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ITSG International Secretariat:

Penny Prime
ITSG Secretariat
Attention: Gabelle LLP
20 Fenchurch Street
London, U.K. EC3M 3AZ

Telephone Enquiries
+44 (0) 7711 829987

Email Enquiries
pprime@itsgnetwork.com

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Transfer Pricing Post Chevron

By Gil Levy

Gilsons Chartered Accountants and Chartered Tax Advisers (Australia)

Transfer pricing issues give rise to problems for corporate management and their tax advisers, particularly when there are controlled entities in multiple countries with different reporting currencies. These issues also raise problems for courts having to determine the proper price denominated in the proper currency in often-intricate fact settings. This article summarises the recent judgement on appeal to the Full Federal Court of Australia in *Chevron Australia Holdings Pty Ltd (C.A.H.P.L.) v. Commissioner of Taxation (C of T) (2017) FCAFC 62*. This is a landmark case in Australia that may have global implications for multi-national companies with respect to internal financing arrangements.

BACKGROUND

In 2003, C.A.H.P.L., an Australian-resident corporation, and Chevron Texas Funding Corporation (C.T.F.C.), a U.S. subsidiary of C.A.H.P.L., entered into a "Credit Facility Agreement" (the Agreement). Pursuant to the Agreement, C.A.H.P.L. borrowed the Australian dollar equivalent of approximately U.S. $2.5 billion from C.T.F.C. Interest was paid by C.A.H.P.L. to C.T.F.C. at about 9% per annum, which was commensurate with the commercial rates typically charged on unsecured loans. No security was posted by C.A.H.P.L., and no guarantee was provided by the ultimate holding company, Chevron Corporation.

C.T.F.C. raised its money through the issuance of U.S. dollar denominated commercial paper. The commercial paper issued by C.T.F.C. bore interest at the rate of 1.2%. The obligation of C.T.F.C. was supported by a guarantee of Chevron Corporation.

The borrowed funds were used by C.A.H.P.L. for an internal refinancing of an Australian dollar denominated debt of Chevron Australia Pty Ltd and the funding C.A.H.P.L.'s acquisition of Texaco Australia Pty Ltd.

In each of the relevant income years, C.A.H.P.L. claimed tax deductions for interest paid to C.T.F.C., thus transforming non-assessable dividends into non-exempt income pursuant to an exemption for foreign non-portfolio dividends[1]. The result from an Australian tax viewpoint was the

[1] Section 23AJ of the Income Tax Assessment Act 1936 (the 1936 Act)

creation of untaxed dividends received by C.T.F.C. that offset interest payments in C.A.H.P.L.'s hands. At the same time, C.T.F.C. made significant profits from borrowing at a rate of 1.2% and lending at a rate of 9%, which would not be taxed in Australia. Testimony at trial indicated that the interest payments were not taxed in the U.S.

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The Commissioner issued amended assessments to C.A.H.P.L. for the relevant years primarily under Division 13 of the 1936 Act, which broadly provides that the Commissioner may substitute an amount that he determines to be arm's length for consideration paid by an Australian tax resident where (i) property is acquired under an international agreement, (ii) the Commissioner is satisfied that the parties have not dealt with each other at arm's length in relation to the property acquired under the agreement, and (iii) the consideration given for the property exceeds the amount that would be paid in an arm's length transaction. Further determinations with respect to some of the years were made under section 815-15 of the Income Tax Assessment Act 1997(the 1997 Act)[2].

OBSERVATIONS

1. **The determination of arm's length should be undertaken in a holistic manner.**

Chevron argued that Division 13 required an analysis of the actual agreement, i.e. an unsecured loan with no covenants, the only flexibility being the interest rate if such an agreement had been entered into between parties acting at arm's length.

The Court held that such a narrow interpretation of the provisions meant that such approach would omit the normal security and operational covenants that would normally be required if the parties were dealing with each other at arm's length. Such terms and conditions were effectively missing in the loan documentation.

Accordingly, it is now important that when undertaking a transfer pricing analysis, all terms and conditions contained in an agreement that may impact the price should be incorporated into the transfer pricing analysis on an arm's length basis. In this case, the relevance is that arm's length parties would not enter into an agreement to advance U.S. $2.5 billion unsecured with no covenants.

2. **The arm's length hypothetical should remain as close to the actual agreement as possible**

In other words, the actual agreement should be respected as much as possible with exception to unrealistic terms, which should be disregarded or substituted.

The Court considered arm's length conditions such as security and covenants to be missing for the purpose of pricing the arm's length interest rate for the Agreement. However, the five-year tenor and Australian currency of the Agreement were not modified.

3. **Taxpayers should not be considered as orphans**

Importantly, the Court predicated that in undertaking a transfer pricing analysis, a taxpayer should be considered in its capacity as a member of a multinational group and not on a stand-alone basis.

Accordingly, the value of any parental affiliation should be taken into account when looking at intragroup loans.

For example, it is possible that support from the parent may be a factor when looking at security.

4. **"Internal" pricing references remain the preferred approach of the courts**

In this case, the Court has remained consistent with the established approach of using "internal pricing references" as a reference. That is, they referred to a prior third-party transaction that was entered into by

[2] The 1997 Act is an ongoing rewrite of the 1936 Act in "plain English" plus some provisions such as Division 13 were updated.

another member of the same international group. In this case, it was the debt funding sourced by C.T.F.C. from the commercial paper market.

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In *FC of T v. SNF (Australia) Pty Ltd (2011) Australian Tax Cases (A.T.C.) 20-265* (as published by C.C.H.), which dealt with the purchase of trading stock by an Australian taxpayer from international related parties, the Australian court relied on pricing relating to the sale of similar stock by the parent to third parties. In Roche Products Pty ltd v. FC of T (2008) A.T.C. 10-036, references were also made to the predicted margins that would be made for sales to relevant third parties by the global group.

The Australian Taxation Office (A.T.O.) has since indicated, with respect to intragroup debt arrangements, that third-party debt arrangements entered into by the ultimate parent, or the group's consolidated cost of debt, will be a relevant factor for risk assessment purposes.

From an international perspective, where there is a requirement to consider the O.E.C.D.'s five factors of comparability when determining arm's length conditions, internal pricing references may be the best starting point to make reasonable and reliable adjustments to arrive at appropriate transfer prices. In this regard, comparability factors such as economic circumstances, business strategies of the parties, its functions, assets, and risks of the parties may be relatively strong internal pricing references depending on the availability of other evidence. The question is whether internal pricing references provide strong evidence of arm's length conditions.

5. Appropriate evidence is critical

With the reverse onus of proof lying with the taxpayer as it applies in Australia, taxpayers must now go beyond merely pricing the terms and conditions of an agreement as it stands, and "step back" to make sure the agreement makes commercial sense overall with reference to all the relevant factors.

For example, the Court placed little weight on evidence put forward by certain Chevron experts that the pricing of the Agreement was not unreasonable given it was accepted by these experts that the Agreement, as constructed, would not have been entered into by a single lender or a group of lenders without financial covenants.

OUTSTANDING QUESTIONS

Notwithstanding the guidance given by the Court in this case, there are a number of important questions which remain open.

1. What is the degree of evidence required to satisfy the onus of proof?

The Court was clear that they considered the Agreement could not be entered into without securities or financial covenants. However, the Court also accepted Chevron's submission that the hypothetical agreement might reasonably have been expected to be in Australian currency on the basis that this would limit foreign exchange gains or losses despite a large portion of C.A.H.P.L.'s revenues being denominated in U.S. dollars.

Depending on the facts and evidence available, this would imply that the determination of a particular term or condition as commercial may not necessarily require "external" market data to support the position taken. Rather, contemporaneous internal documents, such as treasury policies, which the Court considered in reaching its decision, may provide useful evidence.

In any event, a degree of judgement may be required regarding the extent of evidence required to support a condition as commercial, particularly given taxpayers will inevitably have fewer resources available to them to make such decisions for standard tax compliance purposes relative to the resources and evidence available to the A.T.O. when intragroup arrangements are scrutinised at a later point in time.

2. Can guarantee fees and/or other relevant financing costs form part of the arm's length conditions?

The Court made it clear that there are likely instances where arm's length payments could have been given by independent parties and could be factored in the determination of arm's length conditions, regardless of whether such payments were actually made.

Justice Pagone used the example of a guarantee fee that may be charged by Chevron Corporation to C.A.H.P.L. for obtaining access to a cheaper interest rate. However, this was not explored further, as no evidence was provided with respect to this example. Nonetheless, there is a question as to whether independent parties would have provided a guarantee under similar facts and circumstances. The value of such a guarantee and the degree of evidence required to satisfy the onus of proof remain open as a matter of law but are frequently taken into account by transfer pricing economists.

A similar question arises for other arm's length terms that could be expected in independent loan arrangements. Breakup costs, penalty payments, and upfront fees can all form parts of third-party debt agreements and may, based on the available evidence, be relevant for determining the arm's length conditions which apply to an intragroup loan.

3. Is the parent's cost of fund always the right reference point?

In Chevron, the A.T.O. calculated amended assessments with reference to the interest rate that applied to the commercial paper that was borrowed by C.T.F.C. This commercial paper was guaranteed by the Chevron Corporation, the ultimate parent of the group. Although the A.T.O. was successful in this case and has since confirmed its expectation that in most cases, intragroup debt should be aligned to the ultimate parent's external cost of debt. There are possible instances where, based on available evidence, an alternative reference point should be considered notwithstanding the fact that the taxpayer is a member of a multinational group. For example, the use of a parent's cost of funds may be inappropriate where that parent is the head of a sovereign wealth or pension fund, as a number of these funds may 'ring-fence' their underlying operations from the remainder of the group or may not source external debt for funding purposes.

4. Which Currency?

The currency in which an international related-party dealing is denominated is a relevant transfer pricing consideration. In Chevron, it was the Commissioner's contention that if the Agreement had been between independent parties dealing at arm's length, C.A.H.P.L. would have borrowed in U.S. dollars and incurred a liability to pay interest and repay principal in U.S. dollars.

Both sides produced a high volume of evidence to support their competing contentions as to the appropriate currency in which to undertake the transfer pricing analysis. There were various arguments or positions put forward, but perhaps it is best to start with the facts:

a. For the year which ended 31 December 2003, 88% of the Chevron Australia Consolidated Group revenues, which were derived from the sale of crude oil and L.N.G., were denominated in U.S. dollars with the remaining 12% denominated in Australian dollars.

b. For the same period, approximately 97% of expenses of that group were incurred in Australian dollars, which presumably includes interest paid on both the subject related-party borrowing and also the debt that it replaced. The remaining expenses were incurred in U.S. dollars (1%) and other currencies (2%).

c. The currency of the existing borrowings that were being refinanced by the Agreement was denominated in Australian dollars.

d. The financial reports for the Australian group were prepared with an Australian dollar functional currency. In the author's view, this factual scenario, which involved predominantly U.S. dollar denominated revenues but Australian dollar denominated expenses, makes the determination of the natural functional currency of the Chevron Australia Consolidated Group the product of a finely balanced analysis. Without wanting to re-examine the accounting or tax ideals of functional currency, the reporting currency was the Australian dollar. However, it is worth setting out a number of factors that were argued or put into evidence in the case on the point of currency. These can be loosely grouped into three categories.

- *The nominal outcome*. Some evidence suggested that U.S. dollar was the more appropriate currency for the loan simply because, at the time, the interest rates for U.S. denominated dollar borrowings were lower than the interest rates for Australian dollar borrowings. However, this is a somewhat overly simplistic analysis without consideration for the additional factors that follow.

- *The accounting outcome*. Various evidence was provided on the "accounting" impact of the currency of the borrowing. A U.S. dollar denominated borrowing would have resulted in profit and loss volatility (in the form of foreign currency gains and losses) being recognized as the U.S. dollar denominated liability; thus, it would be restated using the prevailing Australian dollar/U.S. dollar exchange rate at each balance date. There was no evidence that there were significant U.S. dollar denominated accounting assets on the balance sheet that were required to be restated in the same way. Accordingly, there was not a "natural" accounting hedge in the local accounts if the Agreement was denominated in U.S. dollars. This potential accounting volatility had a number of consequences, which include (i) the ability of the Australian group to pay dividends in the event of adverse unrealized F.X. losses being incurred and (ii) the adverse impact on the thin capitalisation position of the group, given that the thin capitalisation provisions use accounting numbers as the basis for the calculation of safe-harbour debt amounts.

  It is also worth considering the group's position at the consolidated accounting level. The evidence correctly confirmed that, given the Agreement was within the broader Chevron group, the currency in which the agreement was denominated made no difference in accounting the foreign exchange risk of the group as a whole. However, if the Australian dollar borrowing had been from an unrelated party, then the Chevron Group's consolidated U.S. dollar denominated accounts would have been exposed to profit and loss volatility as a result of currency fluctuations.

- *The economic outcome*. Evidence also suggested that, while a U.S. dollar denominated borrowing may cause accounting profit and loss volatility, a significant proportion of U.S. dollar denominated revenues, out of which C.A.H.P.L. could service the loan, would have provided an economic hedge for the currency exposure on a U.S. dollar denominated loan.

OTHER FACTORS

Other factors argued in the case include:

- The extent of planned capital expenditure in Australia and the currency in which that capital expenditure would be incurred.
- Forecasted operating expenditures in Australia, which was predominantly in Australian dollars.
- Future movements in the price of goods and

services to be purchased in Australia to undertake planned capital expenditures.

- Future movements in prices of commodities to be sold.
- Future movements in exchange rates between the Australian dollar and U.S. dollar.

OBSERVATIONS

It is beyond the scope of this paper to answer the question as to which currency an international related-party dealing should be denominated in. However, it is relevant to make a number of observations:

- The points made above in relation to the nature of the evidence required and the onus of proof are obviously relevant.
- The A.T.O. clearly is seeking greater disclosure of foreign exchange gains and losses arising from international related-party dealings.
- Whilst the risk hypothesis may not be particularly well developed outside of the intragroup funding sphere, the greater focus on foreign exchange gains and losses means that the relevant currency of agreements needs greater attention.
- Where it is appropriate to denominate non-funding international related-party dealings, such as IT charges in a foreign currency, the absence of an actual prompt settlement of those charges may result in foreign exchange gains or losses on the payables/receivables. It is not clear at which point receivables and payables become related-party funding.

The discussion about these factors was not undertaken for the purposes of assessing their correctness. There was obviously competing evidence given by both sides at the trial. It is included here for the purpose of highlighting the difficulties in assessing the question of currency given that the judgment in the case now requires having either an inbound or outbound loan that is inconsistent with the functional currency of the borrower which results in a risk rating of at least "high risk." This does not apply in the case of outbound loans as the loan is denominated in Australian dollars.

LAST WORDS ON CHEVRON

On the basis that the functional currency of the Chevron group in Australia was the Australian dollar, the agreement would not have been adversely risk rated on the basis of currency alone. Similarly, the fact that U.S. dollar interest rates were lower than Australian dollar interest rates and the fact that the traceable third-party debt was U.S. dollar denominated but the related party loan was Australian dollar would not have necessarily resulted in an adverse risk rating provided that the "margin" on the related-party debt is not greater than 50 basis points above the external debt.

On a prospective basis, it should be expected that full documentation will be provided for comparable lending transactions – this means 500-page indentures accompanying the loan. Also to be expected is that the Commissioner will argue that none of the restrictive provisions imposed on the borrower was intended to be enforced. Theoretically, this raises further questions of whether there is value in being part of a multinational group and, if there is, should the parent be compensated for sharing that value with an Australian subsidiary.

Whilst this is an Australian case, it is clear that similar considerations will apply in other jurisdictions. It would therefore be interesting to hear how other countries are addressing the points raised in this article.

Tax Developments in Argentina

By Javier Canosa
Durrieu | Canosa Abogados (Argentina)

Argentina – a place that promised to be among the wealthiest countries in the world at the beginning of the 20th century but somehow managed to become a breeding ground for currency devaluations and economic crisis – has taken significant strides in recent months and has once again reformed its tax system. This article looks at some of these changes and considers their impact on cross-border activity, in particular developments in the tax treatment of digital services.

INTRODUCTION: WINDS OF CHANGE

In December 2015, Mauricio Macri took office in Argentina. His coalition, "*Cambiemos*" ("*Let's change*"), altered the course of history by putting an end to the left-wing populist government of the Kirchners (first the husband and then his wife) who had controlled Argentina for over a decade.

Among the many promises, *Cambiemos* pledged to terminate populist policies, change the complex tax system and reduce the tax burden in Argentina (which is second only to the Island of Comoros according to the World Bank tax burden index[1]). Five days after taking office, the new administration lifted all existing exchange controls in Argentina. Subsequently, in July 2016, Argentina launched a new tax amnesty – the largest in the world ($117 billion). This was followed by discussions of large-scale tax reform, which eventually became law on the last working day of 2017, December 29, 2017, with effect from January 1, 2018.

In the cross-border context, the most notable amendments in Law No. 27,340 (the Law) include, *inter alia*, a new definition of permanent establishment, new rules on Controlled Foreign Corporations, new procedural rules and Value Added Tax (V.A.T.) on digital services. Most of these changes follow the Organization for Economic Cooperation and Development's (O.E.C.D.) action plan on Base Erosion and Profit Shifting (B.E.P.S.).

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[1] https://data.worldbank.org/indicator/IC.TAX.TOTL.CP.ZS?name_desc=false&view=chart

NEW PROVISIONS

1. Income Tax

Tax Developments in Argentina

Corporate tax rate. The tax on retained earnings of corporations and permanent establishments is reduced to 30% for fiscal years commencing from January 1, 2018, and then to 25% for fiscal years commencing from January 1, 2020. The previous rate was 35%.

However, there is a new tax on the distribution of dividends. An additional tax of 7% for 2018 and 13% as from 2020 will be charged. The Law renders void the equalisation tax set forth by the section which follows section 69 of the tax law. Dividends and earnings resulting from accrued benefits prior to the date the Law becomes effective will be exempt from the additional tax on dividends.

The Law also provides that two new business entities – simplified corporations (S.A.S.) and single-shareholder corporations (S.A.U.) – will be subject to income tax, also.

Presumed income for dispositions of funds and goods. The Law provides for a presumed interest for each currency, which must be duly regulated. The Law establishes that presumed income 8% of real property's current market value and 20% of the current market value of other goods.

Transfer pricing. The Law establishes a minimum amount to the taxpayers' annual income and a minimum amount for transactions in order to enforce the filing of annual declarations related to transfer pricing. Bear in mind that Argentina had already implemented the country-by-country (CbC) report provided in B.E.P.S. action 13.

Imports and exports. The tax authorities estimate that large amounts of income tax are lost through the use of intermediaries. Therefore, with regard to the import and export of goods via foreign intermediaries, taxpayers must now prove that the intermediary´s remuneration is proportional to the risks, functions and assets involved in the operation if the intermediary, the exporter or the importer is related to a local taxpayer.

If the foreign intermediary is linked with the local taxpayer and such intermediary is located in a non-cooperative jurisdiction or in a low or zero-tax jurisdiction, an agreement must be in existence and filed with the Argentine Tax Authorities.

Sales of real property. Earnings obtained by individuals from the sale of real property, except when the property is a dwelling, will be taxed at 15%. This tax replaces the tax on transfers of real estate property and applies to properties sold and acquired as from January 1, 2018.

Executive termination. Compensation payments arising from the termination of employment of an individual with director or executive positions in a company that exceed a specified amount established by Argentine labor law will be subject to income tax (previously exempt). Amounts arising from a consensual agreement are subject to tax to the same extent as amounts paid the minimum compensatory amount set forth by the applicable labor law for unjustified dismissal.

Permanent establishments. The Law redefines the concept of "permanent establishment." It is a fixed place of business in Argentina from which a foreign person performs activities in whole or in part. Moreover, the Law establishes that permanent establishments include but are not limited to the following: (a) a headquarters, (b) a branch, or (c) a factory.

In addition, the Law provides that there is no permanent establishment when an individual acts in Argentina on behalf of a foreign individual or legal person and (a) has a deposit account in the country where he or she regularly delivers goods on behalf of the foreign person, (b) takes risks on behalf of the foreign person, or (c) acts under detailed instructions or the control of a foreign person, etc.

Self-employed persons. The Law attempts to boost entrepreneurship by establishing a special 100% (or 150% for new professionals and new entrepreneurs) deduction for self-employed persons. Contributions to the Argentine Social Security System ("S.I.P.A.") or an applicable pension fund are an essential requirement for calculating the deduction.

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Trusts and other offshore structures. Trusts and other offshore structures are now generally considered transparent. A tax on profits arising from the management of assets on behalf of trusts, private interest foundations and other similar structures organised, domiciled or located abroad will be imposed to a resident who controls the foreign structure.

The Law provides that income earned by trusts incorporated, domiciled or located abroad must be declared by the local taxpayer who controls the trust. A local taxpayer is considered to have "control" when there is evidence that the financial assets remain under his or her power or management. For example:

- The settlor is also a beneficiary.
- The taxpayer directly or indirectly decides to invest or divest the assets.
- The taxpayer holds rights to dispose of the assets of the trust, has a right to appoint administrators, or is manager and its vote defines the decisions to be followed.
- The taxpayer has power to remove managers.
- The taxpayer has a current right to benefits.

Non-cooperative and low or zero-tax jurisdictions. The Law defines "non-cooperative jurisdictions" as countries or jurisdictions where there are no tax information exchange agreements in force or international agreements to avoid double taxation under which information exchange with Argentina is allowed. Countries that have entered agreements with Argentina but which do not effectively comply with them will be deemed non-cooperative jurisdictions. The Law leaves the preparation of a list of non-cooperative jurisdictions to the Tax Authorities.

In addition, "low or zero-tax jurisdictions" are defined as countries, jurisdictions, territories, associated states or special tax regimes which impose a maximum tax on corporate income at less than 60% of the current rate in Argentina.

Indirect transfers of assets located in Argentina. The Law considers that income arises from an Argentinian source when it arises from the transfer of shares, quotas, convertible stock or any other certificate representing ownership interest in an entity, fund, trust or similar instrument, permanent establishment, property subject to encumbrance or any other entity organised, domiciled or located abroad, provided certain statutory conditions are met. Transfers made within an economic group are excluded.

Financial income. The Law imposes a tax on financial income, which was previously exempt from taxation for individuals resident in Argentina. "Financial income" includes capital gains from shares of stock and deposit certificates for shares of capital stock, and any other stock or quotas, digital currency, transfers of financial trust certificates and, in general, assignments of rights over trusts and similar contracts, corporate bonds and quotas of mutual funds (except those exclusively created by publicly traded shares).

The tax rate varies as follows:

- Earnings from the sale of shares in an Argentine corporation that is not publicly traded will be taxed at a rate of 15%.
- Earnings from the sale of interests in Argentine bonds (in Argentine pesos and without an adjustment clause) will be taxed at a rate of 5%.
- Interest from fixed-term deposits (in Argentine

Tax Developments in Argentina

pesos and without an adjustment clause) will be taxed at a rate of 5%.

Controlled Foreign Corporations. Argentina has redefined the concept of Controlled Foreign Corporation (C.F.C.).

Foreign-source income obtained by Argentine residents for their direct or indirect participation in corporations or other entities that are organised, domiciled or located abroad or under a foreign legal regime, with no "fiscal personality" in the jurisdiction in which these companies are incorporated will be subject to income tax without deferral proportionately to the respective participation of the local resident.

Foreign-source income obtained by Argentine residents for their direct or indirect participation in corporations or other entities that are organised, domiciled or located abroad or under a foreign legal regime will be immediately subject to income tax, provided the following conditions are met:

1. The income does not have other specific treatment (such as income generated from other "controlled" structures, i.e. trusts).

2. Control over 50% of the capital or voting rights of the relevant foreign corporation is held directly or jointly with (i) an entity controlled by the taxpayer, (ii) the spouse of the taxpayer, (iii) the paramour of the taxpayer, or (iv) relatives of the taxpayer up to the third degree (ascendants, descendants or collateral, and either by consanguinity or affinity).

   This condition will be met where the taxpayer or the related party:

   a. Hold rights to dispose the assets of the entity

   b. Hold rights to elect and remove the majority of the members of the board or managers

   c. Hold rights to the profits of the entity

   It will also be met when at least 30% of the aggregate value of the foreign company's assets is derived from Argentine-source investments generating passive income exempt from income tax in the hands of foreign beneficiaries (regardless of the participation percentage of the Argentine residents).

3. At least 50% of the foreign company's revenue is composed of passive income or other income that generates directly or indirectly deductible expenses for Argentine residents.

4. The foreign company is subject to tax in its home jurisdiction at a rate less than 75% of the income tax that would be applicable in Argentina.

   It is presumed that this condition is met if the foreign company is incorporated or domiciled in a low or zero-tax jurisdiction or in a non-cooperative jurisdiction.

Interests from financial debts. The Law sets forth a limit for the deduction of interest from financial obligations to related resident and nonresident individuals. This interest will be deducted up to (i) the annual amount established by the Tax Authorities or (ii) 30% of the net profit without accounting for interest and depreciation, whichever is greater. Interest that cannot be deducted may be carried forward up to 5 fiscal years.

2. Fiscal Procedures

Voluntary closing agreements. In the context a tax audit, the tax authorities are entitled to enter a "voluntary closing agreement" when appropriate for determining decisive facts or establishing the correct application of the law.

Precautionary measures. Under the Law, tax authorities entitled to take precautionary measures for preventing acts of tax evasion.

Exchange of information. Tax secrecy will not apply to competent authorities of countries with which Argentina has entered an agreement to avoid double taxation in relation to balance sheets and financial statements filed by taxpayers.

Advance pricing agreements. The Law introduces a system of advance pricing agreements known as the "Joint Determination of International Transaction Prices" by which the taxpayer and the tax authorities may determine the criteria to be adopted with regard to transfer pricing assessments.

3. V.A.T.

V.A.T. on digital services. One of the most significant changes is the creation of a new taxable event by adding "digital services" to the V.A.T. Law (Law 23,349 as amended and restated by Decree 280/1997). The tax is the result of three main drivers: (a) the widespread use of digital services in Argentina from foreign companies such as Facebook, Twitter, Netflix, Spotify and Uber; (b) the thirst of a government with a large fiscal deficit; and (c) a desire to be in the good graces of the O.E.C.D. to gain approval for O.E.C.D. membership.

Previously, when an Argentine resident acquired goods or services from a foreign service provider, there would be no V.A.T. applicable in Argentina. This now is no longer applicable to digital services.

Under the Law, digital services are defined as "*those carried out through the internet or any other adaptation or application of protocols, platforms or technology used by internet or other net through which equivalent services are provided that, by their nature, are basically automatized or require a minimal human intervention*".

Digital services are subject to V.A.T. at the rate of 21%. The rate is applied to the net price of the transaction as stated on the invoice provided by the foreign service provider. The recipient of the services is obliged to make the V.A.T. payment.

The law covers various digital services, including foreign web hosting services, designs and components, software downloads, data storage services, games, streaming services, music, media, dating website services, e-learning and data analysis on the internet. E-book or other digital book downloads are not subject to V.A.T., as books are generally exempted from V.A.T.[2].

Digital services relate to services having "effective exploitation" in Argentina. Effective exploitation in Argentina upon the first use of the service by the receiver or when such receiver uses the service for its consumption.

Several exceptions exist to the general rule.

- For V.A.T.-registered taxpayers, a rebuttable presumption exists that effective use or exploitation takes place where (a) the recipient's the mobile phone or SIM card is based or (b) the IP address of the recipient's electronic device is based.
- For V.A.T.-not-registered taxpayers, a rebuttable presumption exists that that effective use or exploitation takes place in Argentina when (a) the recipient's mobile phone or SIM card is based in Argentina, (b) the IP address of the recipient's electronic device is based in Argentina, (c) the domicile of invoice is in Argentina, (d) the bank account of the recipient is in Argentina, or (e) the domicile of the bank account or credit card is based in Argentina.

[2] As per section 7 of the V.A.T. Law 23,349.

The taxable event takes place when the digital service is finalised (i.e., delivered to the Argentine recipient) or upon total or partial payment of the service price, whichever happens first.

Taxpayers registered for V.A.T. in Argentina should include their applicable V.A.T. on digital services on monthly tax declarations to the tax authorities. Taxpayers not registered for V.A.T. in Argentina should pay the tax directly or should have V.A.T. withheld by the local Argentine intermediary carrying out the payment. If there is more than one intermediary resident or domiciled in Argentina, the intermediary with the closest commercial ties to the recipient should act as the withholding and paying agent. Thus, for services paid with a local Argentine credit card or bank account, the local bank or credit card company should withhold 21% of the purchase price of the relevant services. (If the price is in U.S. dollars, use the rate of exchange for selling U.S. dollars of the National Bank of Argentina.) This withholding mechanism became operational on June 14, 2018[3].

The regulation[4] provides a list of companies providing services that should give rise to V.A.T. withholding when payment is made from a local account. This list will be updated on a monthly basis. Certain other payees[5] may be included in the withholding mechanism when the payment does not exceed U.S. $10 (or its equivalent) and the recipients of the services are not registered V.A.T. taxpayers in Argentina.

The withholding should be carried out on the date of payment of the bank or credit card statement, even when the payment is partial. When there is no local bank or credit card payment, the taxpayer should pay the tax directly by the last day of the month in which the digital service were provided.

CONCLUSIONS

It is very difficult to reduce taxes or simplify the tax system in Argentina. Even when the publicly-announced intention is to reduce taxes to spur competitiveness, the net result is often more taxes and a more complicated system.

After the reform, Argentina still ranks number 2 on the World Bank index because, although some taxes have been nominally reduced (e.g., personal assets tax, corporate income tax), the net effect of the reform was neutral due to the creation of new tax charges.

Ronald Reagan once said, "Government's view of the economy could be summed up in a few short phrases: If it moves, tax it. If it keeps moving, regulate it. And if it stops moving, subsidize it."

We often see how human invention and markets create environments that are more efficient and evolve faster than governmental regulations. Governments look at the efficiencies of technology as an interesting source of revenue, and they are eager to chase that revenue. In Argentina, the victim is not the technology company but the local taxpayer who now should pay more for the same services, paying now two governments – the foreign government where the technology company is based and the Argentine government where the taxpayer resides – for the same service.

3 30 days after the publication in the Official Gazette of Resolution 4240/2018 of the Tax Authorities.

4 General Resolution 4240/2018 of the Tax Authorities.

5 E.g., Airbnb, Apple, and SONY.

New French Tax Rules for Restructuring Operations

By Virginie Marrer

Kipling Avocats (France)

In early 2017, the Court of Justice of the European Union ("C.J.E.U.") issued its decision in the *Euro Park Service* case[1], striking down a provision of French tax mandating government approval in all cross-border mergers, including those involving companies resident in other E.U. states. When major tax reform was adopted at the end of 2017, the two Amending Finance Bills dated December 29, 2017 ("Finance Bills") introduced major changes in the French tax rules applicable to restructurings. The new rules apply as of January 1, 2018. This article explains the rules facilitating wholly domestic and cross-border mergers.

GREATER FLEXIBILITY IN RESTRUCTURINGS

1. Favourable tax regime for mergers

The favourable French tax regime applicable to mergers, demergers and partial contributions of assets ("*apport partiel d'actif*") between companies subject to corporate income tax ("C.I.T."), consists of the following tax advantages:

a. the merged or transferor (of shares) company is not subject to C.I.T. on capital gains generated by the transfer of assets to the absorbing or beneficiary company;

b. the merging or transferee company does not report any gain or loss upon receipt of the assets of the absorbed or contributing company;

c. the merging or transferee company's basis in the assets acquired is the same basis as in the absorbed or contributing company;

d. shareholders of the merged or transferor (whether companies or individuals) benefit from a tax deferral on their capital gains; and

e. the transaction is subject to fixed registration duties (€375 or €500 depending on the amount of the share capital of the absorbing or recipient company) instead of registration duties at progressive rates (up to 5%).

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[1] ECJ n° C-14/16, Judgment of the Court, Euro Park Service v Minister of Finance and Public Accounts.

Subject to prior approval of the French tax authorities, the existing tax losses of the absorbed company may be transferred to the merging company and carried forward indefinitely if:

f. the reorganization is motivated by commercial business reasons and its main purposes are not tax purposes;

g. the business generating the losses was not subject to significant changes during the loss-generating period, and the business is carried on by the absorbing company for a minimum period of three years without significant changes; and

h. the losses were not generated by the management of movable assets or real property by holding companies.

2. Prior law involving cross-border mergers

Under prior law, all reorganizations involving a foreign entity were subject to an advance ruling requirement under Section 210 C of the French Tax Code ("F.T.C.") in order to benefit from the French tax deferral regime of Section 210 B.

Notwithstanding French tax law, in the *Euro Park Service* case, no approval was sought by the taxpayer when a French subsidiary was merged into its Luxembourg parent company. The French company did not report taxable gains realized from the transaction. Consequently, the French tax authorities treated the merger as taxable and imposed tax and penalties on the Luxembourg Parent. The basis for this position was that the French company failed to seek required prior approval before transferring its assets, and in any event, the merger was not justified by valid commercial reasons. Rather, it was carried out for tax evasion or avoidance purposes. This arguably enabled the French tax authorities to ignore the general rule of the Merger Directive. Member States are permitted to disallow tax deferral under the Merger Directive where tax evasion or tax avoidance is a principal objective of the cross-border merger.

The case was referred to the C.J.E.U. for a preliminary ruling on whether French law transposing Article 11(1)(a) of the Merger Directive was precluded by the freedom of establishment under Article 49 of the Treaty on the Functioning of the European Union. The court ruled that the French law as applied was invalid. The policy of the Merger Directive is to promote cross-border mergers by eliminating restrictions, disadvantages or distortions arising from domestic provisions. The provision relied on by the French tax authorities is an exception to the general rule and should be applied only in limited circumstances when it is clear that tax avoidance is present as a principal purpose.

3. New merger regime for cross-border mergers

As of January 1, 2018, all cross-border mergers and partial contributions of a complete line of business (see the definition under Complete Line of Business, below) are eligible for this regime provided the following conditions are met:

a. Record keeping

When a company is absorbed or benefits from a partial contribution of assets, the booking of the transferred assets must comply with accounting regulations applicable to all companies registered in France.

Accordingly, the asset value recorded in the accounts of the transferee company depends on (i) control at the time of the reorganization and (ii) the type of restructuring (i.e. whether the parent company is absorbing its subsidiary ("*fusion à l'endroit*") or the subsidiary is absorbing its parent ("*fusion à l'envers*")).

Transferred assets should be recorded at book value when the entities are placed under common control or where they are separately controlled and the reorganization is *à l'envers* (i.e., after the reorganization, the main shareholder of the absorbed company controls the absorbing company or the contributing company takes the control or increases its control of the beneficiary company). In contrast, transferred assets must be recorded at fair market value when the entities participating in the transaction are separately controlled and the reorganization is *à l'endroit* (i.e., after the reorganization, the main shareholder of the absorbing company maintains control over this company or the contributing company either loses its control over the line of business or it does not take control of the company benefitting from the contribution). As an exception to these rules, the contribution of a complete line of business must be recorded at the fair market value if an undertaking exists to sell the shares in exchange for a contribution to a separately controlled entity.

If a restructuring is undertaken between entities that have no common control before the restructuring but are held by the same individual or group of individuals, these entities are deemed to be separately controlled, and the transferred assets must thus be recorded either at the book value if the restructuring is *à l'endroit* or at the fair market value if the restructuring is *à l'envers*.

When the assets are recorded at book value, the merging or transferee company must record, in its balance sheet, the value of assets in the books of the absorbed or contributing company as well as the depreciation allowances and provisions related to these assets. In other words, the carrying value of the assets carries over from the transferor and accumulated depreciation account carries over, as well.

Under the favourable regime, current assets transferred to the absorbing entity or the entity benefitting from the contribution of a complete line of business must be recorded at their value in the books of the absorbed or contributing company. Failing this (i.e., if the current assets are registered for their market value), the profit equal to the difference between the market value and the book value is to be added to the merging or transferee company's income.

The abovementioned record-keeping rules apply on a mandatory basis. If they are not complied with, the favourable tax deferral regime may not be applied.

b. Deferred taxation

The merging or transferee company must take over the obligations of the absorbed or contributing company as to the profits that benefitted from a tax deferral and which must be added back to the taxable income subject to C.I.T.

c. Capital gains on depreciable assets

The merging or transferee company must add back the capital gains related to depreciable transferred assets (i.e. the difference between the transfer value and the net book value in the absorbed or transferring company's books) to its taxable income subject to C.I.T., in equal share over a five-year period.

d. Subsequent sale of non-depreciable assets

The merging or transferee company must calculate the capital gain derived from the subsequent sale of non-depreciable transferred assets using their value in the balance sheet of the merged or transferee company (rather than their transfer value).

e. Information on tax deferrals

Companies that restructure under the favourable tax regime must attach a form to their C.I.T. returns which indicates all deferred capital gains under this regime at the time of the transaction and ensures their follow-up. A register of the gains must be maintained and made available to French tax authorities upon request. Failure to comply with these rules will result in a penalty equal to 5% of the amounts omitted.

If these conditions are met, a tax ruling is now only required for a cross-border restructuring that does not involve a complete line of business. Consequently, when the partial transfer of assets involves a complete line of business, the tax deferral regime applies automatically, subject to the potential application of the new anti-abuse provision discussed in section New Anti-Abuse Provision, below.

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Consequently, the French tax authorities are no longer entitled to require as a condition for granting an advance ruling that the foreign company benefitting from a transfer of shares must retain those shares for as long as the transferor company keeps shares received in exchange for the contribution. However, in order for the cross-border transaction to benefit from the favourable tax regime, the assets must be allocated to a French permanent establishment of the foreign transferee company and the French transferor company must file a specific in return.

4. Special conditions for cross-border transactions

Two special conditions have been introduced with respect to cross-border transactions.

a. Allocation to a permanent establishment located in France

Mergers, demergers, and partial transfers of assets to a foreign company must be allocated to a French permanent establishment of the foreign company in order for the favourable tax regime to apply. All assets and liabilities that are transferred to the foreign company must be registered in the balance sheet of its French permanent establishment.

It should be noted that this requirement, in the case of partial transfer of assets, only covers transfers of a complete line of business. It does not cover a transfer that is deemed to involve a complete line of business (see the definition under Complete Line of Business, below) but does not constitute a permanent establishment.

b. Specific filing

Whenever the favourable tax regime applies to a merger, demerger or partial transfer of assets to a foreign company, the French transferee or transferor company must electronically file a special return to enable the French tax authorities to understand the purpose of the transaction and its consequences.

It must provide the following information to the French tax authorities:

i. the date and nature of the transaction;

ii. the names and addresses of the companies involved, including the address of any permanent establishment located in France of the foreign company involved as well as their financial ties before the transaction and the exact nature of the activity carried out by the foreign company;

iii. the motives and purposes of the transaction, in particular the improvements that are foreseen as well as the related reorganizations, if any, realized prior or after the transaction; and

iv. the tax and economic consequences of the transaction, in particular for activities, means and functions maintained in France or transferred abroad.

This return must be filed together with the income tax returns of the tax year during which the transaction is realized. Failure to file this specific return gives rise to a penalty of €10,000 for each transaction.

PARTIAL CONTRIBUTION OF ASSETS: THREE-YEAR HOLDING REQUIREMENT REPEALED

Section 23 of the second Finance Bill defines a partial transfer of assets as a transaction in which a company transfers, without being dissolved, one or more lines of business (or "branches of activity") to one or more existing or new companies, leaving at least one line of business in the transferring company, in exchange for the pro-rata issue to its shareholders of securities representing the capital of the companies receiving the assets and liabilities and, if applicable, a cash payment not exceeding 10% of the nominal value. This definition is now in line with the definition provided by the E.U. Directive 2009/133 dated October 19, 2009.

Until December 31, 2017, the tax deferral regime applied automatically to the contribution of an autonomous (or "complete") line of business

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provided that the transferring company undertook (i) to hold for at least three years the shares issued by the transferee company in remuneration of this contribution and (ii) to compute the capital gain derived from the subsequent sale of the shares received by carrying over the tax value of the transferred assets in the balance sheet.

1. Complete line of business

A line of business (or branch of activity) is defined by the E.U. Merger Directive as "all the assets and liabilities of a division of a company which from an organizational point of view constitute an independent business, that is to say an entity capable of functioning by its own means".

According to French case law, the existence of a complete line of business must be ascertained both in the transferor company and the transferee company. All the component parts that are essential to the line of business must be transferred, as they exist in the transferring company according to conditions that enable the transferee company to have a durable disposal of all these elements. For example, a line of business is deemed "complete" even though ownership of the trademark or the operating premises is not transferred provided that the transferee company obtains a guaranteed right to use the trademark or the operating premises for a long-term period.

In order for the favourable tax regime to apply regarding C.I.T., the transfer must include all assets and liabilities directly or indirectly related to the line of business. For the French tax authorities, all the employment agreements must be transferred. However, the administrative Supreme Court ("*Conseil d'Etat*") has held that only contracts of employees necessary for the activity to be carried out must be transferred. This determination takes into account the nature of the activity and the characteristics of the employment agreements. The *Conseil d'Etat* also has held that it is necessary to transfer only accounts receivable that are essential to the independent functioning of the transferor and transferee companies.

Assets and liabilities that are common to several lines of business must be allocated between these lines according to criteria that are appropriate in consideration of the nature of each element transferred, such as the turnover or the total payroll.

According to these principles, the line between the transfer of a complete line of business subject to the tax deferral regime and a simple transfer of assets which generates taxable capital gains is sometimes blurred.

Under French domestic law, a shareholding may also qualify as a complete line of business when:

a. the interest represents more than 50% of the share capital of the company, provided that the transferor company does not receive a cash payment exceeding either 10% of the par value of the shares received in exchange for its contribution or the capital gain derived from the contribution,

b. the transferred interest provides the beneficiary company with direct ownership of more than 30% of the voting rights when no other shareholder holds a higher interest, or

c. the contribution benefits a company already holding more than 30% of the voting rights when this company thus acquires the highest percentage of voting rights of the company.

It should be noted that concurrent transfers of interests in the same company are added when determining if the 30% threshold has been met.

2. New tax regime applicable to partial transfers of assets

The Finance Bill repeals the three-year holding requirement when the contributed assets qualify as a complete line of business. This is a revolution in French tax law and will facilitate both French and cross-border restructurings. However, more will be required in order for the French tax deferral regime to be fully compliant with the Merger Directive.

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Capital gains derived from a subsequent sale of shares issued in consideration of a transfer still must be calculated with reference to the tax value of the assets in the balance sheet of the transferor company. This methodology is not included in the Merger Directive and appears to be contrary to its spirit. Due to this rule, the partial transfer of assets may continue to result in double taxation. First, taxation occurs at the level of the transferee company. When the contributed assets are registered at market value, the transferee company must add back to its taxable income subject to C.I.T. potential capital gains related to depreciable assets, using the market value booked as the hypothetical sales price. The gain is added back in equal shares over a five-year period. The transferee company must also compute capital gains derived from the sale of non-depreciable assets using the value they had in the books of the transferor company. Second, taxation occurs at the level of the transferor company when capital gains generated by the sale of shares issued in consideration of the transfer are computed based on costs equal to balance sheet values of the contributed assets.

However, when the transferred shares qualify as a controlling interest, double taxation can be reduced. When a controlling interest is sold after being held for two years, only 12% of the capital gain is subject to C.I.T. The starting date of this two-year holding period is unclear. It may be either the date of acquisition of the assets by the transferor company or the date of the transfer.

3. Advance rulings for assets that are not a complete line of business

Where the transferred assets do not represent one or more complete lines of business, the transaction can still benefit from the favourable tax regime provided that an advance ruling is obtained from the French tax authorities. Advance rulings are granted where:

a. the transaction is economically justified by a business purpose and, in particular, would (i) allow the transferee company to operate on an autonomous basis, (ii) improve the structure, or (iii) to set up an association between various parties through a commitment to keep all shares received for at least three years;

b. the conditions provided by Section 210-O-A of the F.T.C. are met (in particular, the transaction does not fall within the scope of the new general anti-abuse provision and the new filing requirements introduced for cross-border transactions are met (see Prior Law Involving Cross-border Mergers, above)); and

c. the transaction is structured to allow future French taxation of the deferred capital gains.

NEW ANTI-ABUSE PROVISION

A new general anti-abuse provision is introduced whereby any "merger, demerger or transfer of assets having as a main purpose, or as one of its main purposes, tax fraud or avoidance" will not benefit from the favourable tax regime. The provision applies to domestic and cross-border mergers and related transactions. It is similar to the presumption of fraud or tax evasion provided in Section 15, 1-a of the E.U. Directive of 2009.

This provision emphasizes the importance of a valid business purpose. Under a new procedure, a taxpayer may request an advance ruling from French tax authorities that a proposed reorganization does not fall within the scope of the general anti-abuse provision. (see New Ruling Process, below). The reorganization or rationalization of activities carried out by the companies is considered a valid business purpose. Presumably, transactions that are initiated by outside tax advisers may have more difficulty in meeting this requirement.

Due to the existence of this anti-abuse provision, the French tax authorities may no longer be entitled to follow the special procedure for abuse of law ("*abus de droit*") leading to a related penalty of 80%. since, according to Supreme Court case law, *abus de droit* may only be used by the French tax authorities when there is no other basis for the tax reassessment.

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NEW RULING PROCESS

When a taxpayer wishes to ascertain whether a proposed restructuring will benefit from the favourable tax regime and is exempt from the anti-abuse provision, it may now request a formal ruling from the French tax authorities. The request must be made in writing. The request must include a detailed description of the contemplated transaction.

If a formal answer from the French tax authorities is not received within six months of the submission of the request, the transaction is deemed valid and the application of the favourable tax regime can no longer be challenged on the grounds of the anti-abuse provision.

DE-MERGERS OR SPLIT-UPS

Split-ups may also benefit from the favourable tax regime provided additional conditions are met.

A split-up can be defined as a two-step transaction whereby a company (i) transfers all of its assets and liabilities (i.e. a complete line of business) to two or more existing or newly created companies (the beneficiary companies) in return for shares and then (ii) distributes the shares received in exchange for a contribution to its shareholders. A transaction of this type is often referred to as a spin-off or a split-up. According to *Conseil d'Etat*, shares are not deemed to be a complete line of business.

Prior to the Finance Bill, in order for the split-up to benefit automatically from the favourable tax regime, several conditions needed to be met. First, the company undergoing the split-up must have had at least two complete lines of business. Second, certain of its shareholders were required to commit to hold the shares of each transferee company for at least three years. The required holding period was applicable to shareholders holding at least 5% of the voting rights of the split-up company or shareholders holding at least 0.1% of the voting rights who were appointed as managers, directors or supervisory board members. Finally, each transferee company must have come away with one or more complete lines of business. If one of these conditions was not met, an advance ruling from the French tax authorities was required before tax-free treatment was allowed.

The Finance Bill repeals the requirement to hold the shares for at least three years when each of the transferee companies receives at least one complete line of business. When the transferred assets do not constitute a complete line of business, the distribution of shares can still benefit from the favourable tax regime provided an advance tax ruling is granted by the French tax authorities.

CONCLUSION

A sea change has taken place in French tax law regarding merger transactions. Among other things, mandatory rulings as to the absence of abusive tax planning were eliminated and objective standards were adopted for proper record keeping to easily allow for a retroactive review of the validity of the transaction. When comparing the new rules for cross-border mergers with the prior ruling procedures, some French tax advisers will regret the loss of certainty that was provided by the ruling procedure under the old law. Once the ruling was granted by the French tax authorities under the old law, certainty existed that the favourable tax regime applied. Now, in the absence of a ruling, uncertainty may exist concerning the application of the special tax regime when it is not clear that a complete line of business has been transferred.

Digital Economy – An Indian Tax Perspective

By Jairaj Purandare and Shibani Bakshi Parekh
JMP Advisors PVT Ltd. (India)

INTRODUCTION

The term "digital economy" refers to an economy that is based on digital computing technologies and involves the use of digital media of various types. Although, the digital economy is often confused with e-commerce, in reality, digital economy is a very wide term including a variety of software, internet platforms, applications, Internet of things, online advertising, cloud computing, crypto currencies, advanced robotics, electronic business processes, e wallets and online payment services, etc. apart from e-commerce transactions.

DIGITAL ECONOMY IN INDIA

The digital economy continues to make impressive advances across the globe and India is among the leaders in this space.

The landmark event of demonetization of currency in India in November 2016 saw a spur in the use of internet banking, plastic money, and e-wallets to make cashless payments. This was followed by the introduction of the Goods and Services Tax ("G.S.T.") in July 2017, which mandates that all records and documentation are to be updated on the online portal.

Based on press reports, the Economic Affairs Secretary of India expects that the digital economy in India may cross the USD 1 trillion mark by the year 2022 and may even constitute half of the total economy by 2030.

TAXATION CHALLENGES IN THE DIGITAL ECONOMY

With the increasing advances in digitization across various industries around the globe, there has been a significant increase in online transactions in the past few years, especially e-commerce transactions. In a borderless digital economy, it is possible to target a large volume of consumers and to undertake business activities in a foreign jurisdiction without establishing a place of business or a physical presence. As a result, tax administrations in most countries have not been able to keep pace with the advances of digitization and several difficulties can arise in the taxation of the digital economy, more so in the case of cross-border transactions. The important task that awaits completion by tax authorities is the adoption, on a global basis, of an acceptable method of allocating taxing rights among various jurisdictions involved in a digital transaction.

Digital Economy - An Indian Tax Perspective

TAXATION CHALLENGES IN THE DIGITAL ECONOMY FROM AN INDIA PERSPECTIVE

As per the provisions of the Indian tax law, non-residents are subject to tax only in respect of the income received in India or income sourced in India. Generally, business income of non-resident entities is taxed in India only if where a business connection or Permanent Establishment ("P.E.") exists in India. If sufficient connection of a P.E. exists, net business income of non-residents are taxable at the base rate of 40% in case of corporate entities and at 30% in case of non-corporate entities. However, if the income of the non-resident is in the nature of specific items of income such as royalties, fees for technical services, capital gains, or interest, specific rates of gross basis tax are applicable.

Since the digital model of business is quite different from traditional business and there is greater reliance on the use of intangibles, it is not easy to determine whether a foreign entity has a sufficient business connection or P.E. in another country by applying the existing tests under the domestic tax law or tax treaties. In fact, this is not a problem unique to India; tax authorities in most countries are grappling with this issue, France and Italy have adopted legislation, and proposals have been floated by the European Commission.

In view of the above, India has recently introduced certain measures in its domestic tax law to bring certain digital transactions under the tax scanner, based on the Base Erosion and Profit Shifting ("B.E.P.S.") recommendations of the Organisation for Economic Co-operation and Development ("O.E.C.D."). These are discussed below:

1. Equalization Levy

The Equalization Levy ("the Levy") was introduced in India with effect from 1 April 2016, following the recommendations of the O.E.C.D. B.E.P.S. Action 1. The Levy is intended for certain Business-to-Business transactions in India. It will be charged at the rate of 6% applied to the consideration payable for online advertisement, provision of digital advertising space or any other facility or service for the purpose of online advertisement. The Indian tax authorities have the power to apply this charge to other services. As of 31 August 2016, the tax has not been applied to other services. Nonetheless, a general expectation exists that the scope of the tax will be expanded gradually to apply to other services.

The Levy is applicable to the consideration for specified online advertising services payable to a non-resident by (i) a person who is resident in India and carrying on business or a profession or (ii) a person who is not resident in India but who has a P.E. in India. Note, however, if the consideration for the specified services is payable to a non-resident having a P.E. in India and the services are connected to the P.E., the Levy will not be applicable. As can be seen, the Levy is targeted non -residents who provide specified online services that do not maintain a taxable or a business presence in India. Prior to the adoption of the Levy, those non-resident persons were not subject to tax in India in connection with income arising in India.

Further, the Levy is applicable only to payments exceeding an amount of INR 0.1 million (~USD 1,500), which is a low threshold and hence, a large number of online advertising payments could come under the scope of the Levy. The income of the non -resident payee which has been subject to the Levy is exempt from income tax in the hands of the payee in India.

The onus of collection of the Levy is on the payer of the consideration and this amount is required to be withheld by the payer. The payer is required to deposit the Levy so collected with the tax authorities within a specified time and must file a report with the tax authorities. There are penalties for failing to collect or pay over the Levy within the specified time.

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The interesting aspect of the Levy is that it has been introduced in the Finance Act, 2016 and not under the provisions of the Indian Income-tax Act. Moreover, the Levy is strictly not in the nature of an "income tax" charged under the domestic tax law and is not imposed on net income of the non-resident taxpayer. Consequently, there may be no foreign tax credit available for the Levy under the provisions of the tax treaty. Hence, this Levy would become a permanent tax leakage for non-residents.

2. Expansion of the definition of business connection – Introduction of "Significant Economic Presence"

Under the domestic tax law, a non-resident carrying on a business or profession in India and receiving income from such business or profession is subject to tax in India in respect of such income, provided that a sufficient business connection exists in India. The term "business connection" has not been defined in the domestic tax law. Rather, its meaning has been inferred from various judgments rendered by the courts over a period of time. Based on court rulings, the term "business connection" is generally interpreted as a relation between a business carried on by a non-resident yielding income or profits to the non-resident and some activity in India which contributes to the earning of such income or profits.

Even as per the provisions of the tax treaties entered into by India, a non-resident would be subject to tax in India if it has a P.E. in India. Therefore, to date, digital companies were able to remain outside the scope of Indian tax jurisdiction when activities carried on in India did not constitute a PE.

However, legislation was adopted regarding the existence of "business connection." As per the legislation, the concept of "Significant Economic Presence" can be used in defining the existence of a business connection in the context of the digital economy. A non-resident having Significant Economic Presence in accordance with the provisions of the domestic tax law would be considered as having a business connection in India and hence, subject to tax in India.

For this purpose, Significant Economic Presence has been defined to mean:

a. Transactions in respect of any goods, services or property carried out by a non-resident in India including provision of software or data that is downloaded in India and that exceeds a certain threshold, which will be notified subsequently or

b. Systematic and continuous soliciting of business activities or engaging in interaction through digital means with a certain number of users in India, to be determined subsequently.

Once a "Significant Economic Presence" exists, a digital transaction will be taxed in India even if the agreement for such activities is entered into outside India and the non-resident maintains no place of business in India or renders no services in India. Where a "Significant Economic Presence" exists, the income attributable to such transactions would be taxable in India.

This amendment is a radical divergence from the existing tax provisions where establishment of a physical presence or taxable presence was a prerequisite for taxing the income of a non-resident. It has been specifically brought in to tax the transactions undertaken in the digital economy by non-residents attempting to avoid a business connection in India. However, where India has entered into a tax treaty and the provisions of the tax treaty conflict with the new rules in India, the non-resident may be able to seek relief under the tax treaty, except to the extent the provisions of the Multilateral Instrument ("MLI") may have modified the result under the treaty.

Possible challenges may be raised to this provision. The threshold for revenue and number of users constituting a Significant Economic Presence is yet to be announced by the tax authorities. The cost of systems required to compute the number of users with whom the non-resident entity has had interactions during the relevant financial year may be unduly burdensome. Moreover, substantial differences may exist between the taxpayer and the tax authorities in defining the level of contact that constitutes an interaction and establishing whether that contact is deemed to be systematic and continuous.

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The concept of Significant Economic Presence has been adopted by India based on the recommendations of O.E.C.D. B.E.P.S. Action 1. It is important to note that while the Explanatory Memorandum in respect of the amendments to the income tax law states that the concept of "Significant Economic Presence" is introduced to cover transactions in the digital economy, the actual amendment in the law appears to be applicable to the traditional business model, as well, since the definition of Significant Economic Presence is an inclusive definition that is applicable to transactions in respect of any goods, service or property, including download or data or software, etc.

In view of this amendment, it would be interesting to see how the tax authorities would view the activities of foreign companies which provide various online booking facilities in India. and have their servers outside India. If electronic payments are made by Indian customers and routed to the foreign company's offshore server, the Indian tax authorities might feel justified in contend that the payments made to the foreign entity are for the purpose of bookings in India and therefore, the source of income is in India.

In addition to the above, the digital economy is distinctly characterized by heavy reliance on intangibles. At present, there are no separate rules in the Indian tax law in respect of intangibles and especially, in the context of non-residents carrying out business activities in India through digital means. However, judging by the amendments to the tax law in the recent past, it may not be a surprise if provisions to tax intangibles in the digital business model are introduced with general application in the Indian tax law.

3. Key court rulings

Over the last few years, the Indian tax authorities have started scrutinizing transactions in the digital space more closely, as evidenced by the increased level of litigation in this regard. Some of the key decisions rendered by courts recently are discussed below:

a. Flipkart India Pvt Ltd (April 2018)

This ruling was delivered by the Income Tax Appellate Tribunal (i.e. the second level appellate authority) in Bangalore and pertains to the taxpayer's income in fiscal year 2014-15. The issue under consideration was the deductibility of discounts on sales for determining the business income subject to tax.

The taxpayer, an Indian company, was engaged in the business of wholesale trade. It provided large discounts to its customers (i.e., retail sellers) and incurred significant losses. The retail sellers in turn sold the goods on flipkart.com, the internet platform. The taxpayer's argument on the deductibility of these discounts was that the e-commerce sector was at an early stage in India were offered to encourage sales volume.

The Indian tax officer took the view that selling the goods at a loss was not normal business practice and that this particular strategy was followed to establish customer goodwill and brand value in the long run, reaping the benefits in subsequent years. The tax officer observed that the profit foregone by the taxpayer was actually the expenditure incurred for the creation of intangibles and should be characterised as a capital expenditure. The tax officer further observed that two venture capitalists invested in the shares of the taxpayer at a premium during the relevant fiscal year. According to the tax officer, such high share premium was justified only because of the asset base created by the taxpayer in the form of brand value, which is an intangible asset. Hence, the tax officer did not allow a deduction for the discount in computing the taxpayer's income.

The appellate authority ruled in favour of the taxpayer. Where a trader transfers goods to others at a price that is less than charged by competitors, and the transaction is *bona fide*, the tax officer cannot take into account prices charged by others, ignoring the actual price realised from the transaction. Further, since the taxpayer did not incur any expenditure to acquire marketing intangibles, there was no evidence of creation of intangibles. The appellate authority also noted that a tax officers job is to examine the profit or loss reported in the books of account of the taxpayer and cannot ignore the book results of the taxpayer and resort to estimating the income of the taxpayer in a different manner.

b. MasterCard Asia Pacific Pte Ltd (June 2018)

This ruling was rendered by the Authority for Advance Rulings ("A.A.R.") in the case of a taxpayer incorporated in Singapore. The taxpayer, MasterCard Asia Pacific Pte Ltd ("M.A.P.L.") was engaged in carrying out transaction processing and payment related services.

M.A.P.L. entered into agreements with customer banks and financial institutions in India to provide services relating to electronic authorization, clearing, and settlement of payments for transactions made through cards. The processing took place on the MasterCard Worldwide Network. In order to access this network, a MasterCard Interface Processor ("M.I.P.") is installed at the customers location in India. These M.I.P.s are owned by the Indian subsidiary of M.A.P.L. The issue before the A.A.R. was whether a P.E. existed for M.A.P.L. in India.

The A.A.R. ruled, that the automatic equipment installed in the customers premises are in the nature of a P.E. that causes M.A.P.L. to be taxed in India in connection with the revenue generated through the use of the equipment. The A.A.R. observed that in order to constitute a fixed place P.E., it is not necessary that the equipment should be fixed to the ground; it is sufficient that the equipment remains on a particular site, in accordance with the O.E.C.D. Commentary on Article 5 ("Permanent Establishment"). Further, the M.I.P.s were permanently located in India and the fact that neither the sites nor the M.I.P.s were owned by M.A.P.L. are not relevant. As long as M.A.P.L. has a certain space at its disposal, it is sufficient to create a P.E. Further, the A.A.R. observed that any payment processing activities carried out by personnel in India were not preparatory or auxiliary activities. They went to the core of the revenue raising activity.

c. Google India Pvt Ltd (October 2017)

This ruling was issued by the second level appellate authority in Bangalore. The taxpayer, Google India Pvt Ltd was an Indian company and tax resident in India. Google India was granted the marketing and distribution rights of the Adword program for advertisers in India. The principal under the distribution agreement was Google Ireland. Google India made payments to Google Ireland under the Adword agreement without the collection of withholding taxes. According to Google India, the payments made to Google Ireland were for the use of advertising space. The tax officer held that the payments were in the nature of royalties and were subject to withholding tax.

The appellate authority observed that the agreement between Google India and Google Ireland was not merely an agreement for the sale of advertising space. The payment constituted consideration paid by Google India for the use of a patented algorithm of Google Ireland to decide which advertisement was to be shown to a particular user who performed a search on the Google website. The licensed technology allowed Google India to conduct a focused marketing campaign for the products and services of Googles customers with the help of technology. The search engine technology, associated software, and other features constituted intellectual property owned by Google Ireland. Therefore, the payment by Google India for use of these tools for accepting advertisements was in the nature of a royalty.

d. Localized Record Keeping

Apart from the income tax provisions in India, certain guidelines issued by other regulatory authorities in India in the context of the digital economy may also have a bearing on Indian income tax exposure.

The Reserve Bank of India ("R.B.I."), which is the regulatory body for exchange control matters in India, issued directions in April 2018 to payment system operators in India requiring that the entire data relating to payment systems operated in India should be stored on a system physically located in and only in India. Covered data includes the end-to-end transaction such as the details; the information that is collected, carried, or processed as part of the payment message; and the instruction. For the foreign segment of the transaction, if any, the data can also be stored in the foreign country, if required. Further, payment systems operating in India are required to comply with this requirement within six months from the issue of the directions and report the necessary compliance to the R.B.I. latest by 15 October 2018.

Earlier this year, press reports indicated that amendments to the National Telecom Policy of India were under consideration whereby all telecom companies hosting data of Indian citizens and entities may be required to set up their servers in India by 2022.

The Indian Government has appointed a committee chaired by a retired judge of the Supreme Court of India to provide recommendations on data protection. A report was submitted in July containing a broad framework for a data protection law in India.

On the subject of data localization, the report states that every company processing personal data storage must keep at least one copy of personal data on a server or data centre located in India. The Indian Government would be authorized to identify certain categories of personal data as critical personal data that can be processed only on a server or data centre located in India. When implemented, the data protection policy is likely to bring more financial companies under the ambit of data localization by categorizing most types of financial data as sensitive personal data.

In light of the above, it is likely that India may have a comprehensive data protection law soon. Global entities operating in the digital economy may be required to set up servers in India in order to store data pertaining to Indian citizens/entities/ transactions. Indian tax authorities may view these servers Indian P.E.s of the foreign entity, thereby exposing the foreign entity to taxation in India.

CONCLUSION

It can be seen from the foregoing discussion that various dimensions exist regarding the taxation of digital business. The scope of regulation is expanding and non-tax regulations regarding localized record-keeping laws may yield greater exposure to business taxation if local data storage creates a P.E. The Task Force on Digital Economy constituted by the O.E.C.D. B.E.P.S. Committee has issued an interim report on the tax issues that confront business and tax authorities in connection with tax policy. A final report on tax challenges for the digital economy is expected by 2020. It will be a matter of a few years before uniform in tax policy is adopted globally. Until then, Indian tax policy will develop based on the local views and concerns of Indian policy makers.

ABOUT THE AUTHORS

TEL.

+61 9230 9201

FAX

+61 9222 9099

E-MAIL

gil.levy@gilsons.com.au

FIRM

GILSONS, CHARTERED ACCOUNTANTS AND CHARTERED TAX ADVISERS

Level 5, 6 O'Connell Street
Sydney, New South Wales, 2000
Australia

WEBSITE

www.gilsons.com.au

GIL LEVY

Gilsons, Chartered Accountants and Chartered Tax Advisers, Sydney, Australia

EXPERTISE

Australian and international tax, private corporate and trust structures and restructures, private mergers and acquisitions, estate planning and property taxes. 45 years experience in Australian and international taxation.

PROFESSIONAL HIGHLIGHTS

- President of The Taxation Institute of Australia 2003-2004
- President of Asia Oceania Tax Consultants Association 2008-2012
- Chairman of the Education and Examinations Review Board Taxation Institute of Australia

AFFILIATIONS

- Chartered Tax Adviser
- The Taxation Institute (Previously The Taxation Institute of Australia)
- Institute of Chartered Accountants in Australia
- Certified Practicing Accountants Australia
- Registered Public Company Auditor
- Registered Tax Agent

LANGUAGES

English

TEL.

+54 11 5252 2463

FAX

+54 11 5252 2463

CELL

+54 911 5476 1500

E-MAIL

jc@durrieucanosa.com

FIRM

Durrieu | Canosa Abogados

Suipacha 1380, 3rd Floor
C1011ACD
Buenos Aires
Argentina

WEBSITE

www.durrieucanosa.com

JAVIER CANOSA

Partner, Durrieu | Canosa Abogados, Buenos Aires, Argentina

EXPERTISE

Javier Canosa is a partner at Durrieu | Canosa Abogados. Javier's practice focuses in corporate law issues, tax issues and banking issues, advising both national and foreign companies, and families and HNWI in various corporate matters, including investment vehicles, corporate management, directors' and trustees' duties and responsibilities, audits, risk detection and distribution, documents, policies and corporate contracts, together with the design and implementation of a suitable corporate structure for each business. Javier has vast experience in mergers and acquisition and the negotiation of commercial agreements. He has represented and advised several companies, including financial institutions, in corporate M&A, business development and real estate undertakings. Javier is experienced in claims before local and international arbitral courts.

In addition, he is officer of the International Bar Association (IBA), American Bar Association (ABA) and the Society of Trust and Estate Practitioners (STEP) and is regularly engaged in conferences of issues of related to his practice of those institutions.

Javier also collaborates with the World Bank and International Finance Corporation with their Doing Business report and has been engaged for speaking in World Bank, STEP, IBA, ABA conferences on issues related to his practice.

Javier advises many wealthy families in connection with the management, taxation and transfer of their assets, as shareholders, partners, and founders and beneficiaries of foundations and trusts. He has practiced in the area of cross-border tax, estates, and family disputes for more than 15 years.

PROFESSIONAL HIGHLIGHTS

- IBA Jack Batievsky Scholar 2006.
- IBA Scholar 2007.
- Who´s Who: Real Estate 2007-2016.
- Who's Who Legal: Merger & Acquisition 2016.
- Who's Who Legal: Corporate Governance 2016
- IBA Officer 2007-2016 (currently Secretary of the International Sales Committee).
- ABA officer 2008 -2016 (currently Vice Chair of Latin American Committee and Chair of Programs of the International Tax Committee).
- Contributor to the World Bank on Doing Business Report.

AFFILIATIONS

- Board Member of STEP´s International Private Client Special Interest Group.
- Advisory Board to the Government of the British Virgin Islands
- Board Member to STEP Latin American Conference.
- Vice Chair of the International Sales Committee of the IBA (2016).
- Academician of the International Academy of Trust and Estate Lawyers.
- Fellow of the American Bar Association.

LANGUAGES

English, Spanish, French, Portuguese, German, Italian

TEL.

+33 (0)1 80 48 28 48

FAX

+33 (0)1 80 48 28 50

DIRECT

+33 (0)1 80 48 28 42

CELL

+33 (0)6 72 89 04 42

E-MAIL

vmarrer@kiplingavocats.com

FIRM

KIPLING AVOCATS

6, Villa Bosquet
Paris, 75007
France

WEBSITE

www.kiplingavocats.com

VIRGINIE MARRER

Kipling Avocats, Paris, France

EXPERTISE

25 years of experience in French and International taxation, tax planning for cross-border transactions, tax structuring of foreign investments in France, tax and legal representation in corporate reorganisations, international tax planning for executives and high net worth individuals.

PROFESSIONAL HIGHLIGHTS

- Managing partner and founder of Kipling law firm, Attorneys at law, Paris
- Partner of Marrer Melese and Paul & Marrer, Attorneys at Law, Paris
- Partner and head of tax department of Martinet & Associés, Attorneys at law, Paris
- Senior international tax consultant, Arthur Andersen International, Paris

AFFILIATIONS

- I.F.A. (International Fiscal Association)
- I.B.A. (International Bar Association)
- I.A.C.F. (Institut des Avocats Conseils Fiscaux)

LANGUAGES

French, English, Spanish

TEL.

+91 22 2204 1665

E-MAIL

jairaj.purandare@jmpadvisors.in

FIRM

JMP ADVISORS PVT LTD.

12, Jolly Maker Chambers II,
Nariman Point
Mumbai, 400 021
India

WEBSITE

www.jmpadvisors.com

JAIRAJ PURANDARE

Chairman, JMP Advisors PVT Ltd., Mumbai, India

EXPERTISE

Jairaj (Jai) Purandare is the Founder Chairman of JMP Advisors Pvt Ltd, a consulting and tax firm, based in Mumbai, India. Jai has three and half decades of experience in tax and business advisory matters and is an authority on tax and regulation. He has considerable experience on various issues in the Financial Services, Infrastructure, Power, Media, Pharma, Auto and Education sectors.

PROFESSIONAL HIGHLIGHTS

- Former Regional Managing Partner, Country Leader–Markets & Industries and Chairman – Tax of PricewaterhouseCoopers India.
- Former Chairman of Ernst & Young India.
- Former Country Head of the Tax & Business Advisory practice of Andersen India.
- Named among the leading Tax Advisors in India by International Tax Review (Euromoney).
- Frequent speaker at seminars in India and abroad.
- Presented several papers in areas of his expertise including inbound/outbound investment structuring, international tax, transfer pricing, M&As, Indian Budget and Economy.
- Independent Director on the Boards of two reputed companies.

AFFILIATIONS

- Fellow, Institute of Chartered Accountants of India
- Bachelor of Science (Hons), University of Bombay
- Central Direct Taxes Advisory Committee (chaired by the Finance Minister)
- City of London Advisory Council for India
- YPO, Mumbai Chapter
- British Business Group: former Managing Committee member
- Confederation of Indian Industry (CII): former National Council member and Chairman, DT Committee

LANGUAGES

English, Hindi, Marathi

TEL.
+91 22 2204 1666

E-MAIL
shibani.bakshi@jmpadvisors.in

FIRM
JMP Advisors PVT Ltd.

12, Jolly Maker Chambers II,
Nariman Point
Mumbai, 400 021
India

WEBSITE
www.jmpadvisors.com

SHIBANI BAKSHI PAREKH

Senior Manager, JMP Advisors Pvt Ltd., Mumbai, India

EXPERTISE

Shibani is a Senior Manager with JMP Advisors Pvt. Ltd. She has more than 13 years of experience in advising clients on domestic as well as international tax matters.

Shibani has assisted corporate clients on complex tax issues involving cross border taxation and domestic taxation as well as assisted them with compliance and litigation assignments. She also has rich experience on matters relating to taxation of expatriates and high net worth individuals.

Shibani has represented Indian and multinational entities before various income tax authorities in relation to tax audits and obtaining withholding tax orders for companies. She has also represented clients before first level appellate authorities and assisted tax counsels in representation before the second level appellate authorities.

Shibani was a part of the Deloitte India tax practice for 6 years. She also has industry expertise with one of the leading telecom companies which is part of a large and reputed Indian business group.

PROFESSIONAL HIGHLIGHTS

- Associate Member, Institute of Chartered Accountants of India
- Master and Bachelor of Commerce, University of Mumbai

LANGUAGES

English, Hindi, Marathi, Gujarati, French