INTERNATIONAL TAXATION

Case Law Update

CA Tarunkumar Singhal & Dr. Sunil Moti Lala

A. HIGH COURT

1 ***DIT v. Sasken Communication Technologies Ltd***

[2020] 117 taxmann.com 278 (Karnataka)
ITA No. 241 of 2011 for AY 2006-07

Receipt of consideration pursuant to an Employee Non-Compete Agreement would be in nature of salary income and thus would be taxable under Article 16(1) of India-USA DTAA in the Contracting State where the services are rendered.

Facts

i) A subsidiary company of the assessee, an Indian company, was merged with the assessee on 1st April, 2005. Pursuant to the said merger, two employees of the subsidiary company viz., Mr. M.S. Kumar and Mr. Kevin Koenig were offered employment by the assessee, which were duly accepted by the said employees.

ii) Pursuant to the same, three contracts were executed between the employee and the assessee viz., Employer Agreement, Non-Disclosure Agreement and Employee Non-Compete Agreement. The assessee made payments to the said employees under the Non-Compete Agreement without withholding any taxes, since the said payments were not taxable in India under Article 16 of India-USA DTAA (hereinafter referred as DTAA) since the employees were rendering services in U.S.A.

iii) The AO held that agreements and the payment made to the two employees of the assessee were sham and solely created for the purposes of avoiding payment of tax in India. Accordingly, the AO held the assessee as an 'assessee in default' u/s 201 for not withholding taxes on the amount paid to the said employees under the Non-Compete Agreements. The CIT(A) upheld the order of the AO by observing that payments made under the Non-Compete Agreement could not be treated as income arising from employment or as 'profit in lieu of salary' u/s 17(3) and were thus taxable as other income in India under Article 23(3) of the DTAA. However, on appeal, the Tribunal held that the amount paid to the employees by the assessee under the Non-Compete Agreements would fall under the term 'salary' or 'profit in lieu of salary' which would not be taxable in India under Article 16(1) of the DTAA. Accordingly, the Tribunal held that assessee could not be treated as an 'assessee in default' u/s 201(1A) since no taxes were required to be withheld by the assessee.

iv) Accordingly, the present appeal was filed by the Revenue before the Karnataka HC contending that the amounts paid to the said employees were taxable in India u/s 28(va).

Decision

i) The HC referred the provisions of section 5(2) and section 9 and observed that salary income would be taxable in India if it is earned in India and is in relation to the services rendered in India. Further, the HC also observed that as per section 17(3), the expression 'profits in lieu of salary' includes any consideration lump sum or otherwise by an assessee from any person before his joining any employment from that person or after cessation of his employment with that person.

ii) The HC upheld the order of the ITAT, wherein the Tribunal had observed that the employees received the amount as being 'employees' of the assessee and since the employees were rendering services outside India i.e., USA and payments were also made in USA, Article 16 of the DTAA would be applicable and the said amounts would be taxable only in USA.

iii) The HC also distinguished the decision of Supreme Court in case of Performing Rights Society Ltd. 106 ITR 11 (SC) by observing that in the said case the non-resident company was granted performing rights in western music to be broadcast by the All India Radio and since, the broadcasting had taken place in India, therefore, it was held that the income shall be deemed to be accrued or arise in India as prescribed under Section 5(2) of the Act. However, in the present case, section 5(2) of the I.T. Act had no applicability and hence not applicable. Similarly, the decision of Supreme Court in case of PILCOM (CA No. 5749 of 2012) was distinguished by observing that in the said case the cricket associations had participated in the matches which were held in India and therefore, the income had accrued in India. However, considering the factual matrix, the said decision was held to be not applicable to the present case.

iv) Accordingly, the HC observed that the matter stood concluded by findings of fact given by the Tribunal and the Revenue had not been able to either plead or place on record material to show that findings of fact recorded by the Tribunal were perverse. Thus, HC held that no substantial questions of law arose for consideration in this appeal.

B. AUTHORITY FOR ADVANCE RULINGS

2 ***Tiger Global International II Holdings,***
In re [2020] 116 taxmann.com 878 (AAR - New Delhi)

As the transaction of selling shares of a Singapore Co. (deriving its values substantially from assets located in India) by a tax resident of Mauritius (being a 'see through entity' which was

beneficially owned and controlled by a US person), was prima facie designed for avoidance of tax under the garb of India-Mauritius DTAA, application before the Authority for Advance ruling for determining the taxability of the above mentioned transaction, was rejected u/s 245R.

Facts

i) The Applicant (i.e. assessee), a private limited company was incorporated in Mauritius with a primary objective of undertaking long term investment activities and earning long term capital appreciation. The assessee held Category 1 Global Business License and was a tax resident of Mauritius under the India-Mauritius DTAA (hereinafter referred as DTAA).

ii) During the period October 2011 to April 2015, the assessee invested in the shares of Flipkart Private Limited, a company incorporated in Singapore (hereinafter referred as Singapore Co.) and further the Singapore Co. had in turn invested in multiple Indian companies, thereby deriving its value substantially from assets located in India. The assessee was desirous of transferring the shares of Singapore Co. to Fit Holdings SARL, an independent buyer based out of Luxembourg (hereinafter referred to as the Buyer).

iii) In relation to the aforesaid share transfer, the assessee had approached the AO u/s 197 of the I.T. Act seeking a nil withholding certificate, however, the AO denied the request on the premise that the assessee was not eligible to avail benefits under the DTAA since the assessee was not a beneficial owner of the income in as much as, the assessee did not exercise independence in its decision making, as the control pertaining to the purchase and sale of the shares did not lie with it. The assessee thereafter filed an application u/s 245Q before the AAR to determine whether the sale of shares of the Singapore Co. by the assessee to the Buyer would be chargeable to tax in India under the IT Act read with the DTAA.

iv) The Revenue challenged the admissibility of the application u/s 245R on the following grounds:-

a. Issue was already pending before an income tax authority: The Revenue contended that the issue in question had been examined in detail during the proceedings u/s 197, and the conclusion of such proceedings was a reasonable ground for rejecting the application. Further, it was also contended that certificate issued u/s 197 was valid for the financial year 2018-19 and hence there was a pending proceeding on the date when the application was filed by the Applicant.

b. Issue involved determination of Fair Market Value: The Revenue contended that the transfer of shares necessarily involves valuation of shares and the computation of capital gains would be dependent on the sale consideration which would be based on the value assigned to each share.

c. Transaction was designed prima facie for the tax avoidance: The Revenue contended that the assessee was 'see-through entity' designed prima facie to obtain benefits under the India-Mauritius DTAA.

Decision

The AAR held as follows:

i) The AAR rejected the first and second objections of the Revenue by:-

   a. holding that there was no pendency of proceedings since once a transaction is concluded the certificate issued u/s 197 ceases to be in force which is in line with Circular No. 774 of 1999.

   b. relying on the decision of co-ordinate bench in the case of Worldwide Wickets 303 CTR 107 (AAR), to hold that the issue of evaluating eligibility of benefits under India-Mauritius DTAA did not involve valuation.

ii) The AAR accepted the contention of the Revenue that the application ought to be rejected on the grounds that the transaction was designed prima facie for avoidance of tax, by observing as follows:

   a. The transaction had to be looked at as a whole, and hence not only the sale but also the purchase of the shares would have to be examined. Further, though the holding-subsidiary structure might not be conclusive proof of tax avoidance, the fact that subsidiaries were set up for claiming benefit under the India-Mauritius Tax Treaty was an inescapable conclusion. The AAR rejected the contention of the assessee that Mauritius was a preferred jurisdiction for investors due to its comprehensive treaty network with various countries and not just India. The AAR noted from the financial statements of the assessee that they had not made any investment other than the investment in the Singapore Co. The AAR thus concluded that the real intention of the applicants was to avail the benefit of India-Mauritius Tax Treaty.

   b. W.r.t the decision making power of the assessee, the AAR held that the control and management had to be deduced from the 'head and brain' of the entities, and not just their day to day affairs. The AAR observed that a US personnel, a director of the ultimate holding companies of the assessee, was also a signatory to the bank accounts of the assessee, immediate parent entities of the assessee, and was also declared as the beneficial owner of the assessee. The AAR also noted that the said US personnel was controlling the decisions of the board of directors of the assessee. Consequently, the AAR held that the 'head and brain' of the Applicants and their control and management was not situated in Mauritius, but in USA.

   c. The AAR by relying on the holding structure of the assessee coupled with their control and management concluded that the assessee was only a 'see through' entities set up to avail benefits of the India-Mauritius DTAA and the beneficial owner of the group structure was the said US personnel. The AAR further observed that the Supreme Court in the case of ***Vodafone International Holdings BV [2012] 341 ITR 1 (SC)*** held that DTAA and Circular No. 789 dated 13 April 2000 would not preclude the revenue from denying the tax treaty benefits in suitable cases.

iii) Further, the AAR also opined that since the transfer involved shares of a Singapore Co. by the assessee, the benefit provided under India-Mauritius DTAA would not be available, by observing that the intention of the India-Mauritius DTAA was to exempt investments by Mauritius companies in Indian companies only and not the investment in a Singapore entity deriving substantial value from India and hence, the benefit under the India-Mauritius DTAA would not be available to the assessee.

C. TRIBUNAL

3 ***Voith Paper GmbH v. DDIT***
[2020] 116 taxmann.com 127 (Delhi - Trib.) for AY 2010-11

Where the assessee had entered into an agreement with an Indian company for supply of equipments (to be utilized in the commissioning of a Plant) and for services in nature of commissioning the said equipments in India with an intention to install a Plant in India, both the contracts were viewed as one single composite contract. Further, as the equipments were assembled in India with the involvement of the PE of the assessee, the property in the said equipment's was construed to be transferred in India and accordingly a part of profit on supply of the said equipment was to be attributed to the said PE in India.

Facts

i) The Appellant (i.e. assessee), a tax resident of Austria, was engaged in the business of project planning, sale, engineering, processing, sourcing, conceptualizing, developing technology and marketing of 'board and packaging paper machines'. The assessee had entered into two separate contracts with an Indian company for supply of equipments and services for commissioning of a packaging plant (i.e. machinery) in India. The contract for supply included engineering, designing, manufacturing, drawing and supplying of machinery and contract for services included supervision of erection, start-up, training, commissioning and performance test of said machinery.

ii) The assessee contended that the consideration in respect of supply of equipment, was not taxable under the IT Act as well as under India-Austria DTAA (hereinafter referred as DTAA) since it did not have a fixed place of business in India as per article 5(2) of the DTAA. W.r.t the consideration for services, the assessee offered the same to tax in India, since the said activity continued for a period exceeding six months and by virtue of provision of articles 5(2)(i) of the DTAA, the assessee had a Permanent Establishment (PE) in India, only in respect of said service activity.

iii) The AO held that the offshore supply of equipments would be taxable in India since the contract for supply of equipments and service contract were interconnected to each other and hence were composite in nature. Further, the AO held that the sale of equipments were concluded in India (since the PE of the assessee had played a role in assembling and bringing the equipments to a deliverable state as per the supply contract) and the PE of the assessee played a role in marketing and thus profit from supply of the equipment's was directly attributable to the PE of the assessee in India. In the absence of standalone financial statements, the AO assumed a profit of 9.75% on the supply of equipment's and attributed 35% of the said profit to the PE of the assessee in India. The action of the AO was upheld by the DRP.

iv) Accordingly, the present appeal was filed by the assessee before the Tribunal.

Decision

i) W.r.t the issue as to whether both the contracts were composite contracts, the Tribunal held as follows:-

a. The intention of the parties was to provide to the Indian company a plant in deliverable state (i.e. installation of the plant under supervision of the assessee) which was clear from the terms of contract like the date of completion of delivery would be the last date of delivery of the last consignment, provision of monthly progress report both in supply and service contract, performance warrantee clause etc. Since the assessee also specialized in manufacturing the equipments required for setting up of the Plant (custom made specifically for the Indian company), the assessee was also involved in supply of the same and it was not possible for the Indian company to assemble or erect the plant from any other contractor without the supervision of the assessee. Further, the final acceptance of the supply of goods was dependent on the success of performance warrantee test and the service contract had a provision for termination of contract in case of failure of performance and return of machinery supplied under supply contract.

b. In view of the same, the Tribunal held that both the supply and service contract were intrinsically linked to each other and represented a single, composite turnkey work contract. The Tribunal also relied on the accounting practice followed by the assessee for recognizing revenue i.e. at the time of completion of the project, to hold that the intention of the parties was to treat the erection of the plant as a composite project.

c. The Tribunal distinguished the decision of Supreme Court in case of ***Ishikawajma Harima Heavy Industries Ltd. vs. DIT [2007] 158 Taxman 259 (SC)***, by observing that in case of ***Ishikawajma Harima Heavy Industries (supra)*** the party who supplied the goods and erected the plant were different entities, however in the present case the party who supplied the goods and supervised the erection were one and the same party. Further, in the present case, the supply obligation and service obligation were interlinked and complemented to each other and it was not possible for the Indian company to erect the plant without the supervision of the assessee.

ii) W.r.t existence of a business connection and whether the income under the supply contract accrue or deemed to accrue in India u/s 9(1)(i) of the I.T. Act.

a. The Tribunal by relying on the decision of Supreme Court in case of ***Ishikawajma Harima Heavy Industries (supra)*** and ***Delhi HC in case of DIT vs. Ericsson AB [2011] 16 taxmann.com 371***, held that the place of negotiation, the place of signing of agreement or formal acceptance thereof or other responsibility of the assessee were irrelevant for determining taxability of offshore supply of equipments.

b. The Tribunal by relying on section 19 of the Sale of Goods Act, 1930 held that the property is transferred to the buyer at such time as the parties to the contract intended to be transferred. The Tribunal held that though the terms of the contract specified that the ownership and risk of the equipment supplied under the supply contract would be transferred in favour of the Indian company outside India at the port of shipment, however when the intention of the parties was examined from various clauses of the agreements, it was found that in both the agreements, the intention of the Indian company was to install the plant in India.

c. The Tribunal, by observing the following factual matrix, held that the property of the equipments sold to the Indian company had passed in India and thus a part of the consideration of supply agreement for offshore supply was taxable in India:-

- The final acceptance of the supply of goods was dependent on the outcome of the performance warrantee test and the service contract had a provision for termination of contract in case of failure of performance and return of machinery supplied under supply contract.
- The transit insurance of goods had been arranged by the assessee at its own cost from the warehouse of the assessee to the warehouse of the Indian company, hence the risk in case of damage of goods during transit remained with the assessee and accordingly the contention of the assessee that the ownership and risk of the equipments was transferred outside India to the Indian company, remained only on paper and was not acted upon.
- The parts of the machineries had been manufactured outside India but they had not been brought in deliverable state in India (since the necessary assembling was done in India as per the supply contract) as per supply agreement and thus the sale could not be said as effected outside India.
- The Tribunal distinguished the decision of Delhi HC in case of Ericsson AB (supra), by observing that, in the case of

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Ericsson AB (supra) the contract of erection was executed by subsidiary company and thus the HC held that both the entities performed their own independent obligation, received appropriate separate remuneration and were technically not dependent on each other. But in the present case, both the contract of supply and supervision of installation or commissioning of plant had been executed/supervised by the assessee itself.

d. In view of the above, the Tribunal held that the assessee had a business connection in India since a part of the operations of the supply contract had been executed in India and sale of goods were in continuation of the process of erection of the plant. The Tribunal also observed that an element of continuity had been observed between the business of the assessee i.e. from the supply of equipments to successful supervision for the commission of Plant, which represented a real and intimate relationship between activities of assessee done outside India and those done inside India.

iii) W.r.t the existence of PE, the Tribunal held that the employees of the assessee were in India at the time of entry of the part of the machinery in India and those employees were instrumental in supervising the entire activity of inspection of part of the machinery imported into India, assembling the machinery to bring into the deliverable state as per the supply contract. In view of the same, a part of the operations of supply contract had been carried out in India by the PE of the assessee (which was admitted by the assessee in respect of the service contract) and accordingly part of the profit from the supply agreement also needed to be taxed in India in terms of the DTAA.

iv) The Tribunal, by relying on the decision of Delhi HC in case of ***Rolls Royce Plc vs. DIT [2011] 13 taxmann.com 233***, upheld the action of the AO in attributing 35% of the profits on the supply of equipments to the PE of the assessee in India.

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Loyal and efficient work in a great cause, even though it may not be immediately recognized, ultimately bears fruit.

– Jawaharlal Nehru