INTERNATIONAL TAXATION

Case Law Update

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A. HIGH COURT

1 ***PCIT vs. M/s. Visteon Engineering Centre (India) Pvt. Ltd.***

[TS-863-HC-2019] (Bom.) – ITA 1336 of 2017

Transfer pricing adjustment cannot be done at the entity level and has to be done only in respect of international transactions of the assessee with its Associated Enterprises (AE)

Facts

i) The assessee was primarily engaged in the business of designing and developing products in CAD/CAM of auto parts.

ii) The AO pursuant to the directions of the learned DRP computed the transfer pricing adjustment on the entity level income of the Appellant instead of computing the transfer pricing adjustment on international transactions pertaining to provision of Engineering Design Services to its Associated Enterprises (AEs) only. Further, the assessee had included Genesys International Corporation Ltd. in the list of comparables for benchmarking which was also included by TPO.

iii) The Tribunal allowed assessee's appeal and held that transfer pricing adjustment is to be confined to the component of international transactions with the AEs alone and should not be made in relation to non-AE transactions. It also allowed ground of the assessee for exclusion of Genesys International Corporation Ltd. as it was not functionally comparable to the assessee.

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

Decision

i) The Court noted that transfer pricing adjustment cannot be done at the entity level and has to be done only in respect of international transactions of the assessee with its AEs. It further noted that the Tribunal had allowed the assessee's appeal on this issue by placing reliance upon the decision of its Co-ordinate Bench in the case of *M/s. Sandvik Asia Pvt. Ltd. vs. ACIT* dated 27th September, 2013 and Court had dismissed the Revenue's appeal against the same.

ii) Further, the Court observed that the only contention of Revenue for inclusion of Genesys International Corporation Ltd. was that it was included by assessee itself and he would be bound by its selection and could not now urge to the contrary. The Court noted that this issue was no longer *res integra*, as in the case of *CIT vs. Tata*

Power Solar Systems Ltd [2019] 77 taxmann.com 326 it had held that the assessee's submission in arriving at the ALP is not final, it is for the TPO to examine and find out the companies listed as comparables which are, in fact comparable.

iii) Accordingly, it dismissed Revenue's appeal as no substantial question of law arose.

2 ***PCIT vs. M/s. Visteon Engineering Centre (India) Pvt. Ltd.***

[TS-862-HC-2019(Del)] - ITA 411 of 2017

Cosmic Global Ltd was held to be not comparable to an ITES service provider

Facts

i) The assessee was engaged in the business of designing and developing products in CAD/CAM of auto parts and also customer support servicing and techno marketing services to its associate enterprises.

ii) The assessee had selected 9 Comparables in its TP Study report and arrived at a margin of 18.91%. The TPO rejected all comparables selected by assessee and selected 5 new comparables thereby arriving at a margin of 32.87%. DRP rejected the objection raised by the assessee for exclusion of the comparables. Thus final assessment order was passed by AO in conformity with the order ofTPO.

iii) The Tribunal allowed assessee's appeal and excluded Cosmic Global Ltd.

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

Decision

i) The Court noted that Cosmic Global Ltd. was engaged in providing BPO services while the assessee was engaged in provision of Information Technology Enabled (ITES) Services. Also, Cosmic Global Ltd. had out-sourced the services unlike the assessee who used its own engineers to provide services. Thus, it was functionally dissimilar to the business of the assessee and was rightly excluded by the Tribunal.

ii) Accordingly, it dismissed Revenue's appeal as no substantial question of law arose.

B. TRIBUNAL DECISIONS

3 ***Outotec (Finland) Oy vs. DCIT***

[TS-311-ITAT-2019 (Kol)]

Assessment Year: 2015-16

India-Finland DTAA – Article 12 – Taxability of Income from testing and other services – Held: Taxable as FTS under the India-Finland DTAA; Taxability of Income from sale of Designs and Drawings – Held: Not Taxable either as Royalty or FTS under the Treaty

Facts

i) The assessee, a Finland based entity, is a worldwide leader in providing innovative and environmentally sound solutions for a wide range of customers in metal processing industries.

ii) During the Assessment Year (AY) 2015-16, the assessee earned four types of revenue, i.e., technical services, royalty income, design and drawings, testing and other services. The assessee offered to tax income from the rendition of technical services and income from royalty (licence fees) but did not offer to tax income received from the sale of designs and drawings and income from testing and other services.

iii) The assessee contended that income from the sale of designs and drawings was a business income and since the assessee did not have Permanent Establishment (PE) in India, the business profit was not taxable in India.

iv) On the issue of income from rendering of testing and other services, the assessee relied on Article 12(5) of the tax treaty and as the services had been rendered outside India, it claimed that the same was not taxable in India.

v) The Assessing Officer (AO) held that income earned from the sale of designs and drawings was taxable in India as the same was in nature of royalty under the tax treaty and under the Income-tax Act, 1961 (the Act).

vi) On the issue of taxability of income from rendering of testing and other services, the AO held that the same is taxable as royalty/FTS, both under the Act as well as under the tax treaty.

vii) The Dispute Resolution Panel (DRP) upheld the order of the AO.

Decision

On Appeal, the Tribunal held partly in favour of the assessee as under:

A) Re: Taxability of income from the sale of design and drawings

i) On a perusal of agreements for sale of drawings and designs, it indicates that the designs and drawings in question were not embedded in the plant and machinery. They were separate items which were sold by the assessee. The fact that these were sold outside India was not disputed. The Tribunal relied on various cases [*Outotec Gmbh vs. DCIT [2015] 172 ITJ 337 (Kol), Outotec Gmbh vs. DCIT (ITA No. 160 & 193/Kol/2016*) wherein it was held that income earned from the sale of designs and drawings was treated as business income and it was not liable to tax in India under the Act as well as under the tax treaty.

ii) The sale was made outside India, and the consideration was also received outside India in foreign currency. Accordingly, it has been held that income from the sale of designs and drawings cannot be classified either as royalty or as FTS. The income had to be considered as business income, and as the assessee did not have PE in India, it cannot be brought to tax in India.

B) Re: Taxability of income from testing and other services

i) It is an undisputed fact that testing and other services were rendered outside the country, i.e., in Finland. On a perusal of Article 12(5) of the tax treaty, it indicates that the royalties or FTS shall be deemed to arise in a state where the payer is located. In cases where the right of property, for which royalty was paid is used within a state or a case where the FTS relate to services were performed within a state, then the income shall be deemed to arise in the state in which the right of property is used or the state in which the services were performed.

ii) The assessee contended that the technical services of testing were performed outside the country, i.e., in Finland and hence cannot be taxed in India in view of the exception carved out to Article 12(5) of the tax treaty. The exception in question was when the fee is paid for technical services which are performed within a state, then the income therefrom is deemed to accrue or arise within the state in which the services were performed.

iii) The Tribunal observed that this clause does not apply as the payment in question was made for the test results which were used within the state i.e. India. It may be true that the process of testing may have been conducted outside India. However, the payment in question was not for the process but was for the results of testing which were used in India. Accordingly, it has been held that income from testing and other services is taxable as FTS in India under the tax treaty.

Note:

The India-Finland Tax Treaty has been amended with effect from 1 April 2011, where the concept of 'make available' has been removed. Further the new tax treaty contains the most favoured nation (MFN) clause where it is provided that if after the India-Finland Tax Treaty has entered into force, any Tax Treaty between India and OECD country provides for an exemption from tax or a lower rate with respect to dividend, interest, royalty or FTS, the same will apply to India-Finland tax treaty. It is important to note that the MFN clause is subject to a notification to be issued by the Indian competent authorities and it only deals with the benefit of exemption from tax or lower tax rate.

4 ***Spencer Stuart International BV vs. DCIT***
[TS-333-ITAT-2019 (Mum)]
Assessment Year: 2015-16

India-Netherlands DTAA – Article 12 – Taxability of Fees for executive search – Held: Not taxable as FTS or royalty under the India-Netherlands Tax Treaty

Facts

i) The assessee, a non-resident company, had a wholly owned subsidiary in India. The assessee is engaged in the business of executive search services as well as providing Spencer Stuart Technology software and related services to its group concerns worldwide and third party franchisees.

ii) The assessee had two streams of income from India, namely, licence fee and executive search fee. The assessee entered into a 'licence agreement' with its subsidiary in terms of which subsidiary had been granted licence to use trademark, trade name, logos and the right to use the software owned by the assessee and certain other support services. In terms of the agreement, the assessee was entitled to receive a licence fee which was offered as royalty under the Act as well as under the tax treaty.

iii) The assessee had also entered into a service agreement in terms of which the subsidiary agreed to provide, on principal-to-principal basis, support services to each other in relation to executive search assignments.

iv) In terms of the said arrangement, the assessee received consideration which was treated as business income. The assessee claimed that the said income was not taxable as FTS under Article 12(5) of the tax treaty since the said services neither 'made available' any technical knowledge, experience, skill, know-how or process nor did it constitute development and transfer of a technical plan or technical design. The assessee contended that income by way of executive search services were not for services which were ancillary or subsidiary to the property rights for which licence fees was paid.

v) There was no dispute about the taxability of licence fee received by the assessee. However, with respect to executive search fee, the Assessing Officer (AO) observed that it was to be treated as FTS in terms of *Explanation 2* to Section 9(1)(vi) of the Income-tax Act (the Act). Further, such fee was for services which are ancillary and for the application or enjoyment of the right, property or information for which the 'licence agreement' was entered into and, therefore, though it was in terms of a separate 'service agreement' yet it constituted FTS in terms of Article 12(5)(a) of the tax treaty.

vi) The AO held that the amount of the executive search fee received by the assessee was in the nature of FTS under Article 12(5)(a) as well as under Article 12(5)(b) of the tax treaty. Alternatively, the AO held that it was to be treated as royalty under Article 12(4) of the tax treaty read with clause (iv) of *Explanation 2* to Section 9(1)(vi) of the Act. The Dispute Resolution Panel (DRP) upheld the order of the AO.

Decision

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

i) The Tribunal relied on the assessee's own case of earlier year where it was held that:

   (a) The licence agreement which resulted in earning of royalty income (which has been offered to tax) and the service agreement (which resulted in earning executive search fee) were separate and distinct agreements constituting different sources of income.

   (b) The principal business of the Indian subsidiary was to carry out or execute the mandate of executive searches and thus the executive search fee generating activities cannot be treated as ancillary or subsidiary to the licence agreement.

   (c) The licence fee payable in terms of the licence agreement was a percentage of search fee, which was earned by the Indian subsidiary from the execution of executive search mandate during a particular year. Thus, the executive search fee was not taxable as FTS in terms of Article 12(5)(a) or (b) of the tax treaty.

ii) The Tribunal, on reference to the Advance Pricing Agreement (APA) entered into by the subsidiary, observed that the 'licence agreement' and the 'service agreement' between the assessee and the subsidiary are separate and distinct of each other. Further, in the context of the arm's length price (ALP) of the transactions, the APA makes a distinction between the payment of licence fee and executive search fee. There was a complete dichotomy between the nature and characterisation of transactions accepted in the APA in the context of Indian subsidiary *vis-à-vis* the tax authority in the present case. Ostensibly, it does not need any more emphasis that the nature and characterisation of the amount in the present case has to correspond to what has been accepted by the tax authorities in the case of the payer of the same.

iii) If the tax department was to contend that the executive search fee was nothing but licence fee, then even in the APA proceedings, the tax authority should have recharacterised such executive search fee as 'licence fee' to tax it as royalty under the APA. The Tribunal observed that considering the executive search fee as 'royalty' would make the APA redundant. Therefore, the executive search fee cannot be treated as FTS under Article 12(5)(a) as well as 12(5)(b) of the Tax Treaty. Further, it cannot be taxed as royalty under Article 12(4) of the Tax Treaty read with clause (iv) of *Explanation 2* to Section 9(1)(vi) of the Act.

Cases referred to and relied upon:

i) *Spencer Stuart International BV vs. ACIT [2018] 94 taxmann.com 380 (Mum)*

ii) *Ranbaxy Laboratories Ltd. vs. ACIT [2016] 68 taxmann.com 322 (Del)*

iii) *PCIT vs. Ameriprise India Pvt. Ltd. (ITA 206/2016)*

iv) *AXA Technologies Shared Services Pvt. Ltd. vs. DCIT [2016] 76 taxmann.com 102 (Bang)*

v) *Warburg Pincus India Pvt. Ltd. vs. ACIT [2017] 78 taxmann.com 273 (Mum)*

vi) *3i India Private Limited vs. DCIT (ITA No. 581/Mum/2015)*

5 *Gemological Institute of America vs. ACIT*

[TS-356-ITAT-2019(Mum)]
Assessment Year: 2010-11

India-USA DTAA – Article 5 – Subsidiary as a PE – Held: On facts, Indian subsidiary of a U.S. company does not constitute a PE in India under the India-U.S. tax treaty

Facts

i) The assessee, a non-resident company (a company incorporated in the U.S.), is engaged in the business of diamond grading and preparation diamond dossiers.

ii) Prior to the setting up of the subsidiary, the assessee entered into a contract with a third party 'consolidator'. Under the consolidator arrangement, the consolidator co-ordinated the collection of diamonds from India, and the assessee graded the diamonds and issued grading reports. It was agreed between the parties to the consolidator arrangement that the cost to the consumers would be divided in the ratio of 90:10 (90 for the assessee and 10 for the consolidator). This arrangement existed even after formation of subsidiary in India.

iii) Whenever Indian subsidiary faces capacity and/or technical constraints, it sends stones for grading to other entities of the assessee's group across the globe, including the assessee. This was done in terms of a 'GIA Gem Grading Services Agreement' which had been entered into by the various entities of the group including the assessee and Indian subsidiary.

iv) Indian subsidiary only had the technical capacity to grade the diamonds below two carats and hence larger diamonds were being sent to other assessee's group entities for grading. Subsequently, with the increase in technical capacities, Indian subsidiary itself started grading diamonds up to 3.99 carats.

v) In terms of the aforesaid agreement, there was a uniform pricing mechanism of 90:10 for grading services i.e., the entity of the group which was requesting for the grading services retains 10 per cent of the fees it collects from its customer and 90 per cent of the said fees was paid to the entity which provides the grading activity.

vi) In the background of such an arrangement, the Assessing Officer (AO) held that the assessee has a PE in India in the name of Indian subsidiary through which it carries on its business in India. Accordingly, 50 per cent of the gem grading fees received by the assessee from Indian subsidiary has been held to be attributable to the Indian PE, and a profit percentage of 20.31 per cent has been applied thereon to determine the total income of the assessee, which has been held to be taxable in India.

Decision

On Appeal, the Tribunal held in favour of the assessee as under:

A) Re: Fixed place PE

i) On perusal of the agreements, the transaction of grading services between the assessee and Indian subsidiary cannot be considered to be in the nature of a joint venture, since Indian subsidiary has its own independent expertise but only due to its technology/capacity constraints, it forwards the stones to the assessee for grading purposes.

ii) It was not an arrangement between two parties where each party contributes its share in order to undertake an economic activity which was subjected to joint control.

iii) In fact, the arrangement was akin to an assignment or sub-contracting of grading services to the assessee, wherever Indian subsidiary does not have the requisite expertise or technology or capacity for carrying out the grading services.

iv) Further, the aforesaid arrangement has also been accepted as a mere rendering of grading services by the Transfer Pricing Officer (TPO) both in the case of Indian subsidiary and the assessee.

v) Indian subsidiary directly enters into agreement with the client and bears all the risks including credit risks, client facing risks, etc. Also, in terms of the agreement, Indian entity bears the risk of loss or damage to articles while in transit to and from the assessee and also during the time when the articles are at or in the assessee's facilities. Therefore, the economic risks of the gem grading services rendered by the assessee *vis-à-vis* stones/diamonds of customers of Indian subsidiary shipped to it were borne by Indian subsidiary and hence, there was no joint venture arrangement whatsoever between the assessee and Indian subsidiary.

vi) Mere fact that a company has controlling interest in the other company does not by itself construe the other company to be its PE. Accordingly, the assessee does not have a 'fixed place' PE in India.

B) Re: Service PE

i) The assessee renders 'grading services' and 'management services' to Indian subsidiary. In fact, two graders who were earlier employed with the assessee were employed with the Indian subsidiary and were on the payrolls of Indian subsidiary. They were working under control and supervisions of Indian subsidiary and therefore, no Service PE was created in India under the tax treaty.

ii) The Supreme Court has affirmed the decision of the Delhi High Court in *ADIT vs. E-funds IT Solutions Inc [2017] 86 taxmann.com 240 (SC)* wherein it has been held that two employees deputed to e-Fund India (maintain consistency) did not create a service PE as the entire salary cost was borne by e-fund India and they were working under control and supervision of e-fund India.

C) Re: Agency PE

i) Further, considering the functions and the risks assumed by Indian subsidiary *vis-à-vis* its business activities in India (as has been recorded in the transfer pricing study report. Functional and risk analysis has been accepted by the TPO both in the case of Indian and in the case of the assessee), Indian subsidiary was an independent entity which was rendering grading services to its clients in India.

ii) Indian subsidiary also bears service risk and all client facing risks vis-à-vis the stones sent to the assessee for grading purposes (as has been recorded in the Transfer Pricing Study Report).

iii) Hence, Indian subsidiary was not acting in India on behalf of the assessee. Further, Indian subsidiary was not having any authority to conclude contracts and has neither concluded any contracts on behalf of the assessee nor has it secured any orders for the assessee in India. Thus, Indian subsidiary cannot be regarded as 'agency PE' of the assessee in India.

The Tribunal distinguished the decision of the Supreme Court in the case of *Formula One World Championship Ltd. vs. CIT [2017] 394 ITR 80 (SC)* on the basis of facts and held that the Indian subsidiary was operating in an independent manner and there was nothing to show that the Indian subsidiary constitutes a PE of the assessee in India. Accordingly, it has been held that the assessee does not have a PE in India.

6 ***Golden Bella Holdings Ltd. vs. DCIT***

[TS-523-ITAT-2019(Mum)]
Assessment Year: 2013-14

Article 11 of India-Cyprus DTAA – Concept of Beneficial Ownership – Held that Cyprus entity was beneficial owner of interest income for purposes of the tax treaty

Facts

i) The assessee is a limited liability company and a tax resident of Cyprus, engaged in business of an investment holding company. It is a wholly owned subsidiary of a company based out of Mauritius (Mauritius Co). Also, Mauritius Co. held 99.5% in an Indian company (I Co.)

ii) The assessee held compulsory convertible debentures (CCDs) in I Co. It earned interest on CCDs during the relevant assessment year (AY). The assessee filed its tax return for the relevant AY showing income from interest on CCDs in I Co.

iii) Such interest income was offered to tax at the rate of 10% in accordance with Article 11 of the India-Cyprus tax treaty.

iv) The Tax Officer (TO) denied the benefit of the tax treaty on the basis that the assessee was not the beneficial owner of interest income and taxed the said income at rates in force.

v) The Dispute Resolution Panel (DRP) affirmed the finding of the TO and held that the assessee was a mere conduit for the passage of funds.

vi) With regard to the assessee's reliance on the Central Board of Direct Taxes (CBDT) Circular No. 789, the DRP held that the circular was not applicable to the Cyprus entity.

vii) The assessee contended as under:

(a) The term "beneficial owner" is not defined in the Income-tax Act, 1961 (Act) or tax treaty. Internationally, the term denotes the entity that is the legal owner of the property and has dominion and control over the property.

(b) The Revenue had completely failed to prove that the assessee did not exercise full dominion and control over the interest income.

(c) The assessee was the sole owner of the interest income and was under no contractual, legal, or economic obligation to pass on the interest income it received to its immediate shareholder, or to its ultimate parent, or to any other entity.

(d) The fact that the investment was funded using shareholder loan and equity does not *ipso facto,* mean that corporate status may be disregarded.

(e) The assessee stated that the TRC issued by the tax authorities of Cyprus in its name would be a sufficient basis for residential status and "beneficial ownership", as required under CBDT Circular No. 789.

Revenue's contentions.

viii) The Revenue contended as under:

(a) Investment made by the assessee in the I Co. is a back-to-back loan transaction out of the funds received from its immediate parent company, i.e., the Mauritius Co.

(b) The assessee was a mere "name plate" company, carrying out no business activities in Cyprus and a conduit for the passage of funds between the two entities. Hence, it cannot be regarded as a beneficial owner of the interest income.

(c) The CCDs were issued at a hefty premium of 70% over and above the fair market value of each share of I Co.

(d) The Revenue relied on the DRP's observation that the assessee did not possess the CCDs in its own right and its power of disposal is not unhindered. In addition, the financial statements did not indicate the assessee was doing any business other than merely routing the funds.

Decision

On facts of the case, after considering rival submissions, the Tribunal held in favour of the assessee as under:

i) The assessee applied for CCDs using a portion of the share capital and the interest free shareholder loan and was still left with a reasonable cash balance.

ii) The assessee invested in CCDs and received interest for its own exclusive benefit and not on behalf of any other entity.

iii) Reference was made to the provisions of the OECD commentary (2017) to support the meaning of "beneficial owner."

iv) Also, the TO could not establish that the assessee was constrained by a contractual, legal or economic arrangement with any third party with respect to the interest income received.

v) The assessee maintained the foreign exchange risk on CCDs (as they were denominated in INR), and counter-party risk on interest payment arising on the CCDs.

vi) The transactions between the parties cannot be considered as a back-to-back transaction lacking economic substance.

vii) The assessee is eligible for tax treaty benefits, and the interest income from CCDs have been rightly offered to tax at the rate of 10% in the return of income.

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