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International Taxation and Transfer Pricing

INDEX

INTERTNATIONAL TAXATION

The full bench of Delhi High Court held that profit attributable to the activities of the Indian permanent establishment (PE) is required to be determined, even where the assessee at entity level considering the global operation has made losses

Hyatt International Southwest Asia Ltd. vs. ADIT [2024) 166 taxmann.com 466] (Delhi)

(In favour of the Income tax Department)

Brief facts

The assessee, a foreign company was a tax resident of UAE. The assessee was engaged in the business of operating hotels and providing management services to its affiliates in India. The assessee had entered into Strategic Oversight Services Agreements **(SOSA)** with Indian hotels, whereby, the assessee provided strategic planning services and know-how to the Indian hotels to ensure that they were developed and operated, as an efficient and highly quality international full-service hotel. At the time of entering into the SOSA, the Indian hotels, had simultaneously entered into Hotel Operation Service Agreement (HOSA) with the assessee's affiliates, whereby the affiliates had agreed to provide day-to-day operations, management assistance and technical assistance services to oversee the implementation of the overall strategic planning and know-how to be provided by the assessee. In addition, the Indian hotels and the assessee had also entered in certain trademark license agreements pursuant to which the Indian hotels were permitted to use trademarks as specified in the Agreement in connection with the operation of the hotel.

The AO as well as Delhi Tribunal held that the assessee had a PE in terms of Article 5(2) of the India-UAE Tax Treaty. It was further held that the payment received from the Indian hotels under the SOSA was 'royalty' under the Tax Treaty.

Earlier decision of Delhi High Court

Whether the assessee's income receipts from SOSA are liable to be taxed as royalties

In consideration of the host of services to be provided in terms of the SOSA, the assessee would be entitled to fee (strategic fee as well as incentive fee) as set out in SOSA. The said fee was not a consideration for the use of or the right to use any process or for information of commercial or scientific experience. The fees payable were in consideration of providing the services as set out in SOSA. Merely because the extensive services rendered by the assessee in terms of the SOSA also included access to written knowledge, processes, and commercial information in furtherance of the services, cannot lead to the conclusion that the fee received by the assessee was in the nature of royalty as defined under Article 12 of the Tax Treaty.

The consideration received by the assessee in terms of SOSA was clearly in the nature of business income.

Whether the assessee has a PE in India

The assessee had exercised control in respect of all activities at the hotel, *inter alia*, by framing the policies to be followed by the hotel in respect of each and every activity, and by further exercising apposite control to ensure that the said policies are duly implemented. The assessee's affiliate was placed in control of the day-to-day operations of the hotel. The policies and the diktats by the assessee in regard to operations of the hotel were duly implemented without recourse to the owner. This clearly indicates that the assessee exercised control over the premises of the hotel for the purposes of its business. Since the hotel premises were at the disposal of the assessee in respect of its business activities, the assessee had a PE in India in the form of a fixed place through which it carried on its business.

Attribution of profits to PE where entity at global level has incurred losses

One of the principal contentions advanced by the assessee was that even if it is assumed that it has a PE in India, there is no question of attributing any profits to the PE, as it had incurred a loss on an entity level considering the global profit & loss. According to the assessee, income chargeable to tax under the Act could be attributed to its PE in India only if the assessee had made profit on an entity level.

The Delhi High Court took note of another decision of Delhi High Court in CIT (International Taxation) v. Nokia Solutions and Networks OY (147 taxmann.com 165), where it was held that profit attribution to a PE pre-requires the entity as a whole to have earned profits at global level.

The Delhi High Court expressed reservations regarding the said view. As per the Delhi High Court, the profits attributable to the assessee's PE in India are required to be determined on the footing that the PE is an independent taxable entity. It was possible that an assessee may have incurred a net loss at an entity level, but there is profit arising in India because of activities carried on by the Indian PE. As this aspect was not deliberated in the case of CIT (International Taxation) v. Nokia Solutions and Networks OY and therefore, the High Court referred this issue to a larger bench.

Decision of Full Bench of Delhi High Court

Argument of the appellant before Full Bench of Delhi High Court

Profits of an enterprise based in UAE would ordinarily be taxable only in UAE and not in India. If the enterprise based in the UAE were making a loss, the question of taxability, either in UAE or in India, would not arise at all. Only if an enterprise were making a profit, could a PE through which it carries on business be subjected to tax and that too restricted to so much of the profit as is attributable to that PE.

For a foreign enterprise to be taxed in India, the following 3 conditions precedent would have to be conjunctively satisfied: -

- the foreign enterprise must be making a profit;
- the foreign enterprise has a PE in India;
- and at least a part of the profit made by that enterprise is attributable to its PE in India and that part alone being liable to be taxed.

If a foreign enterprise were making a loss, the question of attributing any profit to its PE in India would not arise and consequently that enterprise would have no tax liability in India.

Argument of the Income tax department before Full Bench of Delhi High Court

The Tax Treaty clearly contemplates an exercise of attribution being undertaken under Article 7 in light of the PE being treated as a separate and distinct enterprise in itself. Article 7 mandates the attribution of profits to a PE acknowledging it to be a distinct and separate enterprise and thus, such an exercise needs to be undertaken independently.

The taxability of the profit of the PE would have no connection with either the profit or the loss, which the assessee earns or suffers at a global level.

Held

PE, even though a part of the larger entity becomes subject to taxation on the profits generated from its activities undertaken in the other State. Article 7(1) requires an exercise of identifying the extent of profits that are attributable to the PE. It is to that extent alone that the profits of the enterprise ultimately come to be taxed.

The activities of a PE are liable to be independently evaluated and ascertained in light of the plain language in which Article 7 stands couched. The fact that a PE is conceived to be an independent taxable entity cannot be doubted or questioned. The Division Bench in these appeals has rightly doubted the correctness of taxation being dependent upon profits or income being earned at the entity level.

CNK Comments

The Delhi High Court in CIT (International Taxation) v. Nokia Solutions and Networks OY (147 taxmann.com 165), held that profit attribution to a PE would be warranted only if the entity as a whole has earned profits. The full bench of the Delhi High Court has held that profits can be attributed to a PE in India, even if the non-resident incurred losses at a global level, emphasizing that a PE must be treated as an independent entity for tax purposes.

LLC, which is fiscally transparent entity, wherein tax is not paid by LLC itself, but income gets taxed in the hands of owner is still entitled to benefit of India USA Tax Treaty

General Motors Company USA vs. ACIT (166 taxmann.com 170) (Delhi)

(In favour of Assessee)

Brief facts

The assessee was incorporated in USA as a Limited Liability Company **(LLC)**. The assessee held a valid Tax Residency Certificate **(TRC)** issued by the tax authorities of USA. The assessee had earned certain fees from India, which was offered to tax at 15%, claiming benefit of India-USA Tax Treaty.

The AO reject the assessee's claim of tax benefit as per the India-USA Tax Treaty by observing that LLC, being a fiscally transparent entity, is not a person liable to tax in USA. The term "resident of a Contracting State" as per paragraph 1(b) of Article 4 of India-USA Tax Treaty means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, citizenship, place of management, place of incorporation, or any other criterion of a similar nature. The said paragraph further provides that in the case of income derived or paid by a partnership, estate, or trust, this term applies only to the extent that the income derived by such partnership, estate, or trust is subject to tax in that State as the income of a resident, either in its hands or in the hands of its partners or beneficiaries. The AO concluded that the LLC do not come under the special clauses for partnerships and trusts and therefore, do not qualify as 'Residents' of USA as per Article 4 of the India USA Tax Treaty.

Argument of the assessee before the Tribunal

Publication 3402 of the Department of the Treasury, International Revenue Service (US IRS) of the Government of USA on Taxation of LLC provides that LLC is a business entity recognized by the USA under State law.

The LLC for federal income tax purposes is considered as partnership, corporation or an entity disregarded as separate from its owner. An LLC with at least 2 members is classified as a partnership for federal income tax purposes. An LLC with only 1 member is treated as an entity i.e. disregarded as separate from its owner for income tax purposes, but as a separate entity for purposes of employment tax and certain excise taxes. If an LLC has only 1 member and is classified as an entity disregarded as separate from its owner, its income, deductions, gains, losses and credits are reported on the owner's income tax return.

LLC is given an option to, either be taxed as a corporation or be taxed as a disregarded entity or partnership (depending on number of members) wherein the income of the LLC is clubbed in the hands of its owner who merely discharges the tax that is assessable in the case of the LLC.

Held

The phrase 'liable to tax' has to be interpreted in the way that the assessee is liable to be taxed under the authority of the US Income-tax law. Intent of the India-USA Tax Treaty has to be given precedence, wherein the concept of fiscally transparent entity is the recognized way of recognizing the phrase 'liable to tax.'

Paragraph 1(b) of Article 4 of the India-USA Tax Treaty recognizes partnership as a resident of the USA for the purpose India-USA Treaty, to the extent that the income derived by such partnership is subject to tax in the US as the income, either in the hands of the partnership or in the hands of its partners or beneficiaries. An exclusion provision can only exclude something if it was included at the outset. Hence, LLC was already regarded as 'liable to tax' for the purposes of India-USA Tax Treaty and therefore, would be entitled to Tax Treaty benefit.

Capital gains arising on indirect transfer of shares of a foreign company would be eligible for Tax Treaty benefits. The AAR was incorrect in holding that the benefit of the Tax Treaty would only be available to the sale of shares of a company resident in India

Tiger Global International III Holdings vs. Authority for Advance Rulings [(2024) 165 taxmann.com 850 (Delhi)]

(In favour of Assessee)

Brief facts

The applicants were private companies limited by shares incorporated under the laws of Mauritius **(Mauritius companies).** The Mauritius companies were set-up with the primary objective of undertaking investment activities with the intention of earning long-term capital appreciation and investment income. The Mauritius companies held shares of a Singapore company. The Singapore company had invested in multiple companies in India. The value of the shares of the Singapore company was derived substantially from assets located in India. On 18th August 2018, all the Mauritius companies transferred certain shares of Singapore company to Luxembourg company.

These transfers were undertaken as part of a broader transaction involving the majority acquisition of Singapore company by US company from several shareholders, including the Mauritius companies.

The Mauritius companies had filed an application for an advance ruling on the common question as to whether gains arising from the sale of shares in Singapore company to a Luxembourg company would be chargeable to tax in India.

Earlier decision of the AAR

The AAR had held that the sale of shares was not covered by Article 13(3A) of the India-Mauritius Tax Treaty **(the Tax Treaty)**. The benefit of the Tax Treaty would only be available to the sale of shares of a company resident in India. In case of the Mauritius companies, the capital gains had accrued from the sale of shares of a Singapore company and therefore, no benefit can be claimed as per the Tax Treaty.

The AAR also rejected the application of the Mauritius companies on the ground that the question raised was designed prima facie for avoidance of tax. The AAR observed that even if the Singapore Company derived its value from the assets located in India, what the Mauritius companies had transferred were the shares of Singapore Company and not of an Indian company. The objective of India-Mauritius Tax Treaty was to allow exemption of capital gains on transfer of shares of Indian company only and any such exemption on transfer of shares of the company not resident in India, was never intended by the legislator. Entire arrangement made by the Mauritius companies was with an intention to claim benefit under India-Mauritius Tax Treaty, which was not intended by the lawmakers. Such an arrangement was nothing but an arrangement for avoidance of tax in India and therefore, the applications was rejected.

The Mauritius companies challenged the said order passed by the AAR by filing writ petition before the Delhi High Court

Decision of Delhi High Court

Taxability of sale of shares as per Article 13(3A) of the Tax Treaty

The AAR had held that the sale of shares was not covered by Article 13(3A) of the Tax Treaty. These findings are wholly unsustainable as those shares sold by the applicant derived their value from underlying assets situated in India. If the aforesaid flawed reasoning of the AAR were to be accepted, the transaction itself would have been freed of any tax implications under the Act. The AAR clearly failed to bear in mind that the sale transaction had been undertaken at a time by which the Act had brought indirect transfers within the realm of taxation under section 9.

Article 13(3A) embodies the intent of the Contracting States to ring-fence all such transactions which had been completed prior to 1st April 2017. Article 13(3B) restricted its scope to prescribing separate tax rates for the period between 1st April 2017 till 31st March 2019, but no such tax rate was prescribed for capital gains arising from sale of shares acquired prior to 1st April 2017 which categorically demonstrates the intent of the parties to the India-Mauritius Tax Treaty to exclude capital gains emanating from shares acquired prior to 1st April 2017 from the ambit of taxation. Therefore, the grandfathering clause in Article 13(3A) would exclude the transaction undertaken by the writ petitioners from the ambit of capital gains tax. Domestic tax legislation cannot be interpreted in a manner which brings it in direct conflict with a treaty provision or with an overriding effect over the provisions contained in a Tax Treaty since the same would in effect amount to accepting the right of the Legislature of one of the Contracting States to unilaterally amend or override the provisions of a treaty and would result in the elevation of a domestic subordinate legislation over that of the provisions embodied in a treaty entered into between sovereign nations.

Mauritius as investment destination

The mere factum of an entity being situated in Mauritius and of investments in Mauritius being routed through that nation cannot result in a default adverse inference or raise a presumption of illegality of such an entity being a colourable device. Mauritian entities are not required to satisfy any separate standard of legitimacy or stricter standard of proof. An overall conspectus of the data and material forming a part of public record reveals Mauritius is one of the more favourable jurisdictions for foreign institutional investors **(FII's)** seeking to invest in India as a result of its proximity to India as well as the wide array of agreements that it had entered into with various nations across the globe. Liberalized exchange controls, favourable investment climates and the prevailing socio-political stability appears to have additionally favoured facilitation of Mauritius as a gateway for investments flowing into the Asian and African continent and accordingly lead to Mauritius becoming the preferred destination for various investors wishing to route investments towards South East Asian economies and with India subsequent to the liberalization measures adopted in 1991 seeing almost 50% of the foreign direct investment (FDI) volume in India originating from Mauritius in the year 2012. The establishment of investment vehicles in tax friendly jurisdictions cannot be considered to be an anomaly or give rise to a presumption of being situate in those destinations for the purpose of evading tax or engaging in treaty abuse.

Validity of TRC

The issuance of a TRC by the competent authority must be considered to be sacrosanct and due weightage must be accorded to the same as it constitutes certification of the TRC holding entity being a bona fide entity having beneficial ownership domiciled in a Contracting State to pursue a legitimate business purpose in a Contracting State. The Income tax department would thus not be justified in doubting the presumption of validity attached to the TRC as it would inevitably result in an erosion of faith and trust reposed by Contracting States in each other. The circumstances under which the Income tax department could pierce the corporate veil of a TRC holding entity is restricted to extremely narrow circumstances of tax fraud, sham transactions, camouflaging of illegal activities and the complete absence of economic substance and the establishment of those charges would have to meet stringent and onerous standards of proof and the Revenue being required to base such conclusions on cogent and convincing evidence and not suspicion alone. It is only when the Income tax department is able to meet such a threshold that it can disregard the presumption of validity which would be attracted the moment the TRC is produced, and Limitation of Benefit **(LOB)** conditions are fulfilled.

Treaty shopping, Treaty Abuse and LOB clause

There cannot be an assumption of treaty shopping and treaty abuse merely because a subsidiary or any related entity is established in a tax friendly jurisdiction. Action 6 of Base Erosion and Profit Shifting **(BEPS)** Action Plan, which paved the way for adoption of LOB clauses and Principal Purpose Test (PPT) test in treaties as well as the principles emanating from the Organization for Economic Cooperation and

Development (OECD) Commentary on Article 29 reveals that treaties incorporate disentitlement provisions to deprive persons who were not intended to fall under the ambit of the treaty availing those benefits in an indirect manner.

The LOB clause in the India-Mauritius Tax Treaty came to be included when Chapter X-A had already come to exist and Article 27A accordingly chose to grandfather all transactions relating to alienation of shares acquired prior to 1st April 2017.

LOB provisions and the TRC comprehensively and adequately addresses concerns in relation to potential treaty abuse and it would be impermissible for the Income tax department to manufacture additional roadblocks or standards that parties would be required to meet in order to avail of Tax Treaty benefits, subject to caveats of illegality, fraud and the transaction being in contravention of the underlying object and purpose of the treaty.

Held

The AAR order holding that the applicant is not entitled to Tax Treaty benefit as well as observation that the arrangement was nothing but an arrangement for avoidance of tax in India, suffers from manifest and patent illegalities. The transaction was aimed at tax avoidance is rendered arbitrary and cannot be sustained. Capital gain arose to Mauritius companies on sale of shares of Singapore company would stand duly grandfathered by virtue of Article 13(3A) of the India Mauritius Tax Treaty.

CNK Comments

- The above decision of Delhi High Court is a landmark decision, wherein it was held that capital gain arising on indirect transfer of shares of a foreign company would be eligible for Tax Treaty benefits. The said decision over-turned the decision of the AAR wherein it was held that the benefit of the Tax Treaty would only be available to the sale of shares of a company resident in India. The Delhi High Court has held that Tax Treaty benefit would be available, even where the capital gain arising on indirect transfer of shares is taxable in India.
- The Delhi High Court has accepted Mauritius as one of the more favourable jurisdiction for FII's and investor seeking to invest in India as a result of its proximity to India as well as the wide array of agreements that it had entered into with various nations across the globe. The sanctity of the TRC has been affirmed. It was held that TRC was critical for claiming Tax Treaty benefits unless there is compelling evidence of fraud or sham transactions.
- Once LOB provisions come to be incorporated in a convention, it would be those provisions which would govern and be determinative of an allegation of treaty abuse or a benefit being illegitimately claimed. The doubts of the Income tax department or the material that it may gather in support of its allegation of abuse would have to be demonstrative of the LOB provision being breached or violated.
- TRC as well as the LOB provisions comprised in the Tax Treaty more than adequately, nay comprehensively, address themselves to treaty abuse, and it would thus be wholly impermissible for the Revenue to construct additional barriers or qualification standards for the purposes of extending benefits under the Tax Treaty.
- Additionally, the High Court ruled that General Anti-Avoidance Rules **(GAAR)** would not apply since the transaction occurred before April 2017, prior to the enactment of GAAR provisions. Routing investments through Mauritius did not inherently imply treaty abuse. The High Court reinforced that economic substance and beneficial ownership are key, rather than the mere jurisdiction from which investments are made.

TRANSFER PRICING

The Ahmedabad Tribunal has laid down the arm's length benchmarking principal to be followed where interest bearing loan is advance to foreign Associated Enterprises (AE)

Cadila Pharmaceuticals Ltd. vs. ACIT [TS-265-ITAT-2024(Ahd)-TP]
(In favour of the Income tax department)

Brief facts

The assessee has obtained short term loan of Rs.45 crores from Corporation Bank and Rs.10 crores from Allahabad Bank at the rate of interest of 11.5% and 9.5% respectively. This loan amount was provided as short-term financial assistance to the overseas AEs to enable it to make acquisition related business investment. The assessee had charged interest of Rs. 2.57 crores from its AE at the average interest rate of 7.08%. The TPO found that the assessee had not recovered the full amount of interest from this AE. Accordingly, the differential amount of interest was considered for adjustment to make the recovery of interest from the AE at arm's length.

Argument of the assessee

The assessee had charged interest at 7.08% as against average 12 months GBP LIBOR rate of 1.685% The rate of interest on loans advanced by the assessee to AEs was in accordance with rate of interest prevailing in the country of residence of AEs wherein loan was availed. The domestic prime lending rate (PLR) could not be applied in respect of loans advanced in foreign currency to AEs situated in USA and Europe.

Held

Where the transaction was of lending money in foreign currency to its foreign subsidiary, the comparable transaction would be foreign currency tended by unrelated parties. This will be applicable in the situation where the loan is advanced to AE out of its own fund. In a case, where the loan is advanced to AE out of loan taken from banks, this principle will not apply. In such a situation, the interest paid by the assessee to the banks must be recovered from the foreign AE. In case the interest charged by the assessee from the AE is less than the rate of interest paid to the banks, it would benefit the assessee by shifting profits outside India and principle of BEPS would be applicable to such transactions. Accordingly, where the loan is advanced to AE by obtaining loan from the banks, entire interest paid by the assessee to the banks must be recovered from the AE. Where the loan is advanced to AE out of its own funds, interest recovered can be received at the rate of interest prevailing in country of residence of the AE.

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