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CHARTERED ACCOUNTANTS

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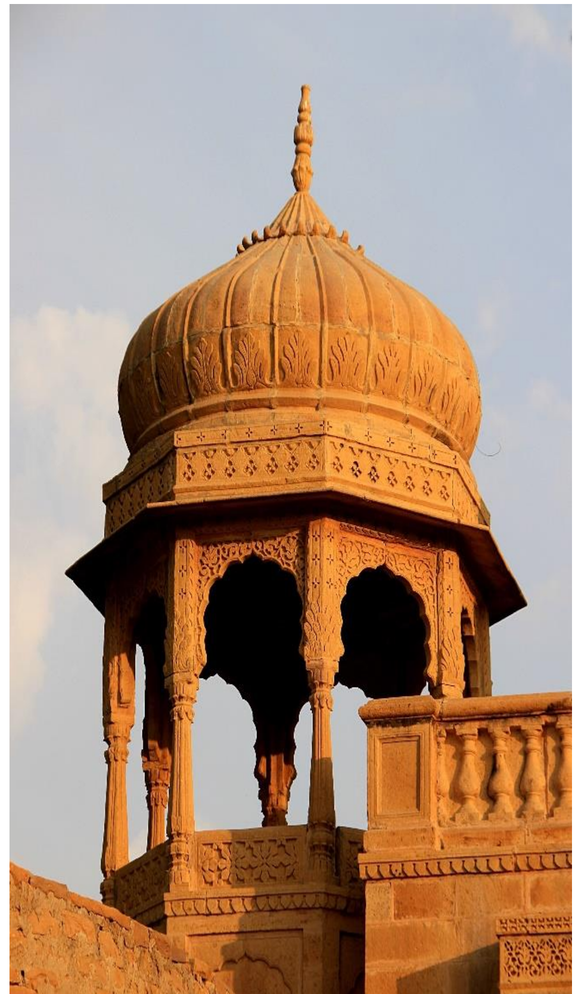

FOREWORD

Dear Reader,

Our Corporate Update for the month of June 2024 covers important cases on the subject of International taxation and Domestic taxation.

The Finance Minister, Government of India, is scheduled to present India's Budget for the Financial Year 2024-25 on July 23, 2024 which will outline major policy initiatives that the Government will pursue as well as proposed changes in the tax regulations. We will cover an analysis on the same in our next Corporate Update.

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DIRECT TAXES

INTERNATIONAL TAXATION

CASE LAWS

ITAT deletes adhoc TP adjustment made due to difference in amount reported by assessee in its Form 3CEB following receipt basis as against accrual basis followed by the AE

Siemens Aktiengesellshaft [TS-236-ITAT-2024(Mum)-TP]

In the above recent judgement, the Hon'ble Income Tax Appellate Tribunal ('ITAT'), Mumbai Bench, *inter alia*, deleted adhoc adjustment @ 10% by taking 10% mark-up value of international transaction made by the Transfer Pricing Officer ('TPO') in respect of international transaction of Royalty and Fee for Technical Services ('FTS'). The TPO had made adjustment of the difference in amount reported by assessee in its Form 3CEB as compared to the amount reported by the Indian Associated Entities ('AEs').

The assessee had submitted that the difference was due to the fact that the assessee has reported the transaction on receipt basis whereas the AEs had reported the transaction on accrual basis as also due to the fact that the assessee reported only those transactions which are taxable in India.

On the facts of the case, the assessee is a non-resident company incorporated in Germany. During the relevant year, the assessee earned income by way of Royalty and FTS under various agreements entered into with its AEs. To justify the arm's length nature of said transactions, the assessee mainly relied on the Transfer Pricing documentation submitted by its Indian AEs. Additionally, the assessee applied the Comparable Uncontrolled Price ('CUP') method to benchmark such transactions considering that the rates are approved by the government authorities.

The TPO observed that there was a difference in amount reported by the assessee in its Form 3CEB and the amount reported by its Indian AE. Based on the same, the TPO concluded that the Transfer Pricing ('TP') Study report in the case of the AE cannot be relied upon to benchmark the assessee's transactions and made an adhoc adjustment of 10% to the value of international transaction.

The Dispute Resolution Panel ('DRP') upheld the order of TPO. On appeal before ITAT, the assessee contended that the AE had carried out detailed Functional, Assets and Risks Analysis while undertaking the benchmarking in its TP study report. The assessee submitted that TP adjustment cannot be made merely on the basis of alleged discrepancy in the amount of transaction reported by assessee and its Indian AEs and that the TPO was bound to determine the Arm's Length Price ('ALP') of the international transaction within the framework of transfer pricing regulations.

It was also submitted by the assessee that in the case of the AEs', the same TPO concluded that AEs have paid excess expense including royalty and fees to the assessee and thereby made an upward adjustment. Whereas in the assessee's case, the TPO has taken a contrary view that the assessee had undercharged from its AEs for the transaction in question.

The revenue questioned that the assessee should have benchmarked the transactions independently. Also, it submitted that the

adjustment has been made because of difference in the amount reported by the assessee and its AEs in their respective Form 3CEB for the same transaction.

With regard to the differences in the amount reported in Form 3CEB, the assessee in its rejoinder submitted that the primary reason for difference was that – (a) the assessee has reported transactions on receipt basis whereas the AE reported the transactions on accrual basis, and (b) the assessee has reported only the taxable transactions.

The Hon'ble ITAT accepted the reasoning for difference given by the assessee and also noted that in the assessee's own case, the Hon'ble High Court of Bombay had accepted taxability on receipt basis. The ITAT further held that the TPO was bound to determine the ALP in accordance with the rules after analyzing the nature of transaction. Also, it held that when the assessee had furnished TP Study report and also relied upon the margins declared by the Indian AEs after carrying out different study reports, then without finding any defect in such TP analysis and determination of ALP by the assessee, the TPO could not have resorted to adhoc mechanism for adding 10% markup on adhoc basis. Accordingly, the adhoc addition made by the TPO was deleted.

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Delhi High Court explains law on permanent establishment (PE), quashes reassessment proceedings ruling out any form of PE as alleged by the Revenue

Progress Rail Locomotive Inc.(Formerly Electro Motive Diesel Inc.) [TS-374-HC-2024(DEL)] dated May 31, 2024

Recently, the High Court of Delhi dismissed Revenue's appeal and quashed reassessment proceedings in the case where the Revenue had sought to place the non-resident taxpayer in all three conceivable silos of permanent establishment (PEs), namely, a Fixed Place PE, Service PE and Dependent Agent PE (DAPE).

On facts, the taxpayer is a company tax resident of USA. It is engaged in manufacture and supply of railway related equipment. During the year under consideration, it supplied equipment to Indian Railways and Diesel Locomotive Works (DLW). The taxpayer had a wholly owned subsidiary in India. The subsidiary had a manufacturing unit in Noida and an office in Varanasi. The subsidiary also provided back office and technical support services to the taxpayer under a service agreement on cost plus basis.

The Revenue issued reassessment notice to the taxpayer alleging that it had fixed place PE, service PE and DAPE in India under Article 5 of the Double Taxation Avoidance Agreement between India and USA (the DTAA) and income from supply of equipment is attributable to the PE and taxable in India. A writ petition was filed by the taxpayer before the High Court against the said notice.

Fixed Place PE

On the issue of fixed place PE, it was contended by the Revenue that

- senior officials of the taxpayer visited India and had complete access to the premises of the subsidiary and they carried out sales activities in India;
- the subsidiary was virtual projection of the taxpayer in India;
- key officials of the subsidiary reported to the taxpayer and performance appraisal of subsidiary's employees was undertaken by the taxpayer;
- the subsidiary was providing assistance in bid submission, inventory management services, post tender/ post agreement services, marketing support, engineering support to the taxpayer;
- the employees of subsidiary were also involved in the designing of components for global tenders;
- the subsidiary performed core business activities for the taxpayer in India and is thus fixed place PE of taxpayer in India.

The High Court observed as under:

- no part of the premises of the subsidiary in Noida or Varanasi were placed under the exclusive or significant 'control' or 'disposal' of the taxpayer;
- the concept of virtual projection would mean that an establishment has been virtually used for all purposes to carry out the paramount business activity of the taxpayer. The taxpayer's principal activity was manufacture and supply of equipment for railways and this activity was not undertaken at the premises of Indian subsidiary.
- the products manufactured by the subsidiary were distinct from those supplied by the taxpayer.
- the activities performed by the Indian subsidiary including collection of information/ technical details or studying market trends or future business prospects, monitoring of upcoming tenders, coordinating with the taxpayer for timely bid submission and other allied activities in connection with global tenders, routing of communications between the taxpayer and Railways/ DLW did not travel beyond being 'preparatory' or 'auxiliary' in nature. These activities were not undertaken in furtherance of the core activity of the taxpayer and appear to be extremely remote from the actual realization of profits.
- both entities did not appear to have been established with a commonality of general purpose.
- performance of role in dual capacity by an official of Indian subsidiary discharging supportive functions pertaining to the independent business activity of the taxpayer and of the Indian subsidiary would clearly not take the case of the Revenue any further. The same would fall in the ken of an auxiliary function as opposed to a core business function.
- the functions performed by the Indian subsidiary were subjected to transfer pricing assessment and the same were accepted as mere back-office operations.
- the mere fact that the parent company placed representatives on the Board of its wholly owned subsidiary was irrelevant for determination of PE.
- reporting of Indian employees to the foreign personnel of the taxpayer was essentially to ensure compliance with global best practices within the group.

In view of the above, the High Court concluded that assumption by the Revenue

of existence of Fixed Place PE of the taxpayer in India was wholly perverse. The High Court placed reliance on the Manual on the OECD Model Tax Convention and various decisions of Hon'ble Supreme Court including in the case of Formula One World Championship (2017) 394 ITR 80 (SC), E-Funds IT Solutions Inc. (2018) 13 SCC 294, Morgan Stanley & Co. Inc. (2007) 7 SCC 1, Samsung Heavy Industries Company Limited (2020) 7 SCC 347, National Petroleum Construction Co. (2016) SCC Online Del 571 and UAE Exchange Centre (2020) 9 SCC 329 to arrive at the conclusion.

Service PE

On this issue, the Revenue contended that the taxpayer's employees visited India to overview subsidiary's operation and were thus furnishing services to Indian subsidiary and as such, the taxpayer had Service PE in India. The Revenue relied upon Article 5(2)(l)(ii) of Indo-USA tax treaty and pointed out that where a foreign entity provided services through its personnel in another country for a related enterprise, even single visit by such personnel could establish a Service PE since the India-USA DTAA does not stipulate a minimum time threshold, unlike other tax treaties.

The High Court observed that the principal reason for initiating reassessment proceedings was concerned with the Indian subsidiary performing functions and services for the taxpayer which in view of the Revenue resulted in constitution of PE. As such, the concept of Service PE was in contradiction to the said reason.

The High Court held that exercise of a degree of managerial oversight by the taxpayer over its subsidiary would not result in a Service PE coming into existence and could only be described as "normal management contribution". The visit of employees of the parent company, their interaction with employees of the Indian subsidiary, discussion on subjects of mutual concern or interest was not the rendering of a service.

DAPE

On the issue of DAPE, the Revenue contended that the Indian subsidiary was authorised to take decisions on behalf of the taxpayer with respect to sales in India to its customers like the Indian Railways, submission of tenders, follow-ups for POs, tracking of delivery, payments, other communications, etc. The Revenue argued that the subsidiary had the authority to conclude contracts and a rubber seal belonging to the taxpayer was also found in the office of the Indian subsidiary during the survey. As such, the Revenue contended that the subsidiary constituted DAPE as per Article 5(4)(c) of Indo-USA tax treaty.

The High Court held that the Revenue could not establish that the Indian subsidiary had the authority to conclude contracts and was in fact habitually engaged in acting in discharge of that authority or that the Indian subsidiary was created solely for the purpose of securing orders for the taxpayer. The High Court also held that mere discovery of the seal of the taxpayer at the premises of Indian subsidiary would not establish that the Indian subsidiary had authority to conclude the contracts on behalf of the taxpayer. The High Court concluded that the Indian subsidiary had independent transactions with DLW and other Indian Railway entities and did not constitute DAPE of the taxpayer in India.

With these observations, the Hon'ble High Court quashed the reassessment proceeding initiated against the taxpayer.

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Tax Tribunal rules on taxability of design and engineering, supervisory receipts and reimbursement under cost contribution agreement

Andritz AG [TS-475-ITAT-2024(DEL) dated June 27, 2024]

Recently, the Tax Tribunal, Delhi Bench held that supply of design and engineering inextricably linked to sale and supply of equipment cannot be taxed in India as Fees for Technical Services ('FTS'). The Tribunal also held that where services are provided through supervisory permanent establishment (PE) in India, the receipts towards such services cannot be taxed as FTS as the same are business profits liable to tax on net basis. Further, on the issue of taxability of reimbursement of expenses claimed from Indian group companies, the Tribunal held that the same cannot be characterized as FTS in absence of profit element.

On facts, the taxpayer is a company and tax resident of Austria engaged in the business of supplying plants and services for hydropower, pulp and paper, metals and other specialized industries. The taxpayer had entered into contracts with Steel Authority of India Limited (SAIL) and Jindal Stainless Limited (JSL) involving offshore supply of design and engineering, offshore supply of plants and equipment and onshore supervisory services.

As the supervisory activities undertaken by the taxpayer exceeded the duration of six months, it admitted supervisory PE in India under Article 5(2)(i) of the tax treaty between India and Austria.

The first issue in litigation pertained to taxability of offshore supply of design and engineering. During the assessment years under consideration, the taxpayer had receipts from SAIL towards offshore supply of drawings and designs, which were claimed as non-taxable in India. In the course of assessment, the tax officer rejected the taxpayer's claim and held that receipts from drawings and designs were to be characterized as FTS under the Act as well as under Article 12 of the tax treaty. While holding so, the tax officer observed that the provision of design and engineering required some sort of technical skill, knowledge and expertise.

In the first appeal, the Commissioner (Appeals) sustained the addition. On appeal before the Tax Tribunal, the Tribunal observed as under:

- the contracts were composite involving not only supply of design and engineering, but also supply of plants and equipment manufactured based on such design and engineering, both done on offshore basis;
- the Revenue has accepted taxpayer's claim of non-taxability of receipts from supply of plant and equipment as the sale transaction was completed outside territory of India;
- on a reading of the contract as a whole, it did not appear that the offshore supply of design and engineering was a completely separate transaction having

no relation to the supply of plant and equipment; and

- it is not the case of the Revenue that the offshore supply of design and engineering would have enabled the customer to get the plant and equipment manufactured through any other independent party.

In view of the above facts and on perusal of terms of the contracts, the Tribunal held that the design and engineering services were inextricably linked with the manufacturing and supply of equipment and the receipts therefrom could not be taxed as FTS. The Tribunal held that basic nature and character of both the transactions are identical and these transactions cannot be segregated.

The contention of the Revenue that since the contracts provided for payment of separate amounts towards design and engineering services, such services are independent to the supply of plant and equipment was held to be untenable by the Tribunal.

The Tribunal noted that the offshore supply of plant and equipment under SAIL contracts were not subjected to tax by the Revenue in any year. The Tribunal thus concluded that when offshore supply of plant and equipment was considered to be not taxable in India, offshore supply of design and engineering inextricably linked to such plant and equipment cannot be subjected to tax in India. In this regard, the Tribunal relied on its earlier decisions in the case of SMS Concast AG [TS-328-ITAT-2023(DEL)] and DSD Noell GMBH [TS-714-ITAT-2023(DEL)]

The second issue pertained to taxability of receipts of supervisory PE as FTS by the tax officer. Before the Tribunal, the taxpayer contended that onshore supervisory charges received by the taxpayer were effectively connected with the supervisory PE, as such the same were to be taxed as 'business profits' on net basis in terms of Article 7 read with Article 12(5) of the DTAA. The taxpayer further contended that it followed project completion method for the purposes of recognising revenue of the PE and since the projects were ongoing during the years under consideration, the supervisory receipts were offered to tax subsequently in the year of completion. As such, the taxpayer submitted that taxing same receipts in the years under consideration would result in double taxation.

The Tribunal noted the exception carved out by Article 12(5) of the DTAA which provides that where FTS is connected with PE in the source country, the provisions of Article 7 shall apply. The Tribunal, thus, held that even though the receipts are in the nature of FTS, however, if it is connected to the PE, it has to be treated as business profit under Article 7 after allowing expenses relating to the PE. The Tribunal further observed that taxpayer has been consistently following project completion method and the said method has also been accepted by the tax officer in the scrutiny assessment of the subsequent assessment years. The Tribunal noted Article 7(5) of the treaty which provides that the business profits of the PE have to be determined by the same method year by year, unless there is good and sufficient reasons to depart from the said method. As such, the Tribunal directed the tax officer to verify if the supervisory receipts were offered to tax in later year on completion of project and if so, no addition could be made in the impugned assessment years.

On the third issue of supervisory/ commissioning receipts not pertaining to any PE project which were claimed as not taxable by the taxpayer, the Tribunal held that the services were technical in nature

and had to be treated as FTS under Article 12 of the DTAA.

Regarding reimbursement of expenses claimed from Indian group companies taxed as FTS by the tax officer, the Tribunal observed that the taxpayer had entered into a cost contribution contract with other group entities for group information and business services (GIS) to achieve cost efficiency within the group. The scope of the agreement included development of the strategic orientation of GIS within the group, support in compiling the yearly GIS budgets in line with the strategic targets, involvement in all relevant decisions processes within the GIS to ensure the achievement of targets with respect to personnel, investments, projects, etc. Cost incurred by the taxpayer for providing such services were allocated by way of specific allocation key to all the group companies, including the Indian entities. The Tribunal opined that the taxpayer had merely shared the expenditure within the group without any mark-up and following the decision of Hon'ble Supreme Court in the case of DIT Vs. A.P. Moller Maersk AS, [2017] 78 taxmann.com 287(SC) and CIT Vs. Expeditors International (India) Pvt. Ltd. [2012] 24 taxmann.com 76 (Delhi) held that in absence of profit element, the receipts cannot be characterized as FTS.

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DOMESTIC TAXATION

CASE LAWS

Provision made for customer loyalty points is an allowable deduction

Titan Company Ltd. v. ACIT [2024] 164 taxmann.com 84 (Chennai ITAT)

Recently, the Chennai Bench of Tax Tribunal ('Tax Tribunal') has held that provision for customer loyalty points created by the Assessee based on estimated percentage of redemption was to be allowed as a deduction under Section 37(1) of the Income-tax Act, 1961.

Brief facts of the case are that the Assessee is a domestic company engaged in the business of manufacturing, trading and servicing of watches, jewellery and clocks. In the financial statements of Assessment Year (AY) 2008-09, the Assessee made a provision of loyalty points estimated to be redeemed by the customer considering the redemption trend of the past period(s) and subsequently, claimed a deduction of the same.

The Tax Officer disallowed such deduction under the premise that the rate of redemption of customer loyalty points was at great variation with the provision made and as such, the Assessee had not adopted any scientific method for creating such a provision. Thereafter, the Commissioner (Appeals) upheld the addition made by the Tax Officer based on a similar reasoning given by Tax Officer.

In appeal before the Tax Tribunal, the Tribunal noted that the Assessee had been consistently following the same methodology of creating the provision based on the redemption trend of past period(s). The

Supreme Court in the decision of **Rotork Controls India Pvt. Ltd. v. CIT [2009] 314 ITR 62** had held that creation of provision for warranty in respect of defects in sophisticated goods based on a historical trend was an allowable deduction under Section 37(1) of the Act.

Following the aforesaid principle outlined by the Supreme Court, the Tax Tribunal allowed the deduction of provision of customer loyalty points by the Assessee under Section 37(1) of the Income-tax Act, 1961.

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Amendment made in section 71 of Income Tax Act by inserting sub-section (3A), restricting set off of loss under head 'Income from house property' against any other head of income to an amount of Rs. 2 lakh is not ultra vires the Constitution of India

The High Court of Delhi in the case of Sanjeev Goyal v Union of India [2024] 163 taxmann.com 122 (Delhi) has held that the amendment in section 71 of the Income Tax Act ("the Act") by the Finance Act, 2017, whereby the set off of loss under the head 'Income from House Property' was restricted to Rs. 2 lakh (0.2 million) is not unconstitutional.

In the present case, the assessee, an individual, filed a writ petition before the High Court, challenging the constitutional validity of sub section (3A) of section 71 of the Act inserted by the Finance Act, 2017, on the ground that the amendment is retrospective in nature and is discriminatory.

The assessee raised a housing loan for construction of house. The construction was completed in April 2014. The income from House Property was computed after deduction of interest on loan u/s 24. The assessee claimed set off of loss under head 'Income from house property' (which arose due to interest payment on loan) with income under head 'Income from salary' for FY 2014-15 to 2016-17. However, by virtue of the Finance Act, 2017, the threshold limit for set off of loss under the head 'Income from house property' against any other head of income was restricted to an amount of Rs.2 lakh for a particular Assessment Year ["AY"] with effect from 01.04.2018 i.e., for AY 2018-19 and subsequent AYs, which the assessee challenged before the High Court.

Before the High Court, the assessee submitted that the amendment to the Finance Act, 2017 has been introduced with retrospective application, imposing a heavy tax liability on the petitioner. The said amendment has shorn off his preexisting right to set off the loss exceeding two lakh rupees. It was, therefore, asserted that insertion of sub-section (3A) to Section 71 of the Act amounts to a breach of promise, which consequently, attracts the doctrine of promissory estoppel against the Government of India.

The tax department submitted that the assessee does not have any vested right to claim the benefit of the provisions in question in the same manner as he has been asserting since FY 2014-15. It was further submitted that the legislature is duly empowered under the Constitution to levy and collect taxes, and any such alleged right cannot be claimed by the petitioner on a mere presupposition for an indefinite period or an infinite amount. It was also submitted that the rationale behind the amendment is that prior to the amendment, there was no

upper limit (except in the case of self-occupied property) on deductions claimed by taxpayers, which led to the escalation in property prices and decrease in tax revenue. The amendment is an anti-abuse provision which seeks to minimise revenue loss.

The High Court observed that with the insertion of sub-section (3A), instead of an indefinite amount which could have been set off as per Section 71 of the Act earlier, an assessee can now only set off a maximum amount of Rs. 2 lakh in the manner mentioned in the said Section qua the 'Income from house property'. The said amendment came into effect only from 01.04.2018.

The High Court held that sub-section (3A) to section 71 of the Act was introduced vide the Finance Act, 2017, which was duly passed by the parliament & therefore, there is no legislative incompetence in formulation of such law. Further, in the absence of any crystallized right allowing the assessee to claim any legitimate expectation to set off the amount without any restriction, the argument of violation of Article 14 is not tenable. The High Court observed that section 71(3A) does not take away the benefits of deduction provided to the petitioner in toto, rather it only attempts to circumscribe the indefinite amount of set off to a certain amount. The change introduced by the impugned legislation is a reflection of the larger policy of the Legislature and has an equalizing effect on all the taxpayers claiming any deduction under the head 'Income from house property'. It does not have the effect of creation of any separate class or classification.

With respect to the challenge raised in the light of the infraction of fundamental right under Article 19(1)(g) of the Constitution, the High Cout held that the scope of the said right cannot be extended to protect one's right to profit. The impugned provision does not create an absolute restriction on the taxpayer's pre-existing right to claim the deduction in question and the capping of Rs. 2 lakh is meant to prevent the abuse of the relevant provision. The tool adopted to prevent the abuse is also reasonable and it is not the case of the petitioner that the Legislature had a less restrictive tool to achieve the object. Therefore, the High Cout held that the impugned law is proportionate with the object sought to be achieved and cannot be faulted as being violative of Article 19.

Referring to the submission of the Petitioner that neither the earlier provisions nor the amended law, expressly or indirectly, dealt with any promise by the Legislature that the benefits under the old taxation regime shall be continued to be offered till an indefinite period, the High Court observed that neither the old provision or the amended provision expressly dealt with any such promise. Therefore, there is no applicability of doctrine of promissory estoppel in the present case. The High Court, therefore, dismissed the writ petition of the assessee.

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