


INTERNATIONAL TAXATION

Case Law Update

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A. HIGH COURT

1 *CIT vs. Honda Motors Co. Ltd.*

[TS-1076-HC-2019] (Delhi) - ITA No. 945 of 2019, Assessment Year 2007-08

Once arm's length principle has been satisfied, there can be no further profit attributable to the assessee, even if it has a Permanent Establishment (PE) in India

Facts

i) The Tribunal had quashed reassessment orders (for AYs 2004-05 to 2007-08) issued in case of assessee noting the Supreme Court's decision in assessee's own case and in the case of E-funds IT Solutions.

ii) In the case of E-funds IT Solutions, Supreme Court held that the fact of assessee having a PE in India was of no consequence since the transaction was found to be at arm's length. Therefore, the impugned notices for reassessment based only on the allegation that the assessee has PE in India could not be sustained once arm's-length price procedure had been followed.

iii) Aggrieved, the Revenue filed an appeal before the High Court.

Decision

i) In view of the Supreme Court's ruling, the High Court held that the finding that the assessee had a PE in India was inconsequential since in the present case the transaction was found to be at arm's length.

ii) Further, since the issue was concluded by the High Court in ITA 562/2019, following the same as well as the decision of the Supreme Court, the Court held that no question of law arose for the High Court's consideration and thus, the appeal was rejected.

2 *Lufthansa Cargo AG vs. DCIT and ANR*

[TS-696-HC-2019] (Delhi) – WP (C) 9136 of 2019 and CM APPL 37760 of 2019, Assessment Year: 2020-21

The Court quashed the certificate under section 197 arbitrarily fixing the rate of TDS at 0.5% on payments made to a German airline company. It directed the AO to issue a fresh certificate under section 197 and held that till then rate of withholding on payments made by Indian deductors to assessee would be NIL, as its income was not

liable to tax in India in view of Article 8 of the India-Germany DTAA

Facts

i) The Petitioner, a Company incorporated in Germany, was in the business of transportation of mail, livestock and goods by air through its aircrafts in international traffic. It was a tax resident of Germany which was also its place of effective management for the purposes of the Income-tax Act and the India-Germany DTAA.

ii) The Petitioner stated that in compliance with the provisions of Section 195 of the Act, the Petitioner filed an electronic Form 13 application with the AO requesting a certificate to be issued under Section 197(1) of the Act allowing a NIL rate of tax withholding to the deductors, as cargo agents on payments to be made to the Petitioner during Financial Year 2019-20.

iii) The Petitioner contended that the impugned certificate dated 29 May, 2019 arbitrarily fixed the rate of deduction of tax at source at 0.5% even though under the DTAA, Petitioner's income was not taxable in India since as per Art 8 of the DTAA, profits from operation of aircrafts in international traffic shall be taxable only in the Contracting State in which the place of effective management is situated.

iv) The AO had proposed issuance of certificate under Section 197 directing payers to deduct tax at NIL rate.

v) The DCIT sought information/reasons for claiming applicability of Art 8 of the DTAA. Previous years assessment statements were called for, which showed the taxable income was accepted as NIL. However, DCIT held that to protect the interest of Revenue, a certificate should be issued at WHT rate of 0.5%.

vi) The Petitioner preferred a writ petition to assail the orders/directions issued by DCIT under Section 197 of the Act directing withholding of TDS at the rate of 0.5% for Assessment Year 2020-21.

Decision

i) The Court held that there was no discussion by the Revenue as to on what basis the decision was taken to withhold tax at source in respect of payments made to Petitioner in India at 0.5%. There had been complete non-application of mind to the germane and relevant considerations by the Respondents while dealing with the Petitioner's application.

ii) Further, the Court relied on the decision in ***Bentley Nevada LLC vs. Income Tax Officer in WP(C) No 7744 of 2019*** decided by it on 29th July, 2019 wherein the effective rate of tax was worked out at 1.04% of the total revenues and the Court had quashed the order under Section 197 allowing deduction of the tax at source at 5% from the payments made to the Petitioner by Indian customers.

iii) The Court held that the situation in the present case was even better for the Petitioner as the total income had been assessed in the return as NIL.

iv) The Court thus quashed the certificate dated 29th May, 2019 and directed Respondents to apply mind afresh and issue a fresh certificate.

v) It further gave a direction that until a fresh certificate was issued the Petitioner's receipt of payment would be subject to NIL rate of deduction of tax at source in respect of Indian payments.

3 ***FCI OEN Connectors Limited vs. DCIT and ITO***

[TS-707-HC-2019] (Kerala) – WP (C) No. 11952 of 2019, Assessment Year: 2015-16

As the assessee had not opted for e-proceedings, the time limit to file objections before the DRP would have to be computed from the date of manual receipt of the draft assessment order, notwithstanding that the same was also electronically received on an earlier date

Facts

i) The Petitioner, a public limited company, was engaged in the business of manufacture of connectors and other articles.

ii) The Petitioner was served with a notice under Section 143(2) on 15th April, 2016 and thereafter with notices under Section 142(1) of the Act requiring it to produce various documents for assessment purposes.

iii) With effect from 2017, as part of the Government initiative towards e-Governance, there was a move to shift to e-proceedings facility for completion of assessments. Circulars and instructions were issued by the Government of India, Ministry of Finance, in the Department of Revenue, requesting assessees to switch over to the e-proceedings facility for completion of their assessments. The e-proceedings facility was initially made mandatory in seven metro cities. In Cochin, it was optional.

iv) The Petitioner did not opt for e-proceedings and thus, manually filed the documents sought.

v) On a reference to the TPO under Section 92 CA of the Act, the TPO by order dated 26-10-2018 recommended certain adjustments to the computation of income. Thereafter, the AO prepared a draft assessment order based on the recommendations of the TPO, in terms of Section 144(C) of the Act and served a copy of the draft assessment order to the Petitioner electronically on 31 December 2018 and manually on 5th January, 2019.

vi) As per sub section 2 of Section 144(C) the petitioner has to file his objections to the draft assessment order before the DRP, within 30 days of receipt by him of the draft order.

vii) Petitioner's objection was received by the DRP on 1st February, 2019.

viii) The DRP issued show cause notice asking the Petitioner to show cause as to why the objection preferred by it should not be rejected on the ground that it was received by the panel more than 30 days after the service of the draft assessment order through the electronic mode on 31st December, 2018.

ix) The Petitioner informed DRP that the objection was within 30 days of the manual service of order. DRP rejected the Petitioner's contention.

x) However, on 22nd February, 2019 itself, the Assessing Authority passed an assessment order without taking note of the objections filed by the Petitioner to the draft assessment order

Decision

i) The Court held that when the Petitioner had not opted for the e-proceeding facility, and had chosen to have its assessment proceedings continued in the manual mode, the receipt of the draft assessment order in the manual mode has to be seen as the date of service of the draft assessment order.

ii) It would also be an aspect of fairness in tax administration that the assessee is not prejudiced on account of service of an order, through a mode that he did not opt for. The Court must also remind itself that, in the event of an ambiguity in construing the provisions in a taxing statute, it has to take a view that favours the assessee.

iii) Thus, objections filed by the Petitioner, being within 30 days of manual service of the order, was within time.

iv) In matters involving transfer pricing, the assessment order by the AO must necessarily follow the findings of the DRP and hence, based on the finding that order of the DRP was illegal, it held that order of assessment, that did not await the decision of the DRP on merits, is also illegal.

v) The writ petition was therefore allowed and orders of the Respondents were quashed. DRP was directed to consider the objections of the Petitioner on merits and pass fresh orders within 3 months. The AO was then directed to complete assessment proceedings taking note of the order of the DRP and after hearing the Petitioner within 3 months from receipt of order of DRP.

vi) It was clarified that the judgment in the present case was based on the facts and was not to be cited as a precedent.

B. TRIBUNAL DECISIONS

4 ***M/s India Convention and Culture Centre Pvt. Ltd. vs ITO***

[TS-594-ITAT-2019(DEL)] Assessment Year: 2014-15

Valuation of shares under section 56(2)(viib) of the Act – Valuation based on the fair value of assets, cannot be rejected – Held in favour of the assessee

Facts

i) The assessee company filed its tax return for a financial year declaring a loss. During the same year, the assessee had issued shares at a premium.

ii) The assessee owned agricultural land. On 14th June 2012, the competent authority allowed the land to be used for setting up a convention centre. This resulted in a change in the fair value of the land.

iii) The AO determined the FMV of shares under Rule 11UA of the Income-tax Rules, 1962 (Rules) and added the entire premium to the total income of the assessee.

iv) The Commissioner of Income-Tax (Appeals) [CIT(A)], considering the share application money as a liability and correcting certain other error in the valuation of the AO, revalued the shares. Thus, a partial relief was given to the assessee as against the original relief claim.

Decision

On appeal, the Tribunal held in favour the assessee as under:

A) The assessee contended before the Tribunal that:

   i) The competent authority allowed the land to be used for setting up a convention centre. This resulted in a change in the fair value of the land.

   ii) As per *Explanation (a)* to section 56(2)(viib) of the Act, FMV of shares shall be the higher of the value determined under Rule 11UA of the Rules or the value of assessee's assets as substantiated by the assessee to the satisfaction of AO.

   iii) The AO cannot insist on following one particular method.

   iv) Valuation of shares has to take into consideration various factors and should not be simply based on book value.

- v) The circle rate of land was substantially higher than its book value, and the same should be adopted as the FMV of the land instead of the book value.
- vi) On considering the circle rate of land as its FMV, the value of shares under section 56(2)(viib) of the Act is determined at a much higher rate than the premium rate at which the shares were issued by the assessee. Therefore, no addition is called for under section 56(2)(viib) of the Act.

B) The Department contended as under:

- i) The assessee had failed to explain how the change in land use for institutional purpose would increase the fair value of shares.
- ii) In the absence of cogent reasons substantiating the increase in FMV of land, the book value of the land should be considered as a metric for valuing the shares of the assessee.
- iii) The conversion charges paid by the assessee to local authorities for obtaining change in land use permission would have been added to the book value of land, thereby increasing its value to that extent.

C) The Tribunal held and observed as follows:

- i) Valuation of shares has to be made on the basis of various factors and not merely on the basis of financials.
- ii) *Explanation* (a) to section 56(2)(viib) of the Act prescribes that the FMV of shares shall be the higher of the value determined under Rule 11UA of the Rules or the value of assessee's assets as substantiated by the assessee to the satisfaction of AO.
- iii) The assessee had obtained the permission of the competent authority for change of land use from agricultural to institutional, resulting in higher circle rate of land.
- iv) Valuation adopted by the assessee cannot be rejected where the assessee has demonstrated with evidence that the FMV of the asset is much more than book value.
- v) Hence, the FMV of shares as substantiated by the assessee should be accepted and addition of share premium made by the AO and confirmed by the CIT(A) is deleted.

5 *Hitachi High Technologies Singapore Pte Ltd vs. DCIT*

[TS-558-ITAT-2019(DEL)] Assessment Years: 2002-03 to 2007-08

India-Singapore DTAA – Article 5(7)(e) - Liaison Office in India – Whether a permanent Establishment – Held, on facts, that Article 5(7)(e) of the DTAA envisaged a narrower exclusion than India's Treaties with USA and Canada – the Assessee's L.O. in India constituted a PE in India

Facts

- i) The assessee, a Singapore company and a wholly owned subsidiary of Hitachi High-Technologies Corporation, Japan, was engaged in trading operations across Southeast Asia. In 1988, the assessee established an LO in India for providing 'preparatory and auxiliary services, including market research and liaison activities'.
- ii) Based on employee statements recorded in a survey conducted at the LO's premises in 2008, the AO initiated assessment against the Assessee under the Income-tax Act,

1961 ("ITA") for assessment years 2002-03 to 2007-08. A draft assessment order was passed holding that the LO was negotiating and executing contracts for the Assessee in India, and was not limited to undertaking preparatory and auxiliary activities, and hence it was a PE of the Assessee in India under Article 5 of the India-Singapore treaty.

iii) The income of the assessee attributable to the alleged PE was computed by applying the assessee's global profit margin to sales made in India and attributing 50% thereof to the PE. Total addition of INR 72 million was made for the batch of six years assessed.

iv) The DRP summarily upheld the draft order, following which the AO passed the final order. On appeal, the Tribunal set aside the order directing the DRP to re-adjudicate passing a speaking order.

v) The DRP re-adjudicated and framed its order based on which the AO passed another final order. This time the additions made were to the tune of INR 1.23 billion.

vi) The assessee once again approached the Tribunal in appeal against the final order, on four main grounds discussed below.

Decision

Upon the assessee's appeal, the Tribunal held as under:

i) During re-adjudication, the DRP altered the manner of attribution of profits to the PE, resulting in enhancement of the assessment. The Tribunal held that the DRP had merely followed its directions in re-adjudicating the matter. It further observed that the DRP is a continuation of assessment proceedings, intended as a corrective mechanism to guide the AO, and is not an appellate forum – unlike the Commission of Income Tax (Appeals).

ii) The Tribunal observed that while its powers in adjudicating appeals were very widely couched, their power to enhance an assessment in the absence of cross appeals or cross objections by the revenue was limited. For this, the Tribunal relied on the decision of the Supreme Court in ***State of Kerala vs. Vijaya Stores (1978 4 SCC 41***). On this basis, the Tribunal stated that the addition to the assessee's income in the proceedings should be restricted to INR 72 million – being the additions made in the first instance.

Re: LO of the assessee constituting a PE in India

iii) The Tribunal analysed the text of the PE exclusion clause in Article 5(7)(e) of the India-Singapore tax treaty, observing that the words 'for similar activities' used after 'advertising', 'supply of information' or 'scientific research' were noticeably different from the phrase 'for other activities' used in India's treaties with Canada, or the USA. The use of 'similar activities' necessitated the application of the principle of *ejusdem generis*, meaning the scope of the residuary phrase had to be interpreted in light of the words preceding it, being: advertising, supply of information and scientific research. Therefore, unless the LO was being used only for advertisement, for supply of information, for scientific research, or activities similar to these three which have preparatory or auxiliary character, they could not fall in the PE exclusion clause.

iv) The nature of activities, as evidenced by the statements gathered during the survey, were market research and sales promotion – *sine qua non* for a trading business, and hence could not be regarded as preparatory or auxiliary, especially under the restricted scope of the exclusion clause in the India-Singapore treaty. Therefore, the Assessee had a PE in India under the treaty.

Re: Attribution of profits to the PE

v) The DRP directed the AO to use the profit margin of an independent agent used by the assessee – called ForeVision – as an internal comparable, because it found its activities to be similar to that of the LO.

vi) The Tribunal, on the basis of Article 7 of the India-Singapore tax treaty and the decision of the Supreme Court in ***DIT vs. Morgan Stanley [2007] 292 ITR 416 (SC)*** stated that the attribution of profits of the PE was to be determined as if the PE was an independent enterprise, with reference to an analysis of functions performed, assets employed, and risks assumed ("FAR Analysis") by the PE. The Tribunal observed that no such comparative FAR Analysis had been undertaken in respect of the LO and ForeVision, and that based on the business profiles ForeVision was not a good comparable. It then observed that the LO was performing routine and limited functions and was operating in a risk-free environment, in which case a profit attribution by the revenue of 163% to 2357% was absurd, and the allocation should have been done by applying the Transactional Net Margin Method.

(***Note***: In the present case, to conclude on whether the activities of the LO were preparatory and auxiliary in nature, the Tribunal relied on employee statements - specifically correspondence between the LO and the head office - where statements have been made that the representative office clearly was actively involved in commercial activities. This sheds light on the importance of written communication within an organization, and that such communication can also be used as evidence, especially where survey operations are carried out.)

6 ***M/s. Keva Industries Pvt. Ltd vs. ITO***

[TS-674-ITAT-2019(Mum)] Asssessment Year: 2015-16

Valuation of Shares - addition u/s. 56(2)(viia); Rule 11U inapplicable to foreign co. shares pre-2019 amendment – Held in favour of the assessee

Facts

i) Keva Industries Pvt. Ltd (assessee) is a company engaged in the business of manufacturing and distribution of natural and synthetic essential oils and aromatic chemical resinoids.

ii) The Directors of assessee-company had acquired shares in the year 2008 at ₹ 34/- from a Singapore based company (an investment company having main investment in S. H. Kelkar & Co. Ltd.), named "KNP Industries Pte Ltd." (in which assessee's directors were also directors).

iii) Thereafter, assessee's directors sold 400,000 shares to assessee-company, at the same rate of ₹ 34/- per share, on the basis of valuation done as per Discounted Cash Flow Method (DCF) of M/s KNP Ltd (which was taken at USD 0.50 (Dollar rate considered at ₹ 68)). Both the assessee's directors booked Long Term Capital Loss(LTCL) of ₹ 51,64,854/- on the transaction due to indexation. The assessee submitted the valuation report made as per a CA firm as also produced the audit report of KNP Ltd. for the years 2015 & 2016.

iv) The AO compared the results with the projection made during the valuation of shares as per DCF method, and observed that there was huge variation in the projections. Thus, the AO held that the valuation under DCF method worked out by the assessee as per the data provided by the management / directors was nothing but an eye wash and totally unrealistic and accordingly not acceptable. Pursuant to which, he rejected the valuation of shares carried out by an independent valuer using DCF method and proceeded to adopt the book value of shares as per the provisions of Rule 11UA(2)(a) of the Income Tax Rules. The AO for this purpose, observed that since on the date of issue of shares, KNP Ltd did not have its audited financials, the determination of fair market value (FMV) was made on the basis of audited balance sheet for the previous year ended 2014.

v) Against this background, the AO proceeded to make an addition u/s. 56(2)(viia) to the tune of ₹ 107,40,00,000/- (400,000 shares * (2719-34)) by treating the difference between the FMV of the shares and the purchase price of the shares by the assessee. On further appeal, CIT(A) upheld the order of the AO.

Decision

The Tribunal observed and held in favour of the assessee as under:

A) Re: Application of Rule 11UA of the Income-Tax Rules:

i) At the outset, the Tribunal noted that provisions of Rule 11UA(2) of the Rules are applicable only in the case of issue of shares by an unlisted company under the provisions of section 56(2)(viib). The Tribunal further takes note of the term "Balance Sheet" as defined in Rule 11U and clarifies that "since the shares of a foreign company were acquired by the assessee company in the instant case, the ld AO ought to have relied on the balance sheet as audited by the auditor appointed under the Indian Companies Act."

ii) The Tribunal noted that the AO had relied on the balance sheet of KNP Industries Pte Ltd, Singapore, which was prepared in accordance with the Singapore Companies Act. Thus the Tribunal clarified that "the case of the assessee falls squarely on clause (ii) of the definition of "Balance Sheet" as defined in Rule 11U of the Rules supra. Hence it is mandatory to draw a balance sheet as on the valuation date i.e. 10-2-2015 /11-2-2015 (being the date of purchase of shares by the assessee company) and that the said balance sheet should have been audited by an auditor appointed under section 224 of the Companies Act, 1956."

iii) Therefore the Tribunal stated that "it could be safely concluded that the ld AO had applied the valuation method on a different date which is not in accordance with law and that since the computation mechanism provided in Rule 11UA of the Rules is not applicable to the facts of the instant case, the provisions of section 56(2)(viia) of the Act also could not be invoked."

iv) Further the Tribunal held that since the assessee-company had acquired the shares of a foreign company, "We also find the provisions of section 56(2)(viia) of the Act refers to transaction of acquisition of any property being shares of a company not being a company in which public are substantially interested. Since foreign company does not fall in the above category, the provisions of Section 56(2)(viia) of the Act cannot be said to apply to the above transaction."

v) The Tribunal further holds that the provisions of section 56(2)(viia) of the Act cannot apply to a foreign company as the relevant Rule 11U which defines "balance sheet" was not applicable to a foreign company. The Tribunal further found that the amendment in this regard was brought in Rule 11U with effect from 1-4-2019 under Rule 11U(b)(ii) of the Rules. Thus the Tribunal ruled that "This amendment is only prospective in nature and cannot apply to the year under appeal. We hold that the case of the assessee company herein falls under old provision of Rule 11U(b)(ii)."

vi) The Tribunal explicated that the legislature had sought to rectify the mischief hitherto prevailing up to Asst. Year 201819 in the statute/rule and had accordingly brought an amendment effective from Asst. Year 2019-20 onwards to curb the loophole available in the Act/Rules, hence the Tribunal held that "the pre-amended definition of balance sheet cannot include foreign company therein."

B) Re: Valuation of Shares:

i) The Tribunal observed that in 2005, in case of S. H. Kelkar & Company (in which assessee's directors were shareholders & in which KNP was part of promoter group), there was a major disagreement between groups of shareholders and their families, which ultimately resulted in separation of two factions from the company, whereby the Company Law Board passed an order of settlement keeping in view the interests of the stakeholders.

ii) The Tribunal further observed that as a part of the settlement, the promoters had to raise capital to fund settlement cost of the existing factions from the company, whereby the banks demanded exorbitant rates of interest. Therefore, the promoters decided to raise capital in the form of private equity from M/s. Blackstone Capital Partners (Singapore).

iii) Next, the Tribunal noted that in accordance with above, a shareholders agreement was executed, whereby it was agreed that protection to the Investors in the event of their exit without procuring the agreed IRR on their investment, i.e. in the event of exit of Blackstone from SHK without procuring the agreed IRR on investment, the promoters of the company would become personally liable to make good the loss incurred by Blackstone. For this purpose, the Tribunal observed that, the shares of SHK held by KNP were placed in escrow-account which was in the custody of Deutsche Bank AG, Hongkong Branch (which acted as the Escrow Agent to the above arrangement). It was agreed that if any specified event occurred (resulting in loss of wealth for Blackstone), the escrow agent shall handover the shares of SHK held in the escrow account to the said M/s. Blackstone

iv) Thus the Tribunal remarked that "During such period when shares were placed in escrow, KNP Industries Pte Ltd could not have sold the shares in the open market due to the overriding charge created. Further, if any adverse event was triggered, the shares would have been directly handed over by escrow agent to Blackstone (who had been roped in as an investor). In nutshell, the value of shares of S. H. Kelkar & Co. held by KNP Industries Pte Ltd. was virtually zero."

v) The Tribunal rejected AO's action of refuting assessee's valuation per share based on DCF model due to variations arising in actual *vis a vis* the projections, and held that "From due appreciation of the entire facts narrated above, we find that the valuation of USD 0.50 per share of shares of KNP arrived in the valuation report is to be accepted as just and fair in view of the fact that the main investment in KNP Industries Pte Ltd is in the shares of S. H. Kelkar and Company Limited."

vi) The Tribunal further noted that, as on the date of valuation of shares, the valuer did not have the benefit of the actual figures which had happened subsequent to the valuation date. The Tribunal further acknowledged that, "It is a calculated business risk and commercial decision taken by the respective investors by placing reliance on the share valuation report."

C) Re: Compliance with Law:

i) The Tribunal noted that assessee had argued that in the year 2015, as RBI/ FEMA had changed their norms with regards to investment in foreign shares by a resident individual, therefore, its directors had transferred their shares to assessee in order to comply with the legal requirement.

ii) The Tribunal observed that, "Infact for acquiring the shares worth ₹ 1.36 crore from the directors, the assessee company in turn took loan of the very same amount from its directors to make payment to the directors for acquisition of shares of ₹ 1.36 crore. Therefore the motive of the transaction was not to make any gains but to comply with the law."

iii) The Tribunal further noted that the assessee company did not have any independent activity apart from the above acquisition of shares. The Tribunal accepted assessee's argument that as the value at which the shares were acquired by the assessee company, corresponded to the value at which the shares were originally procured by the directors, therefore "This itself corroborates the fact that the entire exercise of change in ownership was undertaken only to comply with the RBI/FEMA regulations and there was no intention to make any gains out of the said transaction."

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