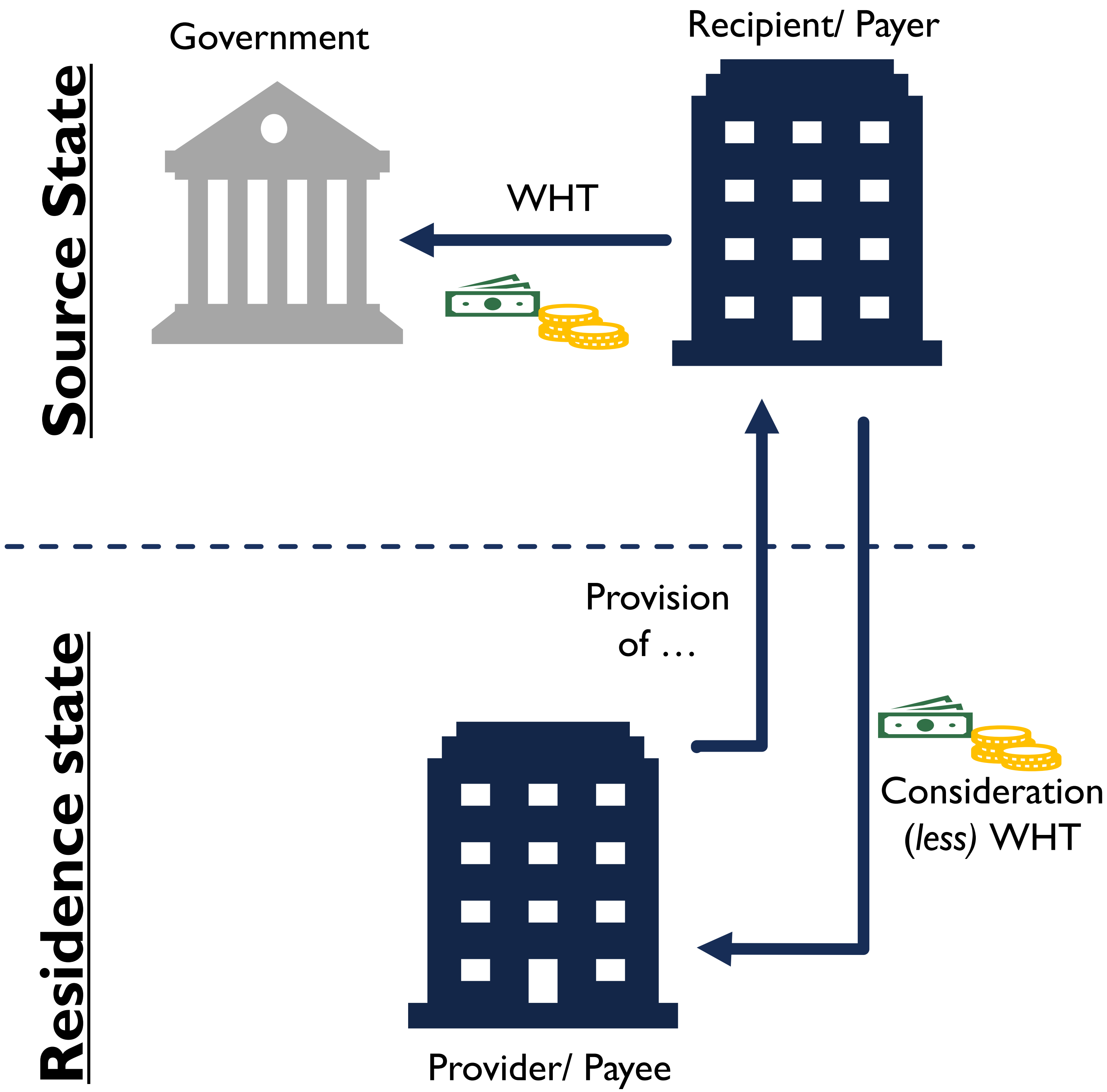


Establishment of New Company to take advantage of domestic law and/ or treaty network



WITHHOLDING TAX

WITHHOLDING TAX



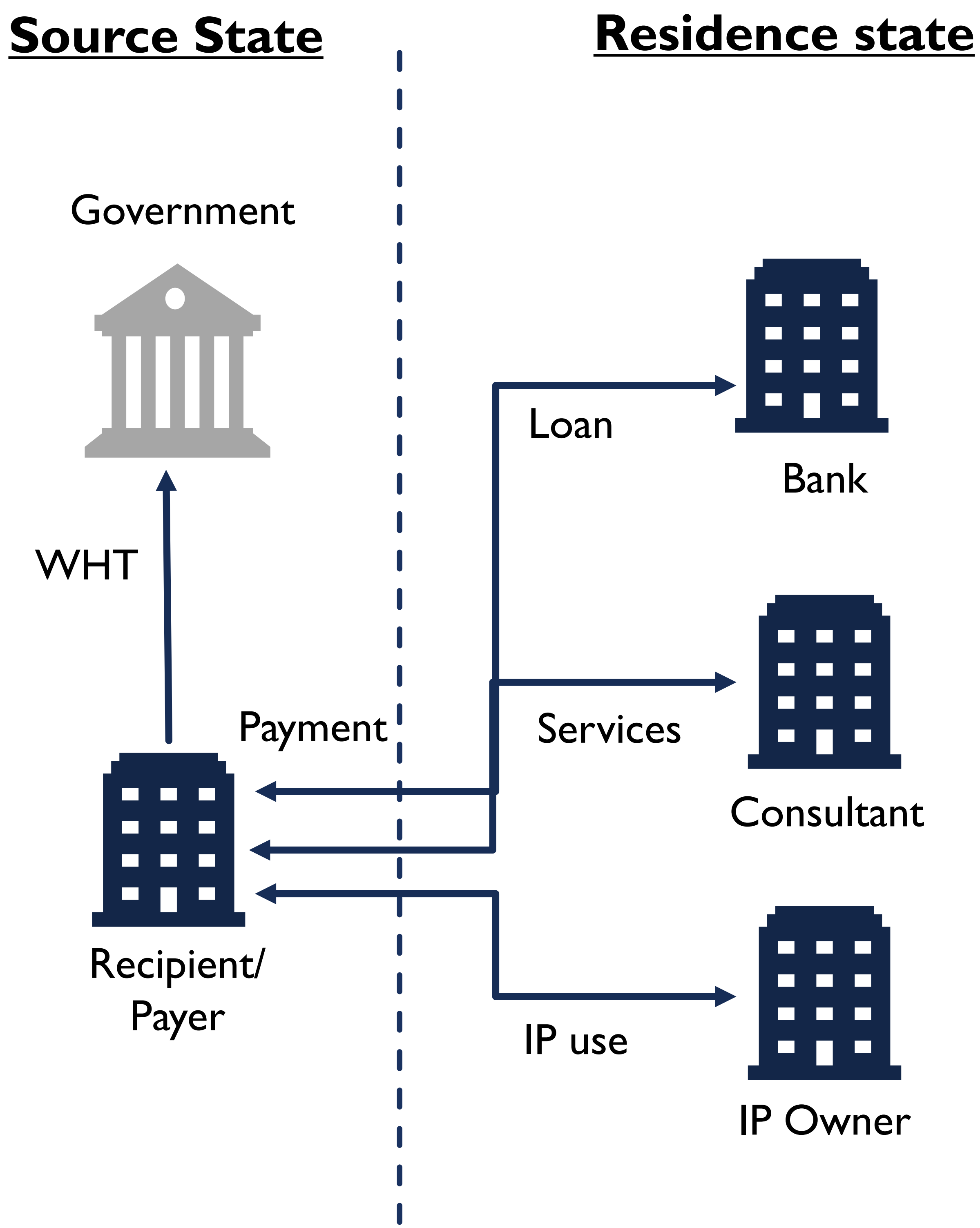
Key aspects of WHT

- Paid to the Government by Payer
- Paid on behalf of Payee
- Taxes are withheld/ deducted from consideration amount – commercially parties may also agree to a gross up
- Typically treated as final tax payment on behalf of non-resident Payee – unless PE is constituted
- Some countries also levy domestic withholding taxes

Issues

- Types of payment covered and their scope?
- Foreign tax credit in Residence State?
- Planning avenues?

WITHHOLDING TAX – ILLUSTRATION



Particulars	Interest to Bank	Service fees to consultant	Royalty to IP owner	Total
Contract amount	1,000	1,000	1,000	3,000
WHT rate (domestic law)	15%	5%	15%	-
WHT (Treaty)	10%	10%	15%	-
WHT to Govt	100	50	150	300
Net payment	**900**	**950**	**850**	**2,700**

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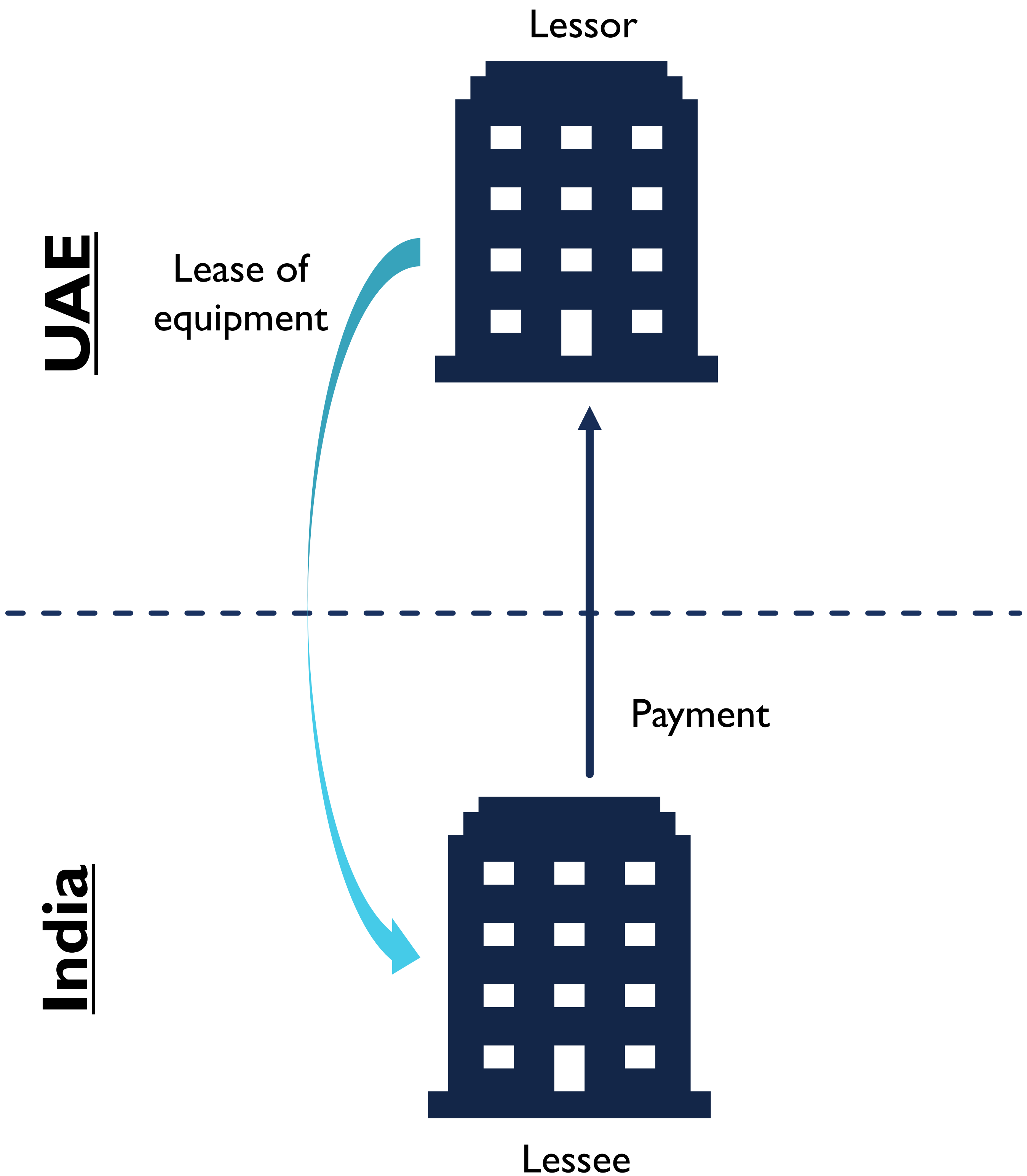
DTAA & WITHHOLDING TAX INTERPLAY – ILLUSTRATION

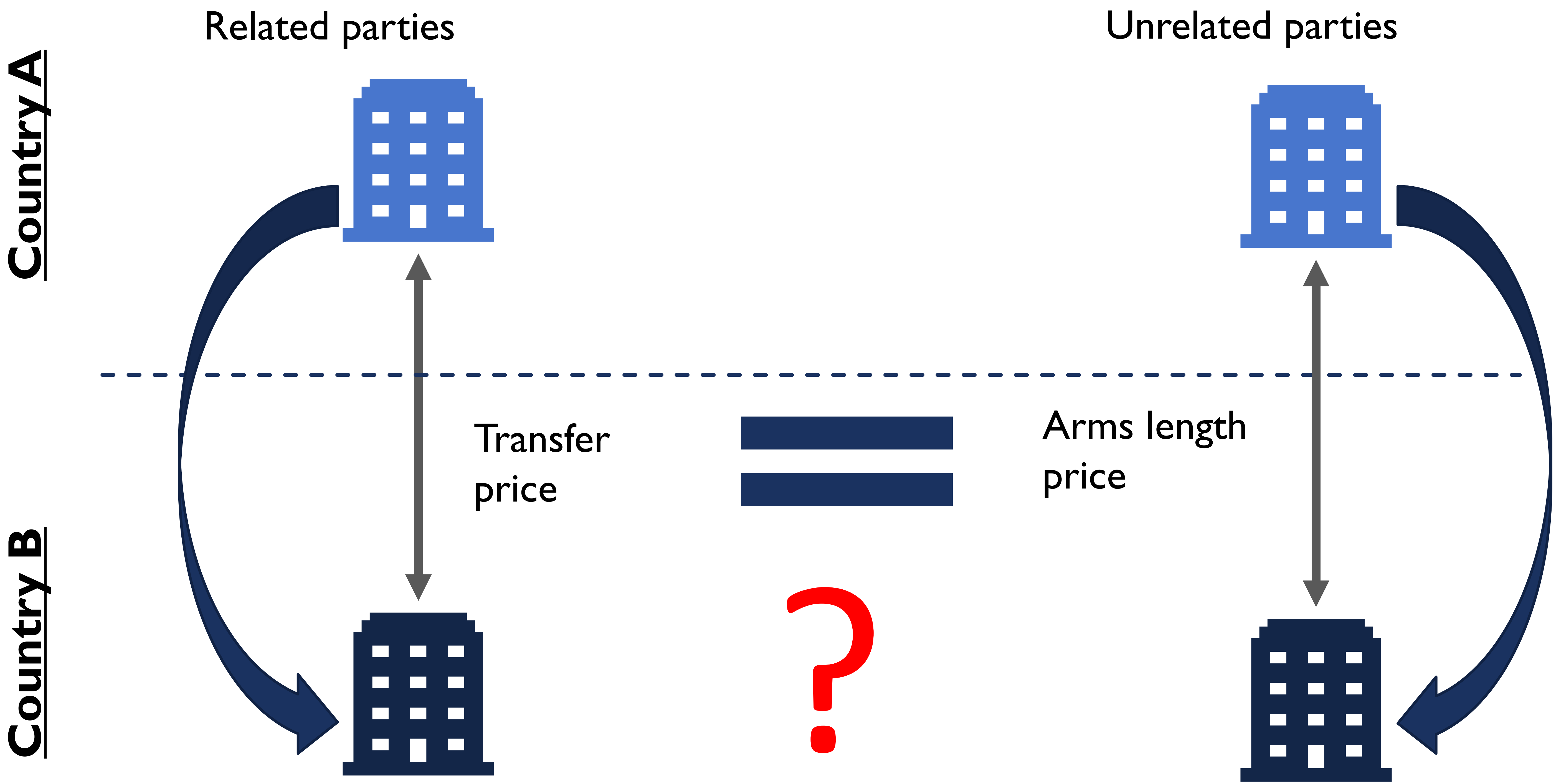


<u>Tax treatment analysis</u>

1. Whether income taxable in India (Source State)?
2. Treaty exists between India and UAE?
3. Lessor resident as per India-UAE treaty?
4. Is the income attributable to a PE of Lessor in India?
   a. If yes, taxable as business profits
   b. If no, WHT triggers and treaty benefits to be evaluated

TRANSFER PRICING

TRANSFER PRICING – THE CONCEPT



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TRANSFER PRICING – ILLUSTRATION

Scenario I – transactions between A & B (Related parties) with transfer pricing

Books of A (Tax rate 0%)

Particulars	Amt	Particulars	Amt
Purchases	300	Sales to XYZ	100
Profit	200	Sales to B	400
Total	**500**	**Total**	**500**

Tax paid by A = 200 X 0% = 0

Books of B (Tax rate – 30%)

Particulars	Amt	Particulars	Amt
Purchase from A	400	Sales to Client	600
Profit	200		
Total	**600**	**Total**	**600**

Tax paid by b = 200 X 30% = **60**

Scenario II – transactions between A & B (Related parties) without transfer pricing

Books of A (Tax rate 0%)

Particulars	Amt	Particulars	Amt
Purchases	300	Sales to XYZ	100
Profit	300	Sales to B	500
Total	**600**	**Total**	**600**

Tax paid by A = 300 X 0% = 0

Books of B (Tax rate – 30%)

Particulars	Amt	Particulars	Amt
Purchase from A	500	Sales to Client	600
Profit	100		
Total	**600**	**Total**	**600**

Tax paid by b = 100 X 30% = **30**

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TRANSFER PRICING – METHODS ADOPTED

Traditional transaction methods

- Comparable Uncontrolled Price (CUP)
- Resale price (RSP)
- Cost Plus (CPM)

Transactional Profit Method

- Profit Split (PSM)
- Transactional Net Margin (TNMM)

Possible to use any other method?

TRANSFER PRICING - METHODS

CUP

What and How?

- Operates by seeking to determine the price for a property transfer/ service supply in an uncontrolled transaction
- Price may be adjusted to factor in differences which may arise on account of different aspects
- Requires stringent comparability with respect to the property/ service
- Factors that may impact comparability/ adjustments
  - Contractual terms
  - Volume of transactions
  - Credit terms, etc

RSP

What and How?

- Applicable to taxpayers engaged in the business of procuring from related parties and selling to unrelated parties
- Operates by seeking to determine the resale gross margin for a property transfer/ service supply which is resold/ provided onward
- Preferred method for traders/ distributors where the reseller does not add substantial value

TRANSFER PRICING - METHODS

CPM

What and How?

- Operates by seeking to determine the normal profit which should accrue on a cost base
- Involves aggregation of direct and indirect costs attributable to production of goods/ provision of services
- Once available, the typical margin that should be earned is interposed to evaluate whether the price is at arm's length
- Preferred method in cases of semi-finished goods, contract manufacturing, provision of standard services, etc

PSM

What and How?

- One of the most complex methods and is typically used when multiple related parties are involved
- Operates by first aggregating the combined net profit of the related parties and then splitting the pot amongst each of the entities basis their contribution
- Used typically in cases involving consortium arrangements, transfer of unique intangibles, multiple transactions which are inextricably linked
- Comparable external data is usually hard to find

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TRANSFER PRICING - METHODS

TNMM

What and How?

- Operates by examining the net operating profit as a percentage of a certain base (for eg, operating costs, turnover, etc)
- Most frequently used method as compared to the others, given the specific nuances of other methods
- Easier to make adjustments on account of variances in functions due to availability of broad based data
- Also, usually preferred as it operates more on functional comparability vis-à-vis product comparability

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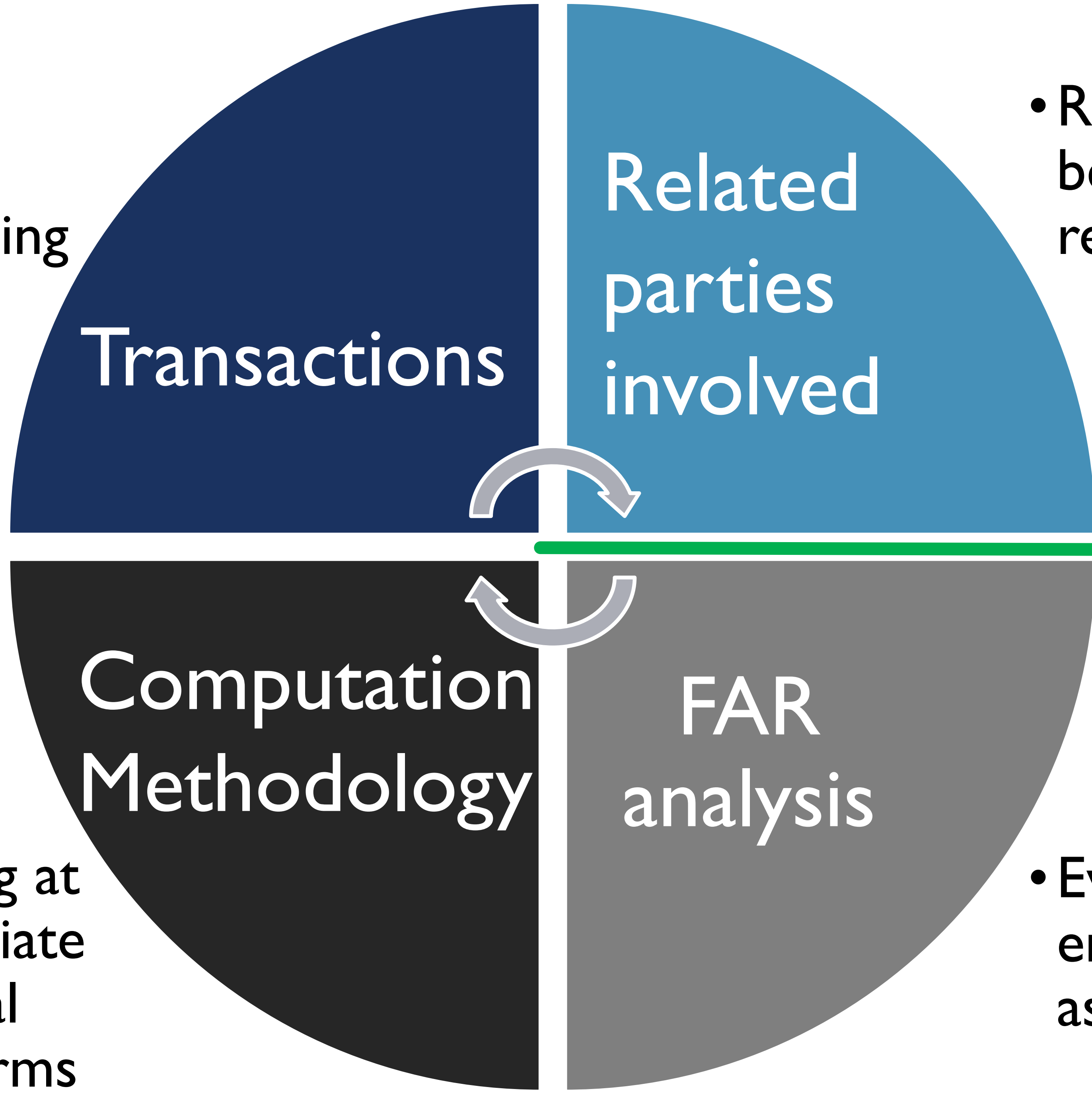
TRANSFER PRICING – DOCUMENTATION

- Important to determine the transactions being undertaken

- Relationship between the related parties



Periodic refresh

- Manner of arriving at the most appropriate method and actual computation of arms length price

- Evaluation of each entities Functions, assets and risks

WHAT IF TAX AUTHORITIES IN ONE COUNTRY DO NOT AGREE TO THE TRANSFER PRICE?

Q & A

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