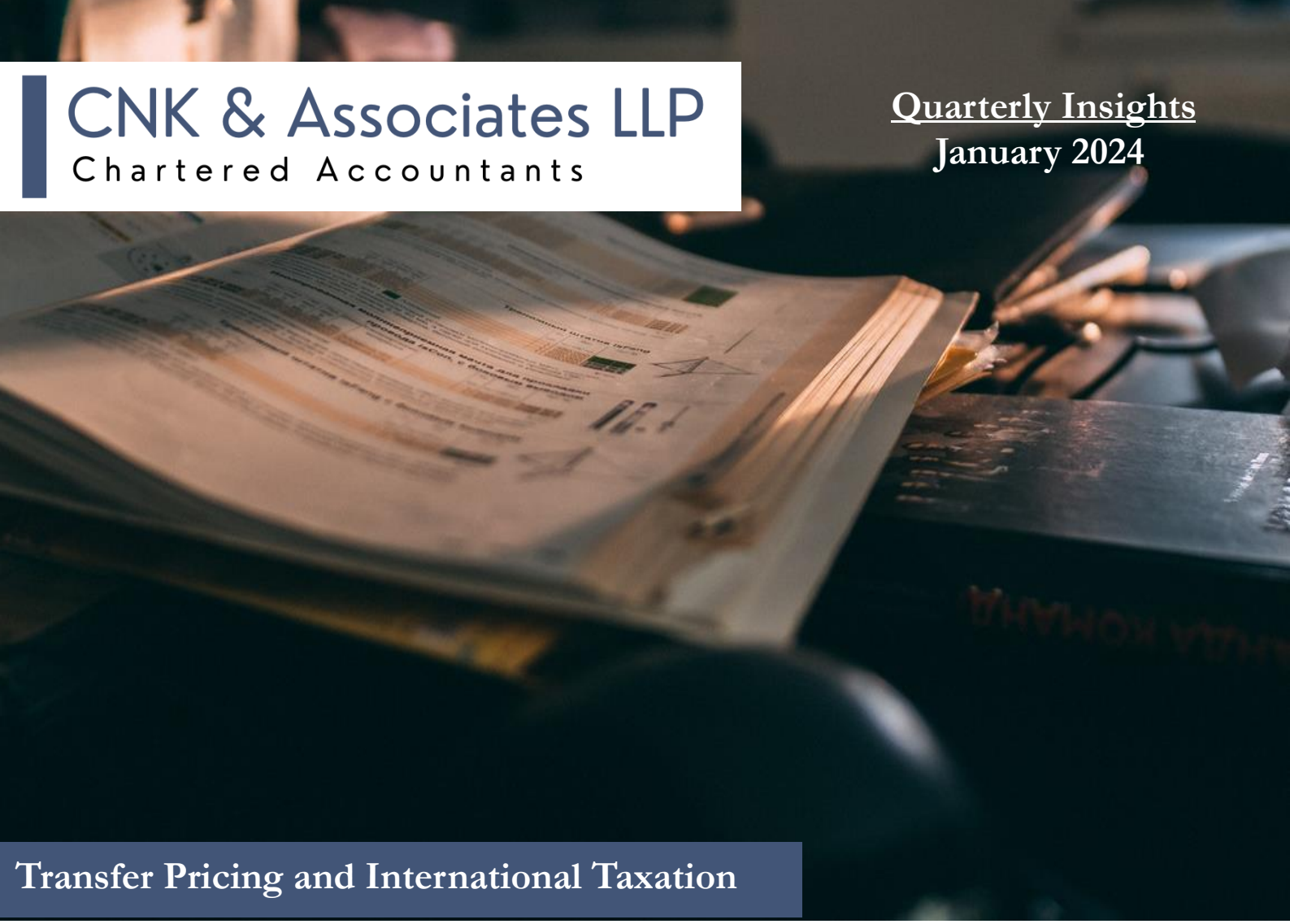

CNK & Associates LLP
Chartered Accountants

Quarterly Insights
January 2024

Transfer Pricing and International Taxation

INDEX

Particulars	Page No
Supreme Court holds that the applicability of Most Favored Nation ('MFN') clause requires a separate notification under Section 90	2
Resale Price Method ('RPM') was the Most Appropriate Method ('MAM') for determining the Arm's Length Price ('ALP') of international transaction in case where sales are made to unrelated parties without any value addition	4
In case where all international transactions are closely linked, no separate benchmarking of royalty required	5

Supreme Court holds that the applicability of Most Favored Nation ('MFN') clause requires a separate notification under Section 90

Assessing Officer (International Taxation) vs. Nestle SA (458 ITR 756) In favor of Income Tax Department

Brief Background

India has entered into various Tax Treaties with different countries to achieve various objectives that aim to foster economic cooperation, prevent double taxation, promote cross-border trade and investment, and prevent tax evasion. Tax Treaty becomes effective once it is notified in the official gazette. Any amendment to the Tax Treaty requires parliamentary nod, which can be achieved through a separate statute or a legislative device like notifications.

India has entered into Tax Treaties with various Organisation for Economic Co-operation and Development **('OECD')** countries illustratively, Netherlands, France, Switzerland, Sweden, Spain, Hungary which have an MFN clause. MFN clause in the Tax Treaty provides that if after signature/entry into force of the Tax Treaty with the first country, India enters into a Tax Treaty at a later date with another OCED countries ('third countries') providing for a beneficial rate of tax or restrictive scope for taxation of particular income viz. dividend, interest, royalty, etc. a similar benefit should be accorded to the first country.

With the abolishment of Dividend Distribution Tax ('DDT'), the dividend was taxable in the hands of shareholders. India has entered into Tax Treaties with OECD countries like Slovenia, Colombia, Lithuania which provide for lower rate of 5% tax for dividend taxation. Accordingly, where the resident of OECD country with Tax Treaty having MFN clause received dividend from the Indian companies, they started claiming benefit of lower tax rate on dividend of 5% invoking MFN clause. In certain situation, these third countries were not OECD members when their respective Tax Treaties were entered into with India but became OECD members only at a later date.

India has entered into Tax Treaty with certain OECD countries which provides that if India enters into a Tax Treaty on a later date with a third country, which "is" an OECD member, providing a beneficial rate of tax or restrictive scope for taxation of dividend, interest, royalty, etc. a similar benefit should be accorded to Tax Treaty as well.

Litigation before the Delhi High Court

The Delhi High Court had decided the following appeals wherein the taxpayer sought benefit of MFN clause to claim lower tax rate on dividend income or restricted definition of certain income:

- **Concentrix Services Netherlands BV vs. ITO(TDS) (434 ITR 516)**

  The taxpayer and residents of the Netherlands were in receipt of dividends from their Indian subsidiaries. With the abolishment of the DDT, the taxpayers made an application under Section 197 of the Act with the Assessing Officer ('AO') for issuance of a lower withholding certificate at the rate of 5%. The Delhi High Court allowed the taxpayer's claim of a 5% withholding rate by stating that benefit under the MFN clause could be extended from the date on which a Contracting state becomes a member of the OECD.

- **AO vs. Nestle SA ([WP(C) - 3243 of 2021, dated 4-6-2021]**

  The taxpayer, a tax resident of Switzerland, based on the MFN clause contained in India- Switzerland Double Taxation Avoidance Agreement (DTAA) imported the lower tax rate of 5% from India-Lithuania Tax Treaty and applied for a lower withholding tax **(WHT)** certificate at the rate of 5%. The AO rejected the application for lower WHT. The Delhi High Court allowed Nestle SA's claim by relying on its decision in the case of Concentrix Services.

- **Steria (India) Ltd. vs. CIT (386 ITR 390)**

  The taxpayer claimed benefit of the Protocol to India-France Tax Treaty and imported the definition of 'fees for technical services' as provided in India-UK Tax Treaty. The Delhi High Court held that a Protocol is considered part of the Tax Treaty

itself and does not have to be separately notified for the purposes of application of the MFN clause.

Another issue which was subject matter of interpretation was whether a notification by the Government of India is required to confer the benefit of MFN clause or the provisions operate on an automatic basis, if any favourable treatment has been accorded to third State, subject to conditions stated therein.

CBDT Circular on the subject

With the Delhi High Court deciding the cases, wherein it was held that no separate notification is required for conferring the benefit of MFN clause as the same operates on automatic basis, the CBDT issued Circular No. 3/2022 dated 3 February 2022. The said Circular provides that benefit of lower rate and restricted scope under MFN clause will be extended only when all the below mentioned conditions are satisfied cumulatively:

- India's Tax Treaty with the country which has beneficial lower rate or restricted scope is entered into after the signature/entry into force, depending on language of MFN Clause, of India's Tax Treaty.
- The third country has to be an OECD member at the time of signing its treaty with India.
- India limits its taxing rights in relation to rate or scope of taxation in its treaty with the third country.
- India issues a separate notification for importing the favorable benefits of third country treaty into the original treaty.

Pune Tribunal in the case of GRI Renewable Industries S.L.

The Pune Tribunal in the case of GRI Renewable Industries S.L. [TS-79-ITAT-2022(Pun)] held that imposing a requirement of separate notification for importing the beneficial treatment from another Tax Treaty overlooks the language of Section 90(1) and the Protocol, which treats the MFN clause an integral part of the Tax Treaty.

Appeal before the Supreme Court

The present appeal before the Supreme Court arose from batch of appeals with lead case of Nestle SA, wherein following two issues were addressed by the Supreme Court:

- Whether the MFN clause is to be given effect to automatically or it comes into effect only after a notification is issued; and
- Whether there is any right to invoke the MFN clause with respect to provisions of the third country with which India has entered into a Tax Treaty, which was not an OECD member at the time of entering into such Tax Treaty.

Held

A notification under Section 90(1) is necessary and a mandatory condition for a court, authority, or tribunal to give effect to a Tax Treaty, or any protocol changing its terms or conditions, which alters the existing provisions of law. In absence of separate notification under Section 90, the beneficial tax treatment granted by another OECD country would not automatically apply to the Tax Treaty with First Country. In such an event, the terms of the earlier Tax Treaty require to be amended through a separate notification under Section 90.

The interpretation of the expression "is" has present signification. To claim benefit of a "same treatment" clause, based on entry of Tax Treaty between India and another state which is member of OECD, the relevant date is entering into treaty with India, and not a later date, when, after entering into Tax Treaty with India, such country becomes an OECD member.

CNK Comments

Where the Delhi High Court decided the MFN clause in favour of the taxpayers, various applications were filed before the Tax Authorities seeking refund of excess tax paid on dividend in earlier AYs claiming benefit of MFN clause in the Tax Treaty. The taxpayer's interpretation of the MFN clause was that the same is automatic and does not require any separate Notification. The Supreme Court decision would disentitle benefit of MFN clause. It was interpreted by the Supreme Court that benefit of MFN clause would not be automatically available to any taxpayer, unless there is amendment in the Tax Treaty through a separate notification under Section 90.

In many cases, where payment of Fees for Technical Services **('FTS')** was made to a tax resident of France,

a benefit of India UK/ Portugal Tax Treaty which provides for restrictive definition of FTS were claimed. The Indian taxpayer would have claimed benefit of MFN clause, applied make available clause in FTS clause and would not have deducted TDS relying on India UK/ Portugal Tax Treaty. After the Supreme Court decision, such benefit would not be available.

A review petition has been filed before the Supreme Court, which is pending. Till the Supreme Court decides on the review petition, the appellate authorities would decide the appeals against the taxpayers, based on the Supreme Court decision.

Resale Price Method ('RPM') was the Most Appropriate Method ('MAM') for determining the Arm's Length Price ('ALP') of international transaction in case where sales are made to unrelated parties without any value addition

PCIT vs. Fujitsu India (P.) Ltd. (156 taxmann.com 310) (Delhi HC)]
In favour of Assessee

Facts

The assessee was a distributor of goods purchased from Associated Enterprises **('AEs')** and there were sales to unrelated parties without any processing and value addition. The assessee selected RPM as MAM. The Transfer Pricing Officer ('TPO') made upward adjustments by observing that the assessee was a full-fledged risk-bearing distributor performing various functions and, therefore, the MAM cannot be RPM.

The Tribunal found that the assessee had resold the goods in the market without any value addition and therefore, the gross margin earned on such transaction was the only determinative factor for analysing the gross compensation after the cost of sale.

The High Court took note of the following principles laid down by various courts:

- **PCIT vs. Matrix Cellular International Services (P.) Ltd. (90 taxmann.com 54) (Del.) -** The business of the assessee only involved re-selling or distributing the SIM cards imported from the AEs, without making any value addition. There was no distinction between airtime and SIM cards, as no value could be added to the airtime resold by the assessee. Since the SIM cards are resold without making any value addition, the Tribunal concluded that the assessee carried out purely trading business, and hence the RPM was the MAM for calculating ALP.

- **Nokia India (P) Ltd. v. DCIT (167 TTJ) (Del.) -** A close scrutiny of the two sub-clauses along with the remaining sub-clauses of Rule 10B(1)(b) makes it clear beyond doubt that RPM is best suited for determining ALP of an international transaction in the nature of purchase of goods from an AE which are resold as such to unrelated parties. Ordinarily, this method presupposes no or insignificant value addition to the goods purchased from foreign AE. In case the goods so purchased are used either as raw material for manufacturing finished products or are further subjected to processing before resale, then RPM cannot be characterized as a proper method for benchmarking the international transaction of purchase of goods by the Indian enterprise from the foreign AE.

- **CIT vs. L'Oreal India Pvt. Ltd. (ITA No. 1046 of 2012) (Bom.)** - RPM was the MAM in case of distribution or marketing activities especially when goods are purchased from AEs and there are sales effected to unrelated parties without any further processing. The RPM loses its accuracy and reliability where the reseller adds substantially to the value of the product or the goods are further processed or incorporated into a more sophisticated product or when the product/service is transformed.

Held

RPM was the MAM for determining ALP of international transaction in case of distribution and marketing activities especially when goods are purchased from AEs and there are sales to unrelated parties without any processing and value addition.

In case where all international transactions are closely linked, no separate benchmarking of royalty required

Toyota Kirloskar Motor Private Ltd., vs. ACIT [TS-726-ITAT-2023(Bang)-TP]
In favour of Assessee

Facts

The assessee was a company setup in India to manufacture and sell Multi Utility Vehicle **(MUV)** and passenger cars. It obtained license and technology to manufacture and sell passengers cars from AEs. It also imported certain models of cars and sold them in India. The assessee purchased various spares/ components from AEs, which formed part of those cars and were sold as spare parts as part of post sales service activity. The assessee paid royalty for technology transferred by AE. The assessee adopted transactional net margin method **(TNMM)** as MAM at entity level by aggregating all the international transactions. The average margin of comparable companies was 2.76%, whereas the assessee average margin was 9.47%. However, the TPO was of the view that royalty should be separately benchmarked. The TPO compared royalty to sales ratio of the assessee with average research and development (R & D) expenses plus royalty ratio of comparable companies.

The Tribunal in the assessee's own case for earlier AYs had decided the appeal in favour of the assessee, wherein it had noted that the assessee's margin was computed, including royalty payment which was higher than the margin of comparable companies. No separate adjustment of royalty was proposed by the TPO since TNMM was adopted to entity level which included royalty as well.

Held

The Tribunal following the said order held that no separate benchmarking of royalty payment was required.

CNK comments:

In many cases of benchmarking of royalty payment, it is difficult to find exact comparable companies in same or similar business to apply comparable uncontrolled price (CUP)/ other specified method (OSM) as MAM. Where the payment of royalty in closed linked to sales transactions and the taxpayer has earned profit level indicator **(PLI)** which is more than comparable companies, it is possible to aggregate royalty payment and compare PLI at entity level.

Disclaimer and Statutory Notice

www.cnkindia.com

CNK & Associates LLP
Chartered Accountants

Mumbai
3rd Floor, Mistry Bhavan, Dinshaw Vachha Road, Churchgate, Mumbai 400 020.
Tel: +91 22 6623 0600

501/502, Narain Chambers, M.G Road, Vile Parle (East), Mumbai 400 057.
Tel: +91 22 6250 7600

Chennai: +91 44 4384 9695
Vadodara: +91 265 234 3483
Ahmedabad: +91 79 2630 6530
GIFT City: +91 79 2630 6530
Bengaluru: +91 91 4110 7765
Delhi: +91 11 2735 7350
Pune: +91 20 2998 0865
Dubai: +971 4355 9533
Abu Dhabi: +971 4355 9544