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Transfer Pricing and International Taxation

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TRANSFER PRICING

Mumbai Tribunal rules that loan/ advance given to foreign subsidiaries in order to meet business and commercial exigencies as well as to meet regulatory requirements prevailing in associated enterprise's (AE's) country, would be in the nature of quasi equity. Even if interest on such loan is imputed, non-recovery of such interest would be allowable as business deduction

Tata International Ltd. vs. DCIT [TS-239-ITAT-2024(Mum)-TP] (Mum. Tribunal) (In favour of Assessee)

Facts

During the financial year 2008-09, the assessee had granted interest free loan of USD 5,50,000 equivalent to Rs.280.49 lacs, to its AE (foreign AE) located at Jebel Ali Free Zone – Dubai **(JAFZA)**. The foreign AE could not recover a debt of USD 4,84.000 from a debtor, as debtor had become a sick company. Further, no assets were available with the debtor for recovery of loan of foreign AE. This resulted in the net assets of foreign AE falling below 75% of share capital.

As per JAFZA Rules, any company located in JAFZA need to maintain net assets more than 75% of its share capital. If there is a shortfall, funds need to be infused to remedy the same. As a parent company of foreign AE, the assessee was required to infuse funds to bridge the gap and for protecting its own investments in foreign AE. In order to meet the said requirement, the assessee had granted an interest free loan.

The Board resolution passed by the assessee clearly mentioned that the loan was made in view of requirements of JAFZA Rules. Money was advanced by the assessee to comply with JAFZA Rules, as quasi equity. Therefore, the assessee contended that such loan/ advances shall not attract any interest. Even where interest on such a loan is imputed, as the loan was given for the purpose of business, non-recovery of interest should be allowed as business deductions.

The AO/ TPO made addition of Rs. 26.84 lakhs by holding that the assessee has not conducted any benchmarking analysis and has failed to identify any comparable uncontrollable transaction for determining the arm's length interest. The AO/ TPO, has also not accepted the alternate contention of the assessee that even where interest on the said loan is imputed, non-recovery of such interest should be allowed as business deductions.

Held

The loan was given for the purpose of business and therefore, no interest should be disallowed keeping in view the decision of Supreme Court in the case of S. A. Builders Ltd. (288 ITR 1). Even otherwise, the loan was granted from interest free funds i.e., receipts from the maturity of mutual funds. Considering the above facts, the addition on account of non-recovery of interest from loan of Rs.26.84 lakhs was deleted

CNK Comments:

Under the Indian Transfer Pricing Regulations, the characterisation of a loan as quasi-equity does not automatically exempt it from the requirement to carry an arm's length interest rate. The Indian Transfer Pricing Regulations requires that any international transactions between AEs should be at ALPs. This means that the terms and conditions of such transactions should be comparable to those that would have been agreed upon by unrelated parties under similar circumstances and the terms of the loan, including the interest rate, must be comparable to what would be charged between independent enterprises under similar circumstances.

The decision has not gone into the issue on how non-charging interest by an Indian company to foreign AE would satisfy ALP. Rather, the Mumbai Tribunal accepted the alternate contention of the assessee by deleting addition due to non-recovery of interest of Rs. 26.84 lakhs

The TPO cannot reject the internal comparable only on the ground that the volume of business with non-AEs was too small vis-à-vis business with AEs. The assessee was justified in adopting internal transactional net margin method (TNMM) and comparing the profit earned on its transactions with AEs with profit earned with non-AEs

CIT vs. Lummus Technology Heat Transfer BV (163 taxmann.com 411) (Delhi High Court)
(In favour of Assessee)

Facts

These appeals were preferred against the orders dated 20th March 2018 and 24th January 2023 for AYs 2009-10 and AY 2007-08 respectively. The TPO rejected the internal TNMM by rejecting internal comparable by getting influenced by the sheer size of the transaction which was undertaken between the assessee and its foreign AE. The TPO rejected the segmental results of the assessee on the grounds that the segmental accounts were not audited, and segmental accounts were not maintained in the normal course of business.

The Delhi Tribunal while passing the order in favour of the assessee had taken note of the following:

- Rule 10B(1)(e) of the Income Tax Rules, which deals with the TNMM requires that the "net profit margin realised by the enterprise (i.e. the assessee) from an international transaction entered into with an AE is computed in relation to costs incurred or sales effected or assets employed or to be employed by the enterprise or having regard to any other relevant base" is compared with the net profit margin realized by the enterprise (i.e. the assessee) or by an unrelated enterprise from a comparable uncontrolled transaction or a number of such transactions is computed having regard to the same base, of course, subject to comparability adjustments which could affect the amount of net profit margin in uncontrolled conditions.
- It is not at all necessary that such net profit computations, in the case of internal comparables (i.e. assessee's transactions with independent enterprise), are based on the audited books of accounts or the books of accounts regularly maintained by the assessee. All that is necessary for the purpose of computing arm's length price **(ALP)**, under TNMM on the basis of internal comparables, is computation of net profit margin, subject to comparability adjustments affecting net profit margin of uncontrolled transactions, on the same parameters for the transactions with AEs as well as Non-AEs, i.e. independent enterprises, and as long as the net profits earned from the controlled transactions are the same or higher than the net profits earned on uncontrolled transactions, no ALP adjustments are warranted.
- It is not at all necessary that such a computation should be based on segmental accounts in the books of accounts regularly maintained by the assessee and subjected to audit.

Based on the above finding, the Tribunal held that the TPO was in error in rejecting the segmental results on the ground that the segmental accounts were not audited and that these segmental accounts were not maintained in the normal course of business.

The Tribunal further observed that there was a vague generalisation by the TPO to the effect that these accounts are manipulated, that allocation basis of expenses is unfair and that these accounts conceal true profitability. The assessee had disclosed the allocation of the expenses on the man hour basis, which is quite fair and reasonable. Every person had punch-in hours on a specific project. All these details and expense allocation basis were also before the TPO and even then, no specific defects were pointed out by the TPO.

The Tribunal held that the size of the uncontrolled transaction or transactions being smaller, by itself, does not make these transactions incomparable with the transactions in controlled conditions. Size of the comparable does matter in entity level comparison because scale of operations substantially varies and so does the underlying profitability factor, but in a transaction level comparison within the same entity, mere difference in size of the uncontrolled transactions does not render the transaction incomparable.

Held

The High Court relied on decision of Sony Ericsson Mobile Communications India P. Ltd. vs. CIT (2015 SCC OnLine Del 8083), where it was held the comparables can be internal, i.e., when one of the AEs enters into a similar uncontrolled transaction with an independent enterprise or external, i.e., involving an independent enterprise in the same market or industry. It is obvious that an internal comparable could in several cases be more dependable and reliable than an external comparable.

The High Court held that the TPO was wrong in rejecting the internal comparable, i.e. profitability of assessee's transactions with non-AEs, on the ground that the volume of business with non-AEs was too small vis-à-vis business with AEs. The assessee was justified in adopting internal TNMM and comparing the profit earned on its transactions with AEs with profit earned with non-AEs.

INTERNATIONAL TAXATION

Cyprus based company earning interest on compulsorily convertible debentures (CCD) would be beneficial owner of the said income where it does not have any compulsion or contractual obligation to simultaneously pass on the said interest to

Little Fairy Ltd. vs. SCIT (162 taxmann.com 766) (Delhi Tribunal) (In favour of Assessee)

Facts

The assessee was a company incorporated in Cyprus and was a tax resident of Cyprus. The assessee had furnished the tax residency certificate **(TRC)** issued by Republic of Cyprus, Ministry of Finance clearly stating that its worldwide income was liable to income tax in accordance with Income Tax law and Republic of Cyprus. The assessee was wholly owned subsidiary of a company which was based in Mauritius (the Mauritius company). The assessee had entered into investment agreement with an Indian company for a project concerning transfer of rights in a land.

As part of said agreement, the assessee subscribed to compulsorily convertible debentures (CCDs) of the Indian company. The assessee earned interest income on the CCDs, which was offered to income tax at 10% as per India-Cyprus Tax Treaty.

The AO, on review of the bank statements of the assessee observed that there was hardly any other activity which were performed by the assessee in Cyprus. There were other companies registered at address of the assessee, in Cyprus and therefore the AO concluded that the assessee hardly had any presence in Cyprus, in terms of operation. The assessee was merely a conduit for channelising the interest funds. The AO denied the benefit of Circular 789 dated 13th April 2000 in the context of India-Mauritius Treaty to the assessee, even though it had furnished a valid TRC. The AO held that the assessee was not beneficial owner of interest income earned by it on CCDs and Mauritius company was beneficial owner of interest income. The AO accordingly taxed the interest income at domestic rate of 40%, after denying benefit of the Tax Treaty to the assessee.

Observation and conclusion drawn by the Tribunal

- Investment Agreement dated 10th January 2012 was entered into pursuant to a director's meeting held at the assessee's registered office on 9th January 2012. The Mauritius company being the sole shareholder of the assessee was entitled to the interim dividend declared by the assessee. The assessee filed copy of resolutions of the Board of Directors to prove the fact that all the board meetings of the assessee company were held in Cyprus, where all the decisions related to its operations were taken.

  Accordingly, it was concluded that the assessee was independently managed by its Board of Directors.

- In the return of income, the assessee had submitted that the beneficial owner of the shares was the Mauritius company. It is a well-settled principle that shareholders of the company are distinct and separate from each other. The Mauritius company was only a beneficial owner of shareholders of the assessee. It does not get any right over the assets of the assessee to such shareholder.

  Accordingly, the contention of the AO that the Mauritius company was also the beneficial owner of assets/ investments in CCDs held by the assessee was not sustainable in the eyes of law.

- The AO had observed that on perusal of the bank statement of the assessee, there is hardly any other activity being performed by the assessee in Cyprus. The assessee had already made investment in CCDs of the Indian company in its own name through proper banking channels. The said investment would fetch either interest or capital gains to the assessee.

  Accordingly, it was concluded that there was no need for the assessee to undertake any business activity as is being done in the case of manufacturing and trading concerns. Therefore, the allegations of the AO that the assessee did not do anything to carry out a business was not sustainable.

- The assessee, on receipt of interest income on investment in CCDs had redeemed the preference shares and also paid interim dividend in various tranches to the Mauritius company. The AO had observed that other companies registered at the address of the assessee in Cyprus establishes that the assessee hardly has any presence in Cyprus in terms of operation and was merely a conduit for channelizing the interest funds. The assessee had shared office space with the local administrator of the assessee. The assessee reimburses the local administrator for use of its office space, which is evident from its bank statements. The assessee, being an investment company, does not require any personnel other than directors in its payroll to carry out day-to-day operations. The directors of the assessee are well qualified and competent to run the company and take its business investment decisions. Furthermore, the assessee had availed services of professional administrator for general administration, such as book-keeping, company secretarial services, etc.

  Accordingly, there was no need to have any employee on their own payroll.

- The assessee was a tax resident of Cyprus as per Article 4 of India-Cyprus Tax Treaty. The assessee had also furnished valid TRC for the fiscal years 2016 and 2017. The assessee had complete control over the interest income on investment in CCDs and was free to enjoy the same as per its own wish. The assessee was not obliged to pass on the same to any other person.

  Accordingly, it was concluded that the assessee was the beneficial owner of interest income and as per Article 11(2) of India-Cyprus Tax Treaty, the same would be taxed in India @ 10% as all the conditions stipulated in Article 11(2) are complied with.

- The AO had denied the benefit of Circular 789 dated 13th April 2000 which was issued in the context of India-Mauritius Tax Treaty to the assessee. The assessee placed reliance on the decision of Mumbai Tribunal in the case ADIT (IT) vs. Universal International Music B.V. (10 taxmann.com 29), wherein, it was held that the TRC issued by the tax authority of Netherland was sufficient evidence of the beneficial ownership as per Circular No. 789 dated 13th April 2000. The said decision of the Mumbai Tribunal was confirmed by the Bombay High Court in DIT(IT) vs. Universal International Music B.V. (31 taxmann.com 223), wherein it was held that the assessee which was incorporated under the laws of Netherland and being beneficial owner of royalty receipts in respect of music tracks given to Indian companies, would be entitled to benefit of concessional rate of tax provided under Article 12 of India-Netherland Tax Treaty.

Accordingly, it was concluded that the objection made by the AO in respect of this issue was not sustainable.

Held

The assessee was tax resident of Cyprus and has complete right to receive the interest income on CCDs. There was no compulsion or contractual obligation to simultaneously pass on the same to the Mauritius company. The foreign currency risk as well as counter party risk in relation to the interest income was completely borne by the assessee. **All these facts categorically go to prove that the assessee was indeed the beneficial owner of the interest income on CCDs from the Indian entity.** When it was held to be beneficial owner of the income, it is entitled for the taxability at a concessional rate as provided under Article 11(2) of India-Cyprus Tax Treaty. Accordingly, the action of the AO in taxing the interest income @ 40% as per domestic law by denying the treaty benefit was incorrect.

The Supreme Court dismissed the review petition filed by the Income tax department in the case of Engineering Analysis Centre of Excellence Pvt. Ltd. (125 taxmann.com 42)

CIT vs. GE India Technology Centre (P.) Ltd (161 taxmann.com 707) (Supreme Court)
(In favour of Assessee)

Facts

The Supreme Court, in the case of Engineering Analysis Centre of Excellence Pvt. Ltd. (125 taxmann.com 42) had held that the license for use of a product under an End-user license agreement **(EULA)** cannot be construed as a license spoken of in Section 30 of the Copyright Act, as such EULA only imposes restrictive conditions upon the end-user and does not part with any interest relatable to any rights mentioned in Section 14(a) and 14(b) of the Copyright Act.

Thus, amounts paid by resident Indian end-users/distributors to non-resident computer software manufacturers/suppliers, as consideration for resale/use of computer software through EULAs/distribution agreements, was not payment of royalty for the use of copyright in computer software, and the same does not give rise to any income taxable in India.

The Income Tax Department had filed a review petition before the Supreme Court contending that the Court had overlooked the provisions of the Income-tax Act as well as the Copyright Act.

Held

The Supreme Court, by the above decision has dismissed the review petition filed by the Income Tax Department, on merits.

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