Tax Matters

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The team at JMP Advisors is pleased to bring to you a gist of some of the significant developments in the direct tax space during September 2024:

Income tax rulings

- **Income attributable to PE not necessarily linked to the financial performance at a global level**

  - Hyatt International Southwest Asia Ltd vs Additional Director of Income Tax[1]

The taxpayer is a tax-resident of the United Arab Emirates ('UAE'). The Hyatt Group to which the taxpayer belongs had incurred a global loss and hence, it was contended that even if it constituted a Permanent Establishment ('PE') in India, no profit or income was attributable to the PE in India. The taxpayer had filed appeal before the Division bench of Delhi High Court ('the Division bench') on several grounds.

Amongst the various grounds, the Division bench determined that one of the grounds related to attribution of income to the PE requires consideration by a larger Bench of the Delhi High Court. This decision was influenced by the reservations regarding the decision of the Co-ordinate bench of the HC in the case of Nokia Solutions and Networks OY2[2] ('Nokia'). In the Nokia ruling it was held that the attribution of profits to a PE of an enterprise should be made only if the enterprise as a whole had earned profits.

The full bench of the Delhi HC ('the HC') in the current case observed that Article 7 of the DTAA creates a dichotomy between the profits that may be earned by an enterprise on a global scale and those which are attributable to a PE situated in another country. The profits of such PE are to be computed as if it is a distinct and separate enterprise and independent of the enterprise of which it is a part. Further, the HC referred to the OECD Commentary which states that a PE as constituting a separate source of profit.

Relying on the OECD and UN Commentaries, the HC emphasized that the profits attributable to a PE should be taxed independently, regardless of the overall performance of the multinational group. The source state is ultimately concerned with the income or profit which arises or accrues within its territorial boundaries. The HC also observed that no nation waives its right to tax capital or transactions which are anchored to its own territory and it is this basic precept of source which continues to bind.

In the HC's view, if the taxpayer's arguments were to be accepted, the Revenue would have the power to tax a PE if the overall group was profitable although the PE itself had incurred losses. The HC further stated that the argument of global income or profit being relevant or determinative is totally unmerited and misconceived.

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[1] ITA No. 216/2020, ITA No. 217/2020, ITA No. 218/2020, ITA No. 219/2020, ITA No. 140/2021, ITA No. 36/2022, ITA No. 201/2023 & ITA No. 215/2023

[2] ITA 503/2022 (Delhi High Court)

Thus, the HC held that Article 7 of the DTAA clearly envisages the profits of a PE being liable to be independently taxed and be treated as a distinct and separate entity engaged in undertaking business activity on its own. Thus, the HC ruled that the profits attributable to the PE should be determined independently of the enterprise's international financial performance.

JMP Insights – *The above judgement empowers Indian tax authorities to independently assess profits of a PE and attribute income to PEs based on their domestic operations, rather than relying on the global financial performance. This ruling increases the emphasis of economic activities carried out in a country as the primary basis of attribution of profits and signals a move towards a localised approach to taxation. Going forward, MNCs operating in India will need to adapt their tax strategies taking into consideration the potential implications of this ruling. Further, it is important to note that attribution of profits to a PE is often a fact-based exercise. In this context, establishing guidelines/rules in respect of computation of profit attribution to PEs in India may help to reduce litigation to some extent.*

- **Tax Residency Certificate considered sacrosanct in the absence of a sham/fraud**

  - Tiger Global International III Holdings v. The Authority for Advance Rulings[3]

Background

The taxpayer ('Tiger Global International III Holdings'), a Mauritius-based investment vehicle whose shareholders are private equity funds which pool funds globally from several investors. The taxpayer holds a Category 1 Global Business License and holds a Tax Residency Certificate ('TRC') issued by Mauritian authorities. The taxpayer had been set up to undertake investments with a focus on long-term capital appreciation. The activities of the taxpayer are regulated by the Financial Services Commission of Mauritius. The taxpayer had raised capital funds from over 500 investors across 30 jurisdictions. Tiger Global Management LLC ('TGM'), based in Delaware, USA manages investments of the taxpayer. Its role is limited to providing investment management services.

The taxpayer had invested in the equity shares of a Singapore based company, Flipkart Private Limited Singapore ('FPLS') prior to 1 April 2017. FPLS, in turn, held investments in the shares of Indian companies.

During FY 2018-19, the taxpayer transferred shares of FPLS to a non-resident. In relation to the said transfer, the taxpayer applied to the Revenue for a certificate of 'Nil' withholding under section 197 of the Act. Although the value of the shares of FLPS which were being transferred by the taxpayer derived their value substantially from assets in India, since the shares were acquired prior to 1 April 2017, the taxpayer sought a tax exemption under Article 13(4) of the India-Mauritius DTAA ('DTAA'). The Revenue asserted that the taxpayer lacked independent control over decision-making, as most of the decisions were made by TGM. As a result, the taxpayer was ineligible for DTAA benefits, and a directive was issued for the buyer to withhold tax at 10%.

[3] Tiger Global International III Holdings v. AAR [W.P.(C) 6764 to 6766/2020]

Subsequently, the taxpayer filed an application before the Authority of Advance Ruling ('AAR') to determine the tax implications, if any, in India in relation to the said transfer. The AAR denied relief under the DTAA on the basis that the DTAA provisions could not be applied to the transfer of shares of a Singapore company, the taxpayer was a conduit company and the transaction was designed with a view to obtain a tax benefit. The taxpayer challenged the Advance ruling in a Writ Petition filed with the Hon'ble Delhi High Court ('HC').

The HC observed that while TGM was the investment manager, it had no equity participation in the taxpayer. Though the directors of TGM were entrusted with signing authority for the taxpayer, the management control remained with the taxpayer's directors, who made decisions collectively, including the authorization of large financial transactions. Further, a parent company would have a legitimate right to exercise oversight and broad supervision of the affairs of its subsidiaries which could take the form of Board presence, appointment of key managerial personnel, etc. Hence, the HC held that TGM's involvement by way of presence on the Board of two directors representing the Group did not strip the taxpayer of independent decision-making powers, thereby rejecting the Revenue's contention that the taxpayer lacked independence.

The HC observed that the taxpayer had incurred substantial expenditure exceeding thresholds set under the Article 27A[4] of the DTAA and had declared considerable amount of dividend to its shareholders, implying that the taxpayer did not lack economic substance and should not be considered as a shell company.

Further, the HC referred to the CBDT Circular no. 789 dated 13 April 2000 and upheld the validity of the TRC issued by Mauritian tax authorities as sufficient evidence of residence. The HC emphasized that the TRC should not be casually disregarded unless there is evidence of sham/fraud, since doing so would erode the trust between treaty countries.

Moreover, the mere fact of an entity being situated in Mauritius and of investments being routed through Mauritius should not result in a presumption of illegality or tax abuse. Further, Mauritian entities are not required to satisfy any separate standards of legitimacy or a stricter standard of proof. The HC noted Mauritius was a well-established destination for foreign institutional investors due to its favourable investment climate, wide array of agreements with various countries, proximity to India and stable business environment. Citing precedents such as Azadi Bachao Andolan[5] and Vodafone[6], the HC reiterated that offshore companies established in tax-friendly jurisdictions should not automatically be suspected of engaging in treaty abuse.

The HC also disagreed with the Revenue's stance on General Anti-Avoidance Rules ('GAAR'). The HC held that the Limitation of Benefits ('LOB') clause was included in the DTAA although GAAR provisions already existed in the Act. Article 27A chose to

[4] Article 27A stipulates that a resident of a contracting state will not be considered a shell or conduit company if its operational expenditure in that state equals or exceeds MUR 15 million or INR 27 million in the 12 months preceding the date the gains arise.

[5] Union of India v. Azadi Bachao Andolan [2003] 263 ITR 706 (SC)

[6] Vodafone International Holdings B.V. v. UOI [2012] 341 ITR 1 (SC)

specifically grandfather investments made prior to 1 April 2017 and hence, the transaction was not subject to GAAR. The LOB provisions and the TRC comprehensively address all concerns relating to potential treaty abuse.

Further, TGM cannot be held as the beneficial owner of the shares in the absence of evidence to demonstrate that the taxpayer is under obligation to transfer the revenue from the sale of shares to TGM or that the transfer was made as a result of actions taken at the behest of TGM.

Based on the above observations, the HC quashed the AAR's ruling, stating that the Article 13(3A) of the DTAA clearly protected the transfer of shares acquired before 1 April 2017 from Indian taxation.

JMP Insights – *It is pertinent to note that the taxpayer claimed DTAA exemption under Article 13(4) for transfer of shares of FPLS while the HC allowed DTAA exemption under Article 13(3A). The ruling is silent on how the benefit of Article 13(3A) of the DTAA is provided to the taxpayer as the said Article applies on transfers of shares of Indian company and not on transfer of shares of a Singapore company. Further, there are no detailed discussions on how the AAR's contention of taxing the capital gains as per the provisions of indirect transfer[7] under the Act vis-à-vis the provisions of the DTAA, is dealt with in the instant case.*

The ruling however provides detailed findings on various aspects relating to economic substance, choice of a jurisdiction for investment, cases of treaty abuse. This ruling is a positive step towards providing a degree of tax certainty to multinational groups and foreign investors, reinforcing India's commitment to honouring treaty benefits and creating a favourable investment climate, while ensuring that only genuine cases of tax avoidance are subject to examination under the GAAR provisions of the domestic law.

- **MAT provisions do not apply to banks constituted as Corresponding New Banks**

    - Union Bank of India v. Deputy Commissioner of Income Tax – Mumbai[8]

Background

The taxpayer, Union Bank of India, is a nationalized bank created under the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970 ('Banking Acquisition Act'). It is not a company formed or incorporated under the Companies Act. Under the Banking Acquisition Act, the business of the then existing entity i.e., Union Bank of India Ltd. ('UBIL'), which constituted the banking business, was transferred to the taxpayer as a 'Corresponding New Bank' ('CNB').

The taxpayer computed its tax for FY 2014-15 under both the normal provisions and Minimum Alternate Tax (MAT) provisions under section 115JB of the Income tax Act, 1961 ('Act'), paying the higher amount under normal provisions. During assessment, Revenue

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[7] Introduced in section 9 by the Finance Act, 2012

[8] ITA 424/Mum/2020 (Mumbai Tribunal)

required the taxpayer to explain why certain provisions and contingencies debited to its Profit and Loss account should not be added back under the MAT computation. Further, Revenue rejected taxpayer's arguments and emphasized that amended section 115JB[9] explicitly brought banking companies within the scope of MAT.

On appeal, Commissioner of Income Tax (Appeals) ['CIT(A)'] upheld the application of MAT provisions to the taxpayer. The taxpayer filed further appeal to the Income Tax Appellate Tribunal ('Tribunal') and for constitution of a Special Bench to decide whether section 115JB(2) of the Act applied in its case.

The Tribunal examined the amended sub-section (2) of section 115JB, which defines the applicability of MAT provisions. The Tribunal observed that the taxpayer was neither a company incorporated under the Companies Act 1956 ('Companies Act') nor was it required to prepare its accounts as per the Companies Act. Further, an entity deemed as a company for the limited purpose of the Act would not per se make such entity as a 'company' for the purposes of the Companies Act, unless the conditions specified in Section 3 thereof are fulfilled. There is no provision to deem a nationalised bank to be a company for the purposes of Section 3 of the Companies Act. Accordingly, it was held that clause (a) of this section did not apply to the taxpayer.

The Tribunal then reviewed clause (b) of the same sub-section, which applies to companies governed by special laws (insurance and banking companies) that prepare accounts in accordance with their respective statutes rather than the Companies Act. The Tribunal noted that for the taxpayer to qualify as a banking company, it should first of all, be a company' and secondly the said company should transact the business of banking in India. Referring to the Central Government's notification [10] issued with the introduction of the Banking Acquisition Act, which distinguished CNBs like taxpayer from banking companies, the Tribunal concurred with the taxpayer's position and held that MAT provisions were not applicable.

JMP Insights – *This ruling of the Special Bench brings clarity on the applicability of MAT provisions to banks established as 'Corresponding New Banks' under the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970. It solidifies the legal distinction between 'Corresponding New Banks' and other banking entities, and affirms that CNBs, governed by a different legal framework than traditional banking companies, are exempt from MAT.*

- **US tax-resident LLC held eligible for Indo-US treaty benefits**

  - General Motors Company USA vs ACIT, Circle International Taxation[11]

The taxpayer is a Limited Liability Company ('LLC') incorporated in USA. The taxpayer is a fiscally transparent entity for the purposes of the domestic tax law of the USA. During FY 2013-14 and FY 2014-15, the taxpayer earned income by way of Fees for Included Services in India. The taxpayer had offered this income to tax at the rate of 15% under the

[9] Amended by Finance Act of 2012
[10] Notification No. SO 710 dated 16/02/1970 [1970] [75 ITR (Stat) 106]
[11] ITA No. 2359/Del/2022 & ITA No. 2360/Del/2022 (Delhi Tribunal)

India-USA DTAA ('DTAA') since the tax rate under the DTAA was more beneficial than that under the Act.

The tax officer rejected the claim of the taxpayer and taxed the income at the base rate of 25% in accordance with the Act. The tax officer contended that being a tax transparent entity in USA taxpayer is not liable to tax in USA and therefore, it is not considered as a 'resident' as per Article 4 the DTAA. Further, the tax officer observed that LLCs are not covered under 1(b) of Article 4 of the DTAA allowing proportionate benefit to tax transparent entities. Thus, the tax officer denied the benefit of the DTAA to the taxpayer.

Before the Delhi Tribunal, the taxpayer referred to the Organization for Economic Cooperation and Development ('OECD') commentary to interpret the term 'liable to tax' used in Article 4 of the DTAA. As per the said commentary, a person is considered to be liable to comprehensive taxation even if the country does not in fact impose tax. A person does not have to be actually paying tax to be considered as being liable to tax. Though a specific reference to LLCs is not included in Article 4 of the DTAA, the concept of an LLC did not exist at the time of signing of the DTAA.

In arriving at its decision, the Tribunal observed that a US LLC is essentially 'liable to tax' but the income is attributed to its tax owner and such tax is imposed and paid by its respective tax owner, like in the case of USA consolidated group rules where all affiliated USA corporations file a single federal income tax return in the USA. Further, the Tribunal placed reliance on the copy of the TRC submitted by the taxpayer and held that the TRC issued by the USA Internal Revenue Service has been issued to the LLC, since it fulfils all the requirements of a body corporate in the form of legal recognition and perpetual existence, separate from its members. This qualifies the LLC as a 'person' and thereby treated as a resident for the purposes of availing the DTAA benefit.

Moreover, in the case of a fiscally transparent entity, partners or members or owners or beneficiaries file income tax returns as residents of USA. Though the taxpayer is a tax transparent entity, the income of the taxpayer is liable to tax in USA and it is clubbed in the hands of its owners, who merely discharge the tax that is assessable in the case of the LLC. The Tribunal further observed that the intent of the DTAA has to be given precedence. The Tribunal relied on the ruling of the co-ordinate bench in the case of Linklaters LLP[12] wherein it was held that the key factor is whether the income is effectively taxed in the DTAA partner country. Thus, it was held in the said ruling that even if a partnership firm's profits are taxed in the hands of its partners, DTAA benefits can still be claimed as long as the entire income of the firm is taxed in the residence country. The Tribunal thus held the matter in favour of the taxpayer.

JMP Insights *– The judgment provides clarity on the application of DTAA provisions to fiscally transparent entities. It also urges tax authorities to align their interpretation of "liable to tax" with global standards, preventing unwarranted litigation and ensuring compliance with international tax treaties.*

[12] ITA No. 4896/Mum/03 & ITA No. 5085/Mum/03 (Mumbai Tribunal)

Income tax Circular and Notification

- **Enhancement of monetary limits for filing of appeals by Revenue before Tribunal, High Court and Supreme Court**

  In order to reduce litigation, the Central Board of Direct Taxes ('CBDT') has issued a circular[13] to increase the existing monetary thresholds of tax effect for filing appeals or Special Leave Petitions ('SLPs') in Income-tax matters by the Revenue before higher tax authorities as under:

  1. **Appeals before Tribunal:** For a particular FY, the minimum tax effect required to permit filing of appeals by the Revenue is increased from INR 5 million to INR 6 million.
  2. **Appeals before HC:** For a particular FY, the minimum tax effect required to permit filing of appeals by the Revenue is increased from INR 10 million to INR 20 million.
  3. **Appeals/SLPs before Supreme Court:** For a particular FY, the minimum tax effect required to permit filing of appeals by the Revenue is increased from INR 20 million to INR 50 million.

  The Revenue will be required to withdraw all pending appeals and SLPs before the appellate authorities if the tax effect is below the new thresholds.

  ***JMP Insights** – Enhancement of the appeal filing limits seeks to reduce tax litigation.*

DID YOU KNOW?

CBDT vide Notification No. 104/2024, F. No. 370142/16/2024-TPL, dated 20 September 2024 has notified the Direct Tax Vivad se Vishwas Scheme Rules, 2024.

The said scheme shall be applicable to appeals that are pending as on 22 July 2024. The taxpayers will be required to pay a specified amount if they opt to settle the dispute as per the said scheme. Four forms have been specified for the said purpose.

The scheme also provides for lower amounts of settlement for taxpayers who file a declaration on or before 31 December 2024. However, the last date to avail benefit of the scheme is yet to be notified.

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[13] CBDT Circular No. 09 of 2024 dated 17 September 2024

Should you wish to discuss any of the above issues in detail or understand the applicability to your specific situation, please feel free to reach out to us on coe@jmpadvisors.in.

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