INTERNATIONAL TAXATION

Case Law Update

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A. High Court

1 ***Virtusa Consulting Services (P.) Ltd. v. DCIT [2021] 124 taxmann.com 309 (Madras)***

Tested party normally should be the least complex party to the controlled transaction and that there is no bar for selection of tested party either local or foreign party. The selection of the tested party is to further the object of comparability analysis by making it less complex and requiring fewer adjustments.

Facts

i) The assessee, a domestic company, was engaged in the business of software development services for its AEs. During the year under consideration i.e. AY 2011-12, the assessee had entered into various international transactions with its AEs and for the purpose of transfer pricing analysis, the assessee had segmented its operations into three segments namely (i) Subsidiary Segment (AEs) (benchmarked using TNMM); (ii) Citi Segment (AEs) (benchmarked using CUP) and (iii) Others/Third Party Segment. As regards (i) above, the assessee considered TNMM as the most appropriate method for benchmarking its international transaction, and by considering itself as the tested party and by using operating profit/operating cost as the profit level indicator, the assessee concluded that its international transaction was at arm's length. Subsequently, during the course of assessment proceedings, the assessee revised its segmental profitability by revising the allocation of selling, administrative and general overheads in the ratio of the turnover for each of the segments.

ii) The TPO rejected the benchmarking analysis carried out by the assessee and proceeded with a segmental TNMM analysis for benchmarking the international transactions undertaken with overseas subsidiaries and Citi

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bank entities. Further, the TPO also rejected the comparable selection undertaken by the assessee and undertook a fresh search for external comparables and arrived at a final list of 12 comparable companies with an average operating margin of 18.94% and made an adjustment of INR 39.43 crores. The action of the AO was upheld by the DRP. Before the Tribunal, the assessee contended that their overseas subsidiaries were the least complex entities to the international transactions and therefore the AEs should be selected as the tested party. However, the Tribunal rejected the selection of the tested party as contended by the assessee stating that the assessee failed to produce material evidence/documents to establish the functional profile and risks assumed by the overseas AEs. The Tribunal further observed that the Indian TP provisions did not allow selection of a foreign AE as a tested party for benchmarking the international transactions and it is the Indian Enterprise that should be taken as the tested party. With respect to the other issues separately raised by the assessee before the Tribunal (i.e. certain transfer pricing issues viz. allocation of cost to the segments, internal TNMM vs. external TNMM, selection of comparable companies, restriction of quantum of transfer pricing adjustment to the actual profits retained by overseas subsidiaries from underlying international transactions and claim of economic adjustments and certain corporate tax issues viz. disallowance u/s 14A of the Act and tax on distributed dividends u/s 115-O of the Act), the Tribunal did not adjudicate the same. The miscellaneous application filed against the order of the Tribunal was also dismissed by the Tribunal on the grounds that there was no mistake apparent from the record.

iii) On further appeal, the Madras High Court held as under:

Decision

i) The High Court observed that the Tribunal had distinguished the decision in Ranbaxy Laboratories Limited v. DCIT (2016) 68 taxmann.com 322 (Delhi-Trib) on the ground that the Delhi Tribunal had proceeded on the basis of the OECD guidelines. However, the High Court noted that the principles that emerged in the selection of the tested party should be culled out from the Ranbaxy Laboratories Limited (supra) judgement, wherein it has been held that the tested party normally should be the least complex party to the controlled transaction and that there was no bar for selection of tested party either local or foreign party, neither in the Act nor in the guidelines. The selection of the tested party is to further the object of comparability analysis by making it less complex and requiring fewer adjustment. Accordingly, the High Court rejected the Tribunal's rejection of the assessee's reliance on the decision of Ranbaxy Laboratories Limited (supra).

ii) Further, the High Court, by placing reliance on the decision of Yamaha Motor India Limited v. ACIT (2014) 50 taxmann.com 444 (Delhi-Trib), held that under the Act and the Rules, the words 'Enterprise' and 'Associated Enterprise' have been used interchangeably and the arguments that the Enterprise will mean the assessee and the Associated Enterprise will mean the other party to/from whom the assessee has sold or purchased goods is incorrect. Therefore, the conclusion of the Tribunal in holding that only the Indian Enterprise should be taken as the tested party was incorrect.

iii) W.r.t the contention of the Revenue that since the assessee had not disclosed its foreign AEs as the tested party in Form 3CEB, the assessee would be precluded from taking a new plea, the High Court observed that Form 3CEB pertained only to transactional claims and had nothing to do with the selection of tested party. Thus, the High Court held that the findings rendered by the TPO, DRP and the Tribunal foreclosing the assessee's claim to refer to the foreign AEs as the tested party were legally not sustainable.

iv) In view of the above, the High Court set aside the orders of the TPO, DRP and Tribunal. Further, the High Court also remanded the grounds (which were not adjudicated by the Tribunal) to the Tribunal. W.r.t plea of the assessee to select its foreign AEs as the tested party, the High Court remanded the matter to the file of the TPO for fresh adjudication having regards to the order passed by the TPO for subsequent years (wherein the TPO had accepted foreign AEs as the tested party for benchmarking the aforesaid international transactions)

2 *GE Oil & Gas India Private Ltd. v. ACIT [TS-21-HC-2021(MAD)-TP]*

Where a transfer pricing adjustment was made by the AO and subsequently the AO passed an order determining the total income of the assessee accompanied with demand notice, without passing a draft assessment order at the first instance u/s 144C, the said order and the consequential demands were quashed being in violation to the mandate of section 144C of the Act

Facts

i) The assessee, a domestic company, for the AY 2016-17 was subjected to certain transfer pricing adjustments during the course of assessment proceedings. The AO instead of passing a draft order u/s 144C passed a final order ('impugned order') quantifying the final demand and imposing a penalty.

ii) In view of the above, the assessee filed a writ petition before the Hon'ble Madras High Court challenging the validity of the impugned order. Before the Hon'ble Madras High Court, the Revenue challenged the maintainability of the writ petition filed by the assessee, by contending that an alternate remedy in the form of application for rectification of order, was available to the assessee and thus the writ petition should be dismissed.

iii) The Hon'ble Madras High Court held as under

Decision

i) The High Court observed that the scheme of assessment in terms of section 144C of the Act statutorily requires the AO to pass a draft assessment order at the first instance and put the same to the assessee for its acceptance or for filing of objections before the DRP. The HC placed reliance on the jurisdictional High Court decision in the case of Vijay Television Ltd. v. DRP 369 ITR 113 wherein it was held that section 144C of the Act sets forth a mandatory scheme of assessment and it is incumbent upon the AO to pass an order of draft assessment at the first instance before proceeding to finalise the assessment in line with the procedure set out u/s.144C.

ii) The High Court observed that the Revenue's plea that the impugned order had been passed 'inadvertently' by choosing of the wrong field in the IT Department software would not just be an over-simplification, but a wrong statement since a perusal of the order of assessment revealed that the assessment had been styled consciously, as an order of regular assessment only. In this regard, the High Court observed that the section under which the assessment was made was stated to be 'Section 143(3)', the heading in the order was 'assessment order', the total income was assessed which was accompanied by a computation sheet determining the demand payable by the assessee along with interest and penalty proceedings were initiated in terms of section 274(1)(c) of the Act. Thus, the High Court held that it was clear that the Officer had consciously proceeded to pass an order of regular assessment, losing sight of the scheme of assessment in terms of Section 144C, which he was statutorily mandated to follow and apply.

iii) The High Court further observed that in the case of PCIT v. Headstrong Services India Private Limited (ITA No. 77 of 2019 dated 24th December 2020), the phrase 'in the first instance' in section 144C was interpreted to the effect that, be it an original order of assessment or an assessment made on remand, the mandate of section 144C must be followed in as much as that a draft order of assessment should normally indicate, in conclusion, that the assessee had the option of either acquiescing with the proposed assessment or proceeding to file objections to the same within 30 days before the DRP.

iv) Accordingly, HC quashed the impugned order and consequential demand and thereby allowed the assessee's writ petition.

B. Tribunal

3 ***DZ Bank AG – India Representative Office v. DCIT [2020] 122 taxmann. com 65 (Mumbai-Trib)***

Interest Income, which was already been brought to tax in the hands of the assessee, a German Bank having a representative office in India, under Article 11 of the DTAA, could not be sought to be taxed again in the hands of the alleged PE (i.e. its representative office in India) of the same assessee, in the same assessment year even if under a different provision i.e. Article 7 of the DTAA.

Facts

i) The assessee, a German company was engaged in the banking business, having its principal place of business in Germany and a representative office in India as permitted by the Reserve Bank of India (RBI). In terms of the RBIs conditions, the representative office was to act as a Liaison Office (LO) without transacting any type of banking business and all the expenses of the representative office were to be met out of inward remittances from the bank. The representative office was not engaged in the core business of the assessee, i.e. banking.

ii) During the year under consideration i.e. AY 2014-15, the assessee provided foreign currency loans to Indian companies which were in the nature of External Commercial Borrowings (ECB). The taxpayer earned interest from such ECB. Further, the assessee also earned a commitment fee and agency fees in connection with certain guaranteed loans. During the course of assessment proceedings, the assessee contended that taxes were withheld on a gross basis on the interest payable by the Indian borrowers and thus as per section 115A(5) of the Act, the assessee was exempt from furnishing a return of income in India since it earned only interest income from foreign currency loans provided to Indian companies, and the appropriate taxes were withheld on the same. Accordingly, the assessee contended that such income was not further taxable in India.

iii) The Assessing Officer (AO) held that the business transaction executed by the assessee's head office and overseas branches with its Indian clients/ borrowers would not be complete without the involvement and actions by its representative office in India. Therefore, the income was deemed to accrue/arise to the assessee from a 'business connection' in India. The AO held that the representative office of the assessee in India would constitute a Permanent Establishment (PE) under the India-Germany DTAA ('DTAA'). Therefore, profits deemed to accrue or arise to the assessee in India would be attributable to the PE under the DTAA. While referring to Explanation 2 to Section 9(1)(i) of the Income-tax Act, 1961, the AO held that the assessee habitually exercised in India, an authority to conclude contracts for or on behalf of the enterprise at the instructions of the head office or overseas branches and that the Indian representative office also habitually secured orders in India, wholly for the foreign entity and its overseas branches. Thus, all the income earned by its head office from clients in India was taxable as its business income in India. The Commissioner of Income-tax (Appeals) [CIT(A)] upheld the order of the AO.

iv) On appeal, the ITAT held as under:

Decision

W.r.t taxability of income in the hands of the assessee and not in the hands of its Representative office in India.

i) The Tribunal observed that it was only elementary that the tax subject was only the foreign enterprise and not its PE in India, though, so far as profit attributable to the PE was concerned, the same was taxable in the hands of the foreign enterprise. The Tribunal, by placing reliance on the decision of Dresdner Bank AG v. ACIT [2006] 11 SOT 158 (Mum), observed that in so far as foreign companies were concerned, the taxable unit would be the foreign company and not its branch or PE in India, even though the taxability of such foreign companies is confined to (i) an income which 'accrues or arises in India' or is 'deemed to accrue or arise in India', and (ii) an income which is received or is deemed to be received by or on behalf of such foreign company. Reference was also made to the decision of the Supreme Court in the case of CIT v. Hyundai Heavy Industries Co. Ltd.

[2007] 291 ITR 482 (SC). Thus, it was held that India Representative Office was not a taxable unit, and the taxable entity was only a foreign entity.

W.r.t taxability of interest income under Article 11 v. Article 7.

ii) The Tribunal, on perusal of Article 7 of the DTAA observed that when a particular type of income was specifically covered under the DTAA provision, the taxability of that type of income would be governed by the specific provisions of the DTAA. There was no dispute that income earned by the assessee from Indian clients was in the nature of 'interest' income, and Article 11 had specific provisions for taxation of interest income, in the hands of a resident of one contracting state, from the other contracting state. Interest income is specifically covered in Article 11(5) of the DTAA and restricts the taxability of such interest income to 10 per cent of the gross amount. Further, the interest relating to the India operations of the foreign entity had been offered to tax under Article 11. Therefore, the interest income was to be taxed on a gross basis, in the source jurisdiction. The Tribunal further observed that the exclusion clause under Article 11(5) would be triggered only when the twin conditions, i.e. the foreign enterprise carried on business in the source jurisdiction and that the debt claim being effectively connected with the PE are satisfied. So far as the debt claim being effectively connected with the PE was concerned, the Tribunal held that it could not come into play only merely because the PE had a supporting role in the creation of the debt claim. Further, unless a debt claim was part of the assets of the PE or income arising therefrom can be said to be the income of the PE, it could not normally be treated as effectively connected with the PE.

iii) The Tribunal also held that when the principal transaction (i.e. interest income in question) itself does not lead to taxable income in India, a transaction subsidiary thereto (i.e. commitment fees and agency fees relatable thereto) could not result in an income taxable in India either. Commitment charges and agency fees were an integral part of the loan arrangements, relatable to the same loan, and part of the consideration for the same loan.

iv) Consequently, the Tribunal held that the tax liability on the interest income of the assessee from its clients in India was already discharged under Article 11 by way of tax deduction at source by its Indian clients. So far as this taxability is concerned, the assessee did not have any obligations to file the income tax return u/s 115A(5) as it existed at the relevant point of time. Therefore, an income, which had already been brought to tax in the hands of the assessee under a DTAA provision, was being sought to be taxed again in the hands of the same assessee, in the same assessment year but only under a different provision. This approach of the Revenue was held to be incorrect by the Tribunal. Therefore, it was held that the entire interest income was to be taxed under Article 11 and not under Article 7 of the tax treaty.

v) W.r.t constitution of a PE in India, the Tribunal observed that it was a wholly academic issue because where there was a PE or no PE, the debt claim in question could not be said to be effectively connected to the alleged PE, and, therefore, neither the exclusion of Article 11(5) could have been triggered, nor the taxability under article 7 could have come into play. It was not even AO's case that the debt claims in question were effectively connected with the PE and thus, the existence of PE was not really relevant for determining the issue of taxability under Article 7 on the facts of the present case.

C. Authority for Advance Rulings

4 ***BG Asia Pacific Holding (P.) Ltd., In re [2021] 125 taxmann.com 2 (AAR - New Delhi)***

Where assessee, a Singapore Co., engaged in bonafide investment holding activities was held not to be a shell/conduit company, capital gains arising on transfer of shares held by it in an Indian Co. to another Indian Co. would not be liable to capital gains tax in India under Article 13(4) of the India-Singapore DTAA, read with Article 3 of Protocol dated 18th July 2005 (which interalia provided the 'limitation of benefits' clause in relation to Article 13 of the DTAA)

Facts

i) BG Asia Pacific Holdings Pte Ltd. (hereinafter referred to as the 'applicant' or the 'seller'), was a tax resident of Singapore and had made significant investments in various group companies situated in India, Singapore, Egypt, Thailand and Trinidad. The applicant was holding 65.122% of the total share capital of an Indian company that was listed on the National Stock Exchange of India and Bombay Stock Exchange of India. The applicant proposed to transfer its entire shareholding in the said Indian company to another Indian company (hereinafter referred to as the 'buyer'), by way of private placement outside the stock exchange as an "off-market" sale transaction. In the above backdrop, the seller as well as the buyer of the shares, filed applications before the AAR to determine the taxability under the Act as well as under the India-Singapore DTAA (hereinafter referred to as the 'DTAA').

ii) Before the AAR, the applicant contended that:

a. The capital gains arising on the transfer of the aforesaid shares would be taxable under the Act since it was an "off-market" sale transaction not covered u/s 10(38) of the Act. However, the said capital gains would not be taxable under Article 13(4) of the DTAA read with the Protocol dated 18th July 2005 (which interalia provided the 'limitation of benefits' clause in relation to Article 13 of the DTAA)

b. The applicant submitted that the conditions prescribed under the aforesaid Protocol were satisfied in as much as that the affairs of the applicant were not structured to avail favourable tax treatment under the DTAA. To support the same, the applicant submitted that the investment was made in the Indian company in the year 1997, it continued to hold the said investment even after the introduction of capital gains exemption (introduced w.e.f 1st August 2005) and therefore, there was a substantial time lapse between the date of acquisition and the date of transfer of shares i.e. 2012. Further, the applicant also submitted that the proposed transaction was entered not to avail favourable tax treatment under the DTAA, rather the transaction was a part of the general policy decision of the applicant's group to focus on core business activities and divest its interest in entities operating in non-core business. The applicant also relied on the decision of the Supreme Court in the case of Vodafone International Holdings BV v. UOI (2012) 341 ITR 1 (SC) and Andhra Pradesh High Court in the case of Sanofi Pasteur Holdings SA v. Department of Revnue, (2013) 354 ITR 316 (AP) to contend that the activity of an investment holding company was essential for the proposer management of an MNC's worldwide business interest and such activities being bonafide were in nature of business activity/operations.

c. The applicant also submitted that it was not a shell/conduit company, since it had employed a number of personnel in Singapore for its regional and local operations and therefore it contended that it had significant business operations in Singapore. The applicant placed reliance on the declaration issued by the Singapore Revenue Authority (SRA), wherein it was mentioned that the applicant conducted its business activities of investment holdings in Singapore. Further, the applicant also contended that the 'total expenses' incurred by the applicant in the preceding two years exceeded the threshold of SGD 200,000 as prescribed by the aforesaid Protocol and therefore the applicant could not be deemed to be considered as a shell/conduit company. The applicant also placed reliance on the TRC (for the two preceding years) issued by the SRA, wherein it was stated that the applicant had satisfied the conditions stipulated in the aforesaid Protocol.

iii) The Revenue contended that the activities undertaken by the applicant being 'holding for the group' was not a business activity contemplated under the provisions of the aforesaid Protocol in as much as for the purpose of the aforesaid Protocol, the company should be engaged in substantive business operations in the state of its Residence. The Revenue also contended that the applicant did not have its own employees rather, the employees were under the payroll of a group entity and the cost was reimbursed by the applicant to the said group entity. Further, the Revenue also contended that only the 'annual operating expenditure in Singapore' should be reckoned for determining the threshold of SGD 200,000 and not the 'total annual expenditure' (which interalia included therein the administrative expenses and expenses incurred for statutory compliances)

iv) The AAR ruled as under:

Decision

i) The AAR observed that Article 13(4) of the DTAA providing the taxability of capital gains derived by the resident of a Contracting State in the state of residence was introduced by the aforesaid Protocol, which interalia also provided a 'limitation of benefits' clause in relation to Article 13 of the DTAA. The AAR, thus observed that, in order to avail the benefit of Article 13, the applicant would be required to satisfy the conditions prescribed in Article 3 of the Protocol.

ii) W.r.t the condition as to whether the affairs of the applicant were arranged with the primary purpose to take advantage of the favourable provisions of the DTAA, the AAR held that the transaction was not an India specific transaction, but pursuant to a general policy decision of the applicant's group and thus it could not be said that the intention of the proposed transaction was to obtain a favourable tax treatment under the DTAA.

iii) W.r.t the condition as to whether the applicant had bonafide business activities and whether the applicant was a shell/conduit company, the AAR, by placing reliance on the decision of Vodafone (supra) and Sanofi Pastuer (supra), held that the activities undertaken by the applicant i.e. management of investment of the Group, was a specialised business operation and thus such an activity was a business activity operation and further it could not be considered as a shell/conduit company.

iv) W.r.t the condition as to whether the total annual expenditure of the applicant's operation was more than SGD 200,000 in the immediately preceding 24 months from the date of deriving the capital gains – The AAR observed that the period of 24 months preceding the date of transfer of shares (i.e. 12th June 2013) had to be reckoned from 1st June 2011 to 31st May 2013. The AAR, placed reliance on the declaration given by SRA and observed that the applicant had incurred total annual expenses, which exceeded the threshold as prescribed under Article 3 of the aforesaid Protocol. The AAR also observed that though the said declaration may not be conclusive and could be rebutted by the Revenue, however, since the Revenue had not bought any material or evidence on record to contradict the declaration issued by the SRA, the AAR accepted the said declaration issued by the SRA. The AAR also placed reliance on the financial statements filed by the applicant and observed that the applicant was engaged in continuous business activity and was also incurring administrative business expenses every year which were directly related to the business activity of the applicant, which exceeded the threshold as prescribed by the Protocol.

v) In view of the above, the AAR held that the conditions prescribed under Article 3 of the aforesaid Protocol were fulfilled and thus capital gains on the aforesaid transaction would not be liable to be taxed in India.