



# PREVENTION OF TREATY ABUSE - ARTICLE 7 OF MLI

SIMPLIFIED LIMITATION ON BENEFITS

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**BACKGROUND**



# CONCERN OF BEPS ACTION PLAN- 6

- ▶ Taxpayers engaged in treaty shopping and other treaty abuse strategies
- ▶ Treaty benefits claimed in situations where these benefits were not intended to be granted
- ▶ Treaty shopping- Practice by persons not residents of either contracting states of accessing treaty benefits using an entity that would otherwise qualify as resident of one of these states



# AREAS IDENTIFIED BY BEPS ACTION PLAN- 6

The report is organized into three sections

(A)

- Treaty provisions and domestic rules to prevent granting of treaty benefits in inappropriate circumstances

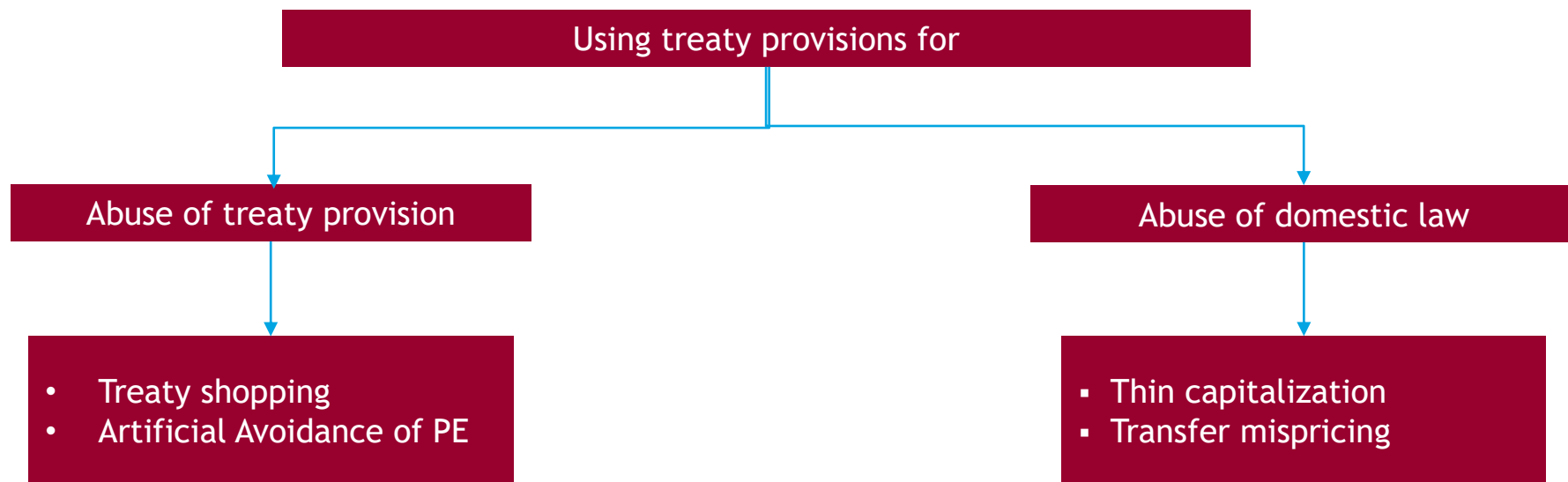
(B)

- Clarification that tax treaties are not intended to be used to generate double non-taxation (forms part of agreed minimum standard)

(C)

- Identify tax policy considerations for jurisdictions to consider before entering into treaties

# PART A: TREATY PROVISIONS AND DOMESTIC RULES TO PREVENT GRANTING OF TREATY BENEFITS IN INAPPROPRIATE CIRCUMSTANCES





# APPROACH OF BEPS ACTION PLAN- 6

## Minimum Standards

### Changes in preamble of treaty

- ▶ Clarify that treaties intend to avoid creating opportunities for non-taxation or reduced taxation through tax evasion or tax avoidance

### Inclusion of any one of the following:-

- ▶ The Principal Purpose Test (PPT) Rule together with Limitation on Benefit (LOB) Rule
- ▶ The PPT Rule alone
- ▶ Detailed LOB Rule and rules to address conduit arrangements

### Implementation of Minimum standard

- ▶ Multilateral Instrument (MLI)
- ▶ Amendment of existing treaties not covered under MLI
- ▶ Inclusion of provision in new treaties
- ▶ If country is not concerned about treaty shopping, it will not be obliged to apply the provision if it agrees to include the provision in treaty for the use of its treaty partner

# BEPS ACTION PLAN- 6

## Events

September 2014

- Interim Report - Detailed LOB

May 2015

- Second Draft Report - Alternative “simplified” LOB rule

October 2015

- Final Report - Commentary on detailed and simplified LOB

June 2017

- Signing of MLI

November 2017

- Amendment to OECD Commentary - Updated Commentary on detailed and simplified LOB

# MLI - ARTICLE 7 - PREVENTION OF TREATY ABUSE

## Arrangement of Provisions

Paragraph	Content
7(1)	PPT Rule
7(2)	PPT shall apply in place of or in absence of existing treaty provision that deny all or part of the benefits
7(3)	Country may choose to apply para 4
7(4) & (5)	If benefit denied under PPT rule - Competent Authority may grant benefit
7(6)	Country may choose to apply Para 8 through 13 Simplified LOB (S-LOB). S-LOB applies only where counterpart countries have chosen to apply it
7(7)(a)	If para 6 not selected - country may choose to apply S-LOB symmetrically (applicable to all countries applying S-LOB)
7(7)(b)	If para 6 not selected - country may choose to apply S-LOB asymmetrically (may not be applied by country electing this, however counterpart country may apply if so elected)
7(8)	Resident will not be entitled to treaty benefits unless Qualified Person test satisfied
7(9)	Qualified Person Test



# MLI - ARTICLE 7 - PREVENTION OF TREATY ABUSE

## Arrangement of Provisions

Paragraph	Content
7(10)	Active Conduct of Business Test
7(11)	Derivative Benefits Test
7(12)	Discretionary Relief (by competent authority)
7(13)	Definition of terms used in S-LOB
7(14)	S-LOB to apply in place of or in absence of existing treaty provision limiting the benefits
7(15)(a)	Country may reserve the right to not apply PPT, if it intends to adopt combination of detailed LOB and rules to address conduit financing structures or PPT - to reach mutually satisfactory solution
7(15)(b)	Country may reserve the right to not apply PPT, if existing treaty already contain PPT provision
7(15)(c)	Country may reserve the right to not apply S-LOB if existing treaty already contain provision limiting the benefits
7(16)	If para 6 selected - country may reserve it's right for article 7 not to apply to jurisdictions that have not chosen to apply S-LOB. Jurisdictions to reach mutually satisfactory solution to meet minimum standard

# MLI - ARTICLE 7 - PREVENTION OF TREATY ABUSE

## Arrangement of Provisions

Paragraph	Content
7(17)(a)	If no reservation under para 15(a) and 15(b) notify article of existing provision providing PPT. Existing PPT to be replaced by para 1
7(17)(b)	Notification of applying para 4
7(17)(c)	Notification of choosing para 6 ( Electing to apply S-LOB)
7(17)(d)	Notification of choosing para 7(a) or 7(b) (symmetrical or asymmetrical application of S-LOB)
7(17)(e)	Notification under para 17(c) or (d) - provision to be replaced by S-LOB Other cases- S-LOB to supersede CTA to the extent incompatible

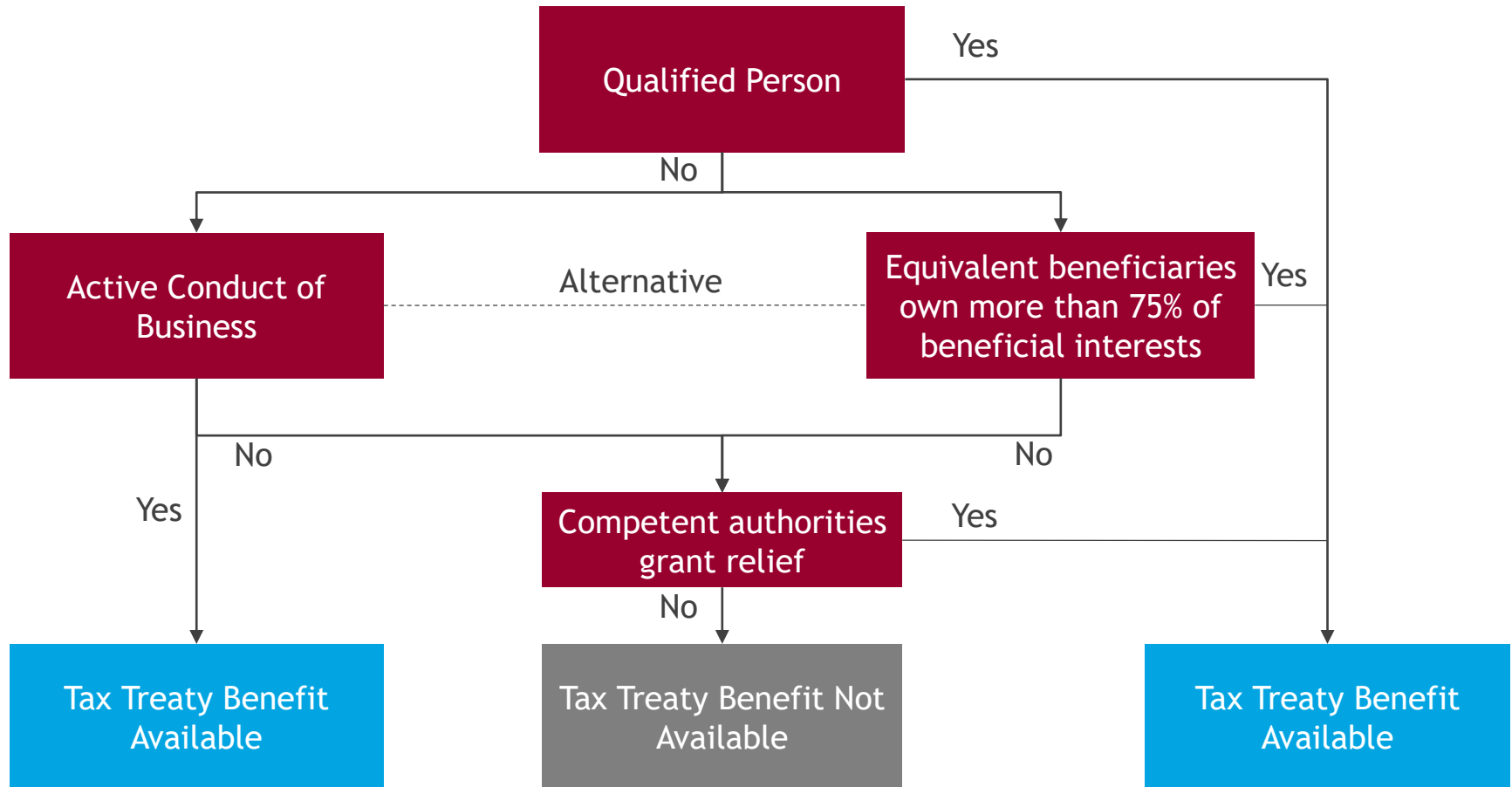


# SIMPLIFIED LIMITATION ON BENEFITS - MLI



# SIMPLIFIED LIMITATION ON BENEFITS - MLI

## Conditions for Availing Tax Treaty Benefits



# SIMPLIFIED LIMITATION ON BENEFITS - MLI

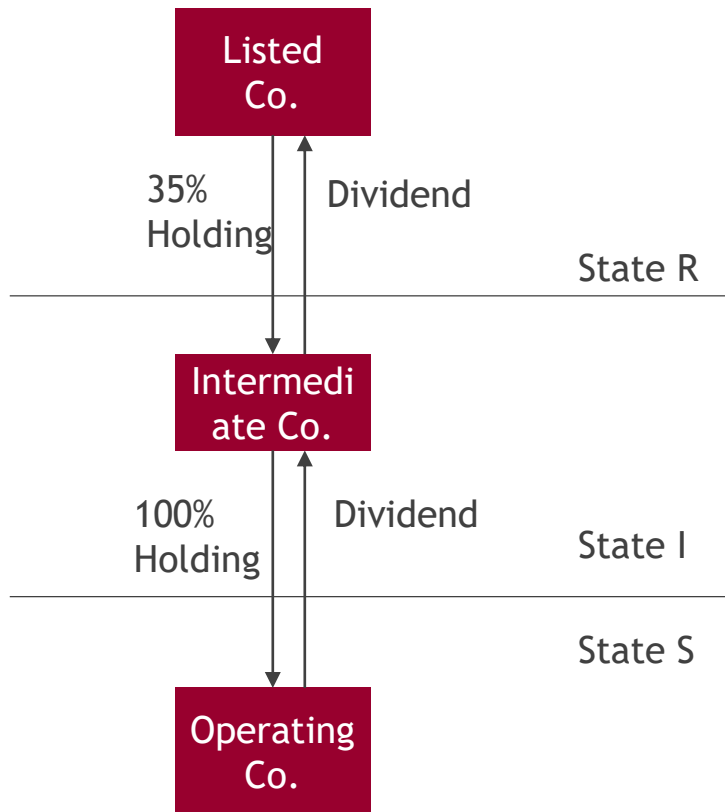
## Qualified Person - Paragraph 9

### Qualified person is a resident:-

- ▶ Individual
- ▶ Contracting jurisdiction or political subdivisions or local authority or their agency or instrumentality
- ▶ Company or entity if principal class of its shares is regularly traded on one or more recognised stock exchange
- ▶ Persons other than individual:-
  - Non-profit organizations
  - Entity or arrangement treated as separate person established to administer and provide retirement benefits of individuals, or invest funds for benefits of such entities
- ▶ Person other than individual whose at least 50% of shares are owned directly or indirectly by above qualified persons on at least 50% of the days of the 12 month period during which treaty benefits are sought

# SIMPLIFIED LIMITATION ON BENEFITS - MLI

## Qualified Person - Paragraph 9 : Illustration



### Facts

- State S and State R do not have a Tax Treaty
- State S and State I have a Tax Treaty which provides reduced rate of taxation on Dividends
- State I and State R have a Tax Treaty which provides reduced rate of taxation on Dividends
- Principal class of shares of Listed Co. Listed on Stock Exchange
- Intermediate Co is a Private Limited Company

### Questions

- Whether reduced rate of taxes as prescribed in the Treaty between State S and State I would be applied to Dividend paid by Operating Co to Intermediate Co
- Does the answer change, if 20% of shares are owned by Mr X, who is a Tax Resident of State I?
- Whether Dividend paid by Intermediate Co to Pvt Co, holding 45% of shares in Intermediate Co, be entitled to reduced rate of taxation on Dividends?

# SIMPLIFIED LIMITATION ON BENEFITS - MLI

## Active Conduct of Business Test - Paragraph 10(a)

### Conditions to be satisfied for active conduct of business test

- ▶ Resident is engaged in active conduct of a business in its country of residence, and
- ▶ Item of income derived from other country emanates from, or is incidental to, that business

### Guidance in OECD Commentary

- ▶ Term 'Business'- meaning under domestic law
- ▶ Entity considered engaged in active business only if Officers or employees of the entity conduct substantial managerial and operational activities
- ▶ 'Emanates from'
  - To be determined based on facts and circumstances
  - Factual connection between actively conducted business and item of income- Comparison of line of business in both countries
- ▶ 'Incidental to'
  - Production of item in country of source facilitates conduct of business in country of residence



# SIMPLIFIED LIMITATION ON BENEFITS - MLI

## Active Conduct of Business Test - Paragraph 10(a)

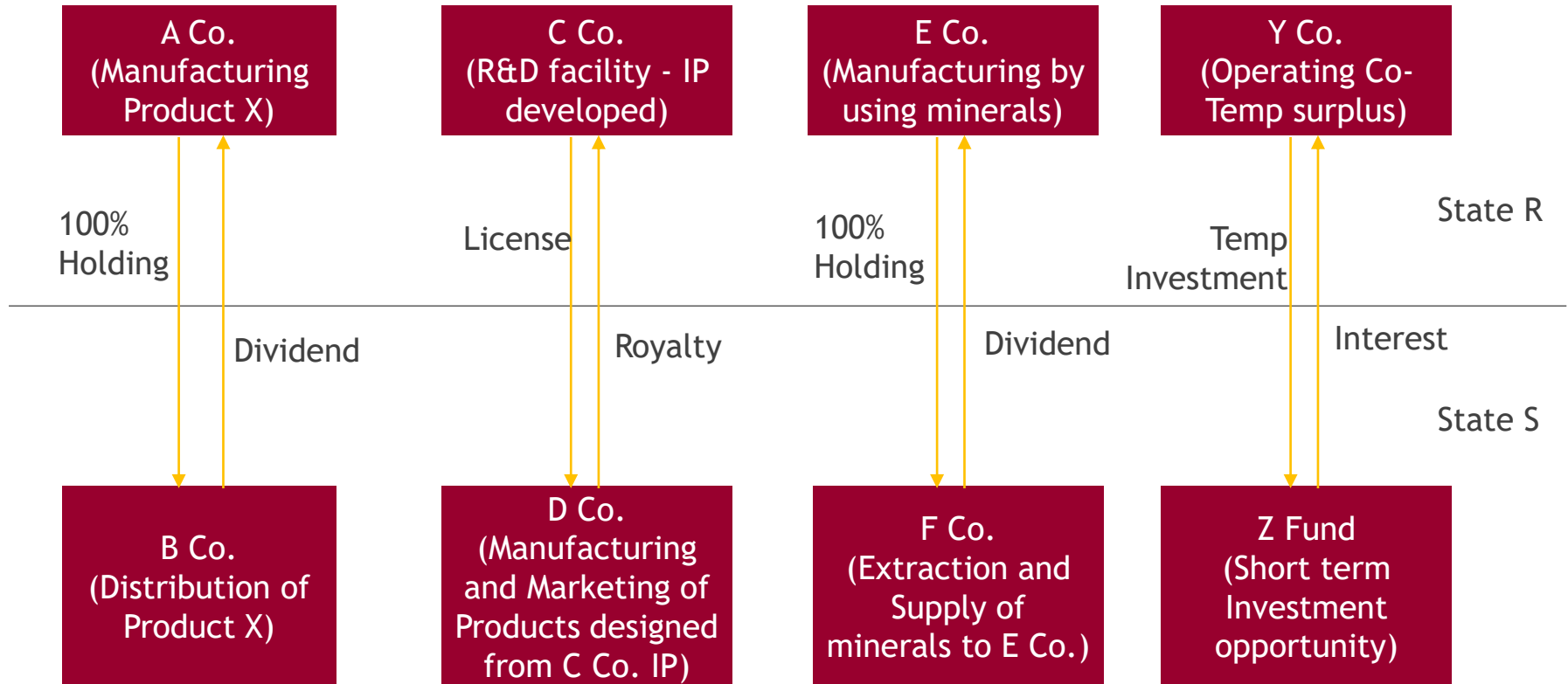
### Activities specifically not included in term “active conduct of business”

- Operating as holding company;
  - Providing overall supervision or administration of a group of companies;
  - Providing group financing (including cash pooling); or
  - Making or managing investments, unless these activities are carried on by a regulated bank, insurance company or registered securities dealer in the ordinary course of its business
- 
- ▶ Intended to clarify that administrative support functions as well as activities of operating as a holding company do not constitute the active conduct of business
- 
- ▶ Income emanating from, or incidental to, above activities cannot be entitled to treaty benefits



# SIMPLIFIED LIMITATION ON BENEFITS - MLI

Illustrations - Income “Emanates from” & “Incidental to” Business





# SIMPLIFIED LIMITATION ON BENEFITS - MLI

## Active Conduct of Business Test (Additional Conditions) - Paragraph 10(b)

### Applicability

- ▶ Where business is conducted either by resident or by a connected person in source country

### Conditions

- ▶ Business activity by resident in country of residence to be substantial in relation to activity conducted in the source country; and
- ▶ The activity in source country is same or complimentary business activity in relation to activity in country of residence

### Other Aspects

- ▶ Condition of substantiality not to apply, if the resident does not carry out business in country of source either directly or by connected person
- ▶ Above conditions to be tested separately for each item of income
- ▶ Once tax treaty benefit is applicable for particular item of income, then all tax treaty benefits affecting taxation of such item of income in source country

# SIMPLIFIED LIMITATION ON BENEFITS - MLI

## Active Conduct of Business Test (Additional Conditions) - Paragraph 10(b)

### Substantial

- ▶ To be assessed based upon all the facts and circumstances
- ▶ Illustrative factors to determine substantiality (OECD Commentary)
  - Comparative size of the businesses
  - Relative size of the economies and markets
  - Nature of the activities performed
  - Relative contributions made to that business

### Connected Persons

- ▶ Two persons shall be connected persons if
  - One owns, directly or indirectly, 50% or more beneficial interest in other, or
  - Another person owns, directly or indirectly, 50% or more beneficial interest in each person, or
  - One has control of the other, or
  - Both are under control of the same person or persons
- ▶ Difference between Connected Persons v/s Related Person v/s Associated Enterprises



# SIMPLIFIED LIMITATION ON BENEFITS - MLI

## Active Conduct of Business Test - Paragraph 10(c)

### Activity Deemed to be Conducted by Resident

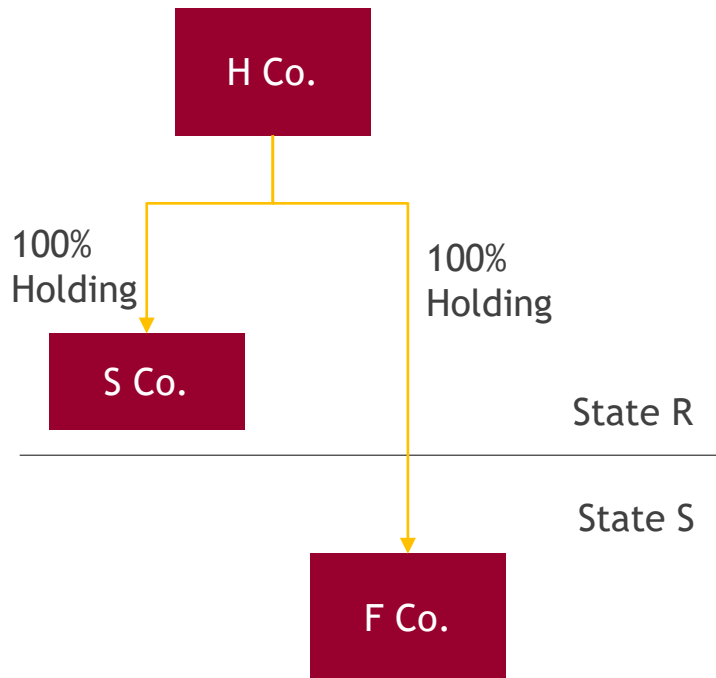
- ▶ For determining whether conditions and additional conditions are satisfied by resident, activities conducted by connected person with respect to resident shall be deemed to be conducted by such resident

### Issues

- ▶ Active conduct of Business is not defined - definite criteria in terms of quantum of income, turnover, employees, assets absent
- ▶ Subjective guidance to determine 'substantiality'
- ▶ Deeming provision of connected person may allow treaty benefits to be awarded to an intermediary that does not, in fact, carry out a substantial activity in its country of residence

# SIMPLIFIED LIMITATION ON BENEFITS - MLI

## Activities Conducted by Connected Persons- Illustrations



### Facts

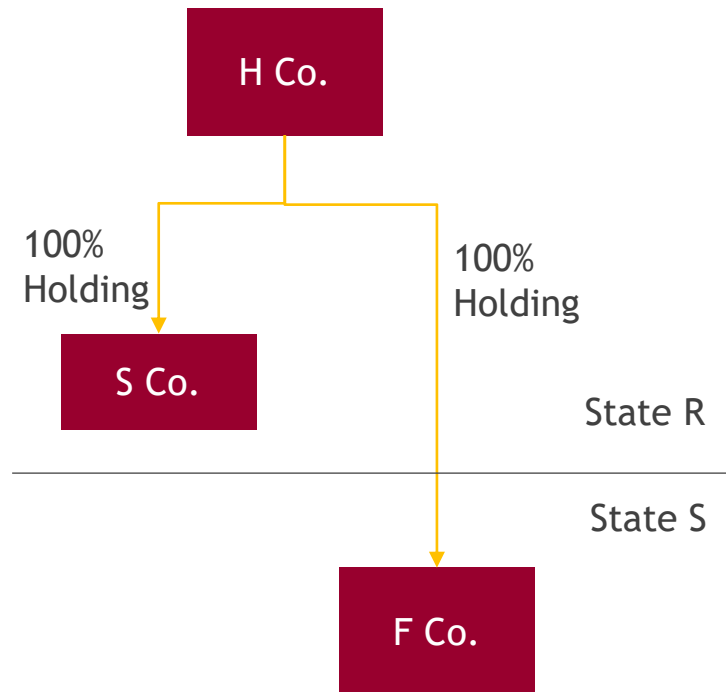
- H Co. - manages the investments of group
- S Co. and F Co. are engaged in manufacturing of same products in their respective countries

### Questions

- Whether H Co. will be considered to be in active business?
- Whether dividend from F Co. would be factually connected to H Co. business?
- Whether dividend received by H Co. from F Co. would be entitled to avail treaty benefit between State R and State S?

# SIMPLIFIED LIMITATION ON BENEFITS - MLI

## Activities Conducted by Connected Persons- Illustrations



### Facts

- S Co. is engaged in manufacturing of product X by using minerals
- F Co. extracts minerals and sells it to S Co.

### Questions

- Whether H Co. will be considered to be in active business?
- Whether dividend from F Co. would be factually connected to H Co. business?
- Whether dividend received by H Co. from F Co. would be entitled to avail treaty benefit between State R and State S?

# SIMPLIFIED LIMITATION ON BENEFITS - MLI

## Derivative Benefits Test - Paragraph 11

### Derivative Benefits Test

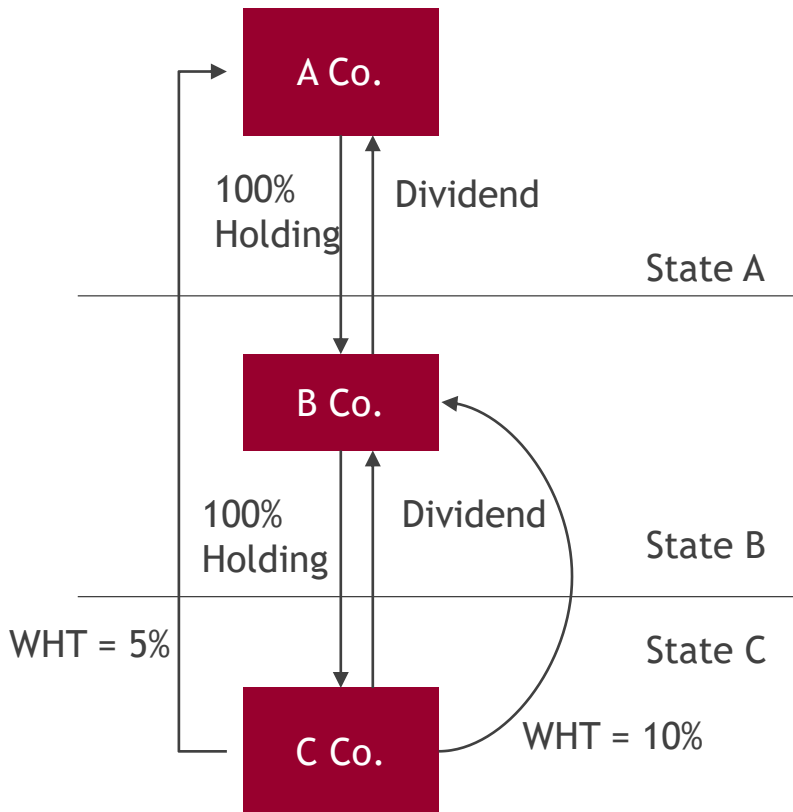
- ▶ Alternative test for tax treaty benefits even if not a qualified person
- ▶ Resident entitled to tax treaty benefits if at least 75% of beneficial interest of the resident owned directly or indirectly by equivalent beneficiaries on at least 50% of the days of the 12 month period during which the benefits are sought
- ▶ Test is applied to individual items of income

### Equivalent Beneficiary

- ▶ Any person who, if it had received the income directly
- ▶ would have been entitled to equivalent or more favourable benefits (treaty between resident country and source country)
- ▶ than the benefits provided by that country (treaty between intermediate country and source country)
- ▶ under the domestic law of that country, the covered tax agreement or any other international instrument
- ▶ For dividend, the potential equivalent beneficiary will be deemed to be a company holding the same capital in the company paying the dividends that the company that seeks the benefits is holding

# SIMPLIFIED LIMITATION ON BENEFITS - MLI

## Derivative Benefits - Illustrations



### Facts

- Tax rate on dividend
  - Treaty between State B and State C - 10%
  - Treaty between State A and State C - 5%
- Tax rate on Capital Gains
  - Treaty between State B and State C - NIL
  - Treaty between State A and State C - 20% (Domestic Rate)

### Questions

- Whether Y will be entitled to treaty benefits on dividend?
- Whether Y will be entitled to treaty benefits on Capital Gains?



# SIMPLIFIED LIMITATION ON BENEFITS - MLI

## Discretionary Relief - Paragraph 12

- ▶ Alternate remedy for tax treaty benefits even if not a qualified person and not satisfying active business test and derivative benefit test
- ▶ Resident may request competent authority of country in which benefits are denied to grant the benefits
- ▶ Benefit may be granted with respect to specific item of income, if
  - Demonstrated to the satisfaction of competent authority that establishment, acquisition, maintenance or conduct of operation did not have one of its principal purposes to obtain benefit under tax treaty, and
- ▶ Competent Authority will take into account
  - object and purpose of the tax treaty,
  - non-tax business reasons,
  - substantial non-tax nexus to country of residence,
  - history, structure, ownership and operations of the resident,
  - double non taxation or reduced taxation, etc.
- ▶ Competent Authority to consult with the competent authority of other country before either granting or denying the request



# SIMPLIFIED LIMITATION ON BENEFITS - MLI

## Other Provisions

### No restriction on accessing tax treaty provisions relating to

- ▶ Tie-breaker rule for person other than Individual
- ▶ Corresponding adjustment following an initial adjustment made on profits of associated enterprises
- ▶ Case considered under Mutual Agreement Procedure

### Other Points

- ▶ Resident must meet the conditions of other provisions of tax treaty even if it satisfies above conditions of Simplified LOB (Eg: resident must be the beneficial owner of dividends in order to benefit from the provisions dividend article)
- ▶ S-LOB applies at any time when the treaty would otherwise provide a benefit to a resident of a Contracting State

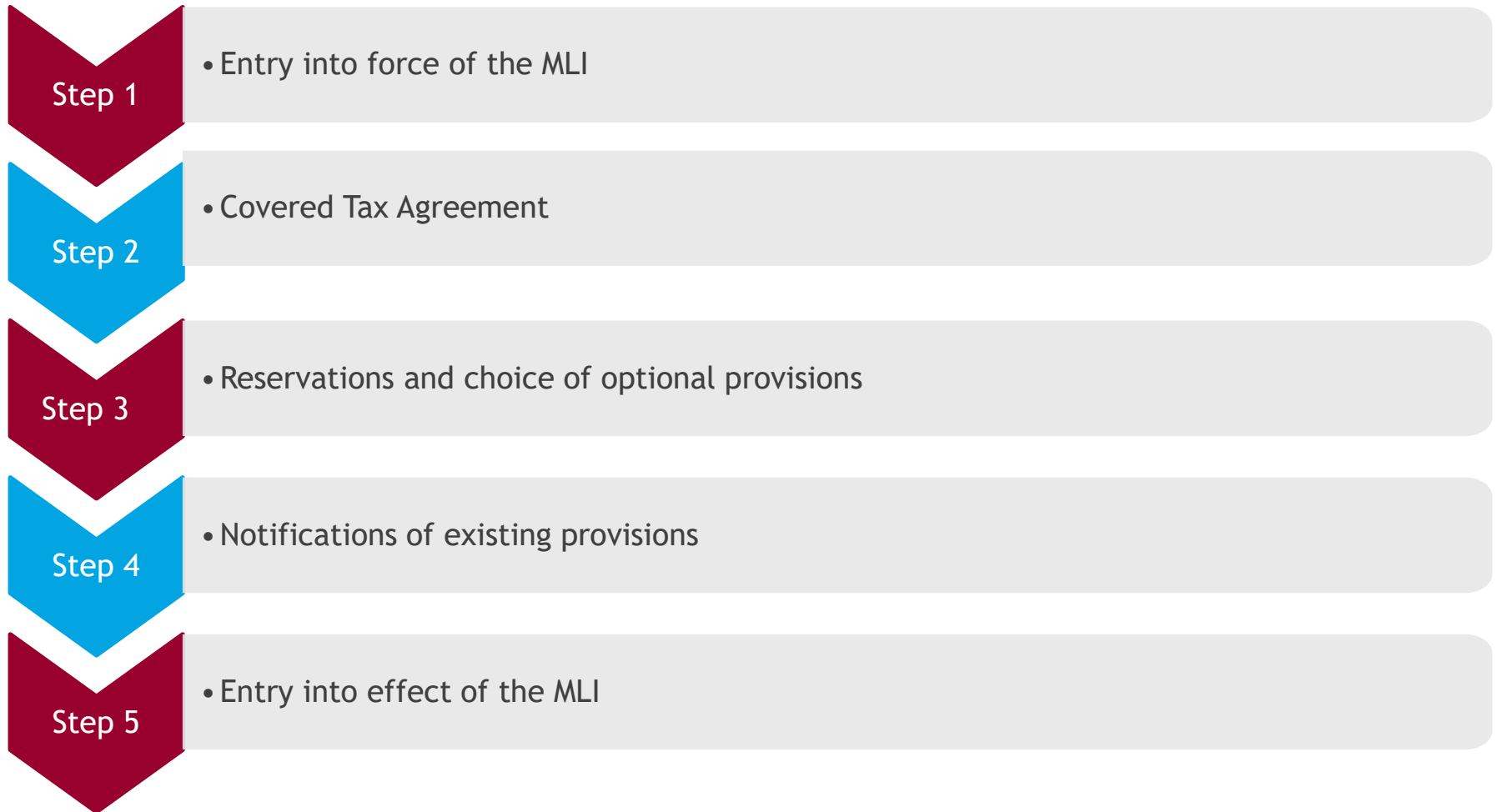


# APPLICATION OF MLI IN TAX TREATY



# SIMPLIFIED LIMITATION ON BENEFITS - MLI

## Application of MLI



# SIMPLIFIED LIMITATION ON BENEFITS - MLI

## Options, Reservation & Notifications

LOB Options	<u>Art. 7(6)</u> Option to adopt SLOB		<u>Art. 7(7)(a)</u> Symmetrical application of LOB	<u>Art. 7(7)(b)</u> Asymmetrical application of LOB	Either
	No reservation	Reservation - Art. 7(16)	No reservation	No reservation	
Reservations (Art. 7(15) or 7(16))	No reservation	Reservation - Art. 7(16)	No reservation	No reservation	Reservation - Art. 7(15)(c)
Consequence	Replace Article as per Para 14	Option not to apply entire Article	Replace Article as per Para 14	Replace Article as per Para 14	Incompatible - MLI supersedes
Notifications (Art. 7(17))	Article 7(17)(c)	-	Article 7(17)(d)	Article 7(17)(d)	Article 7(17)(e)



# SIMPLIFIED LIMITATION ON BENEFITS - MLI

## India's Position - at the time of signature

- ▶ Pursuant to Article 7(17)(c) - Chosen to apply Article 7(6) i.e. Simplified LOB
- ▶ Pursuant to Article 7(17)(c) - Notification of following treaties that contain provisions limiting the benefits
  - Albania
  - Armenia
  - Iceland
  - Mexico
  - Sri Lanka
  - Tajikistan
  - Tanzania
  - Uruguay
  - USA

# SIMPLIFIED LIMITATION ON BENEFITS - MLI

## Options, Reservations & Notifications

Countries	Reservation or Options by Other Country	Remarks	Basis
<b>Indian Treaties that already contain S-LOB provision and notified by India</b>			
Albania Sri Lanka Tajikistan Tanzania USA	Not Applicable	S-LOB does not apply	Not a signatory to MLI
Armenia Uruguay	7(17)(c)- Article 7(6) chosen India notified as CTA containing provision of Para14	Existing provision to be replaced by the S-LOB	Article 7(17)(e) applied - Both have notified each other under Art. 7(17)(c)
Iceland	7(17)(d)-Article 7(7)(a) chosen India notified as CTA containing provision of Para14	Existing provision to be replaced by the S-LOB (Symmetrically)	Article 7(17)(e) applied - India has notified under Art. 7(17)(c) and Iceland has notified under Art. 7(17)(d)
Mexico	7(17)(c)- Article 7(6) chosen 7(15)(c)- Reserves the right not to apply S-LOB to CTA already containing para 14 (India notified in this list)	Existing provisions in Treaty to apply	Mexico reserves the right not to apply S-LOB since CTA with India contains provisions of Para 14

# SIMPLIFIED LIMITATION ON BENEFITS - MLI

## Options, Reservations & Notifications

Countries	Reservation or Options by Other Country	Remarks	Basis
<b>Other countries that chose S-LOB provision - Art. 7(6)</b>			
Bulgaria Colombia Indonesia Kazakhstan Russia Slovak Rep	7(17)(c)- Choose to apply Article 7(6) Notified treaties that contain S-LOB provision (India not in the list)	S-LOB to apply	Para 6 - Both countries have chosen to apply S-LOB provision
<b>Other countries that choose S-LOB provision - Art. 7(7)(a)</b>			
Denmark Norway	7(17)(d)- Chose to apply Article 7(7)(a) No other reservation or notification	S-LOB to apply symmetrically	Para 7
<b>Other countries that choose S-LOB provision - Art. 7(7)(b)</b>			
Greece	7(17)(d)- Chose to apply Article 7(7)(b) No other reservation or notification	S-LOB to apply asymmetrically	Para 7



# SIMPLIFIED LIMITATION ON BENEFITS - MLI

## Options, Reservations & Notifications

Countries	Reservation or Options by Other Country	Remarks	Basis
<b>Interpretation of Other Indian Treaties</b>			
Cyprus Netherlands	Not Applicable	S-LOB does not apply - Mutually satisfactory solution	Not chosen to apply S-LOB
Mauritius	Not Applicable	Existing LOB provisions in DTAA continue to apply	DTAA with India not notified as CTA by Mauritius
Singapore	Not Applicable	Mutually satisfactory solution - Existing LOB provisions in DTAA may apply	Not chosen to apply S-LOB

# DETAILED LIMITATION ON BENEFITS

## Key Features

Countries that prefer to address treaty abuse by adopting a detailed LOB provision- mutually agree to reach a bilateral agreement that satisfies the minimum standard

Parameters	Detailed LOB
Qualified Person Test	<ul style="list-style-type: none"><li>• Elaborate rules for publicly traded companies</li><li>• Provision for collective investment vehicle</li></ul>
Derivative Benefits Test	<ul style="list-style-type: none"><li>• Atleast 95% shares owned by 7 or fewer persons that are equivalent beneficiaries</li><li>• Base erosion test- less than 50% of person's gross income and group's gross income is paid or accrued (deductible for tax purpose) to the persons other than equivalent beneficiaries</li></ul>
Headquarter Company	Even if not a qualified person, may receive treaty benefits with respect to dividend and interest paid by members of multinational corporate group



# DOMESTIC LAW TO COUNTER TREATY ABUSE



# DOMESTIC LAW TO COUNTER TREATY ABUSE

## India - GAAR

- ▶ Applicable from fiscal year 2017-18
- ▶ Impermissible Avoidance Arrangement - main purpose to obtain tax benefit and satisfies one of the four tainted elements
  - Rights and obligations not ordinarily created between persons dealing at arm's length
  - Misuse or abuse of provisions
  - Lacks commercial substance
  - Not for bonafide purposes
- ▶ Consequence include denial of tax benefits under treaty
- ▶ CBDT Circular No. 7/2017
  - *Will GAAR be applied to deny treaty eligibility in a case where there is compliance with LOB test of the treaty?*
  - *Adoption of anti-abuse rules in tax treaties may not be sufficient to address all tax avoidance strategies and the same are required to be tackled through domestic anti-avoidance rules. If a case of avoidance is sufficiently addressed by LOB in the treaty, there shall not be an occasion to invoke GAAR.*

# DOMESTIC LAW TO COUNTER TREATY ABUSE

## UK - Diverted Profits Tax

Designed to tackle and remove tax mismatches that arise from two types of arrangement

- ▶ No permanent establishment in the UK
  - Where a person carries on activity in the UK in connection with the supply of goods, services or other property by a foreign company and that activity does not create PE in UK for the foreign company,
  - tax will be charged if HMRC believes it is reasonable to assume there is a tax avoidance purpose for, or a tax mismatch created by, these circumstances.
  - However, an exception applies where UK-related sales are less than £10m or UK-related expenses are under £1m.
  
- ▶ Insufficient substance
  - Where an entity within the charge to UK corporation tax is party to a transaction or series of transactions with a connected overseas company, a tax mismatch exists, and the overseas entity contributes little substance to the transaction.
  - This potentially affects groups using central IP companies, centralised purchasing and services companies, limited risk distributors and those making rental payments overseas.

The DPT yield has increased from £13m in 2015/16 to £388m in 2017/18

# DOMESTIC LAW TO COUNTER TREATY ABUSE

## Australia - MAAL

- ▶ Multinational Anti-Avoidance Law (MAAL) came into effect on 11 December 2015. It applies to certain schemes on or after 1 January 2016, irrespective of when the scheme commenced
- ▶ MAAL will apply if under the scheme, or in connection with the scheme:
  - a foreign entity supplies goods or services to an Australian customer
  - an Australian entity, that is an associate of or is commercially dependent on the foreign entity, undertakes activities directly in connection with the supply
  - some or all of the income derived by the foreign entity is not attributable to an Australian permanent establishment, and
  - the principal purpose, or one of the principal purposes of the scheme, is to obtain an Australian tax benefit or to obtain both an Australian and foreign tax benefit.
- ▶ The MAAL only applies to significant global entities (SGEs). An entity is an SGE for an income year if it is:
  - a global parent entity with annual global income of A\$1 billion or more, or
  - a member of a group of entities consolidated (for accounting purposes) where the global parent entity has an annual global income of A\$1 billion or more.

# WHAT NEXT?

## What to expect further?

- ▶ Review of structures and business operations
- ▶ Prove substance
- ▶ Stress on documentation
- ▶ Subjective interpretations





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- ▶ MLI Text, Positions, FAQs, Toolkit - <http://www.oecd.org/tax/treaties/multilateral-convention-to-implement-tax-treaty-related-measures-to-prevent-beps.htm>
- ▶ OECD Model Convention 2017 - <http://www.oecd.org/ctp/treaties/model-tax-convention-on-income-and-on-capital-condensed-version-20745419.htm>



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