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Tax Matters

Issue No. 2024/08 Date: 5 September 2024

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 July and August 2024:

Income tax rulings

- **Article 7 not the main head of income for taxation under the treaty, is open to revenue to examine the appropriate taxability of income.**

  - International Management Group (UK) Ltd[1]

Background

International Management Group (UK) Ltd ('IMG/Taxpayer') entered into a contract to render advisory and managerial services to the Board of Control for Cricket in India ('BCCI') to establish, commercialise and operate the Indian Premier League ('IPL'). IMG was appointed as an agent by BCCI in this regard. IMG received revenue from BCCI for their services for Financial Year ('FY') 2009-10 to 2017-18. The IPL was conducted in India except in the FY 2009-10 and 2014-15. IMG declared the constitution of a Permanent Establishment ('PE') in India and offered the income attributable to such PE as 'Business Income' taxable in India under Article 7 read with Article 5 of the India UK Double Taxation Avoidance Agreement ('DTAA').

The tax officer considered the remaining service fee (i.e. the amount not attributable to PE) taxable as Fees for Technical Services ('FTS'). The taxpayer filed an appeal with the Dispute Resolution Panel ('DRP') against the order of the tax officer.

The DRP held that the amount which is not attributable to the PE shall be taxed as FTS under Article 13 of the DTAA. The taxpayer filed an appeal with the Tribunal against the order of the DRP. The Tribunal upheld the order of the DRP.

Before the Delhi HC, the taxpayer contended that

- Income remaining after attribution to PE is not taxable in India. The income earned is through a composite contract and thus it cannot be bifurcated into FTS and business income for various services provided to BCCI.
- Once the Service PE clause is applied with respect to services provided by the taxpayer, such services cannot be taxed as FTS.
- Even if the income is FTS, the services to be categorised as FTS should fulfil the 'make available' test as envisaged in the DTAA. In this case, the services were rendered to BCCI for a period of 10 years, meaning that the services did not fulfil the 'make available' condition.

[1] ITA 218/2017 (Delhi High Court)

- For FY 2009-10 and 2014-15, the IPL event was held outside India. During those years, the taxpayer's services were both rendered and utilised outside India. Thus the source of taxpayer’s income originated from outside India. Consequently, the service fee falls under the exception to FTS and is not subject to taxation in India under the Act.

The tax authorities contended that

- The scope of services to be provided by IMG to BCCI includes services that would qualify as FTS. A mere attribution of the income to the Indian PE does not mean that the remaining service fee as not taxable.
- Further, IMG was required to submit survey reports to BCCI which fulfilled the ‘Make Available’ requirement as envisaged by the DTAA. Merely because the tenure of the contract is 10 years does not mean the make available requirement is not fulfilled.
- It was also brought to the attention of the court that the 3 authorities prior to the Delhi HC based on the documentary evidence concluded that the provisions of FTS as per article 13 of the DTAA were satisfied.
- Further, as per the explanation to Section 9, Technical services whether rendered in India or outside India would be deemed to be accrue or arise in India as per section 9(1)(vii).

The issue before the Delhi HC was whether the remaining service fee, if it qualifies as FTS, continues to be taxable on a gross basis or is outside the purview of taxation in India.

Decision

The Delhi HC held that the PE clause is neither the main head of taxation nor concerned with the characterisation of income. Mere attribution of income to the PE in India cannot restrict the Revenue authorities from examination of taxability of income which was not attributed to the PE. Referring to the OECD model, UN Model Convention and Klaus Vogel, it can be derived that the provision of PE does not affect the applicability of the other provisions of the DTAA. Thus, the Revenue authorities can examine the multiple streams of income earned by the taxpayer and tax as per the appropriate provisions of the DTAA.

The court held that IMG was required to carry out research every year to find areas of improvement and management. Merely because the research data was shared with BCCI does not fulfil the ‘make available’ requirement as envisaged by Article 12 of the DTAA. Further, the continued period of service by IMG to BCCI confirms that the ‘make available’ was not satisfied. The explanation to section 9 of the Act cannot override taxability of FTS in some of the years where the source of income for BCCI was outside India. Thus, the amount shall not be taxable as FTS under the Act.

JMP Insights *– The Delhi HC’s decision offers significant clarity on key aspects of the DTAA. By differentiating between FTS and Business Income, the Delhi HC has addressed a critical area of international tax law. It provides valuable guidance for multinational enterprises. This case highlights the importance of accurate legal interpretations and the need for business operations to be in strict compliance with DTAA provisions.*

The Delhi HC has however, not commented on the interpretation of "effectively connected to the PE". This provision excludes the royalty/FTS, if income is earned from a contract connected with the PE.

It serves as a helpful precedent for taxpayers and tax authorities in understanding the tax implications of cross-border transactions and the applicability of the DTAA provisions on multiple types of income earned from a single contract.

- **Expenditure incurred for overseeing parent company's projects was not allowed as a deduction to subsidiary company**

  - M/s Pipelic Energy Software India Pvt Ltd vs Deputy Commissioner of Income Tax[2]

The taxpayer, a subsidiary company of LIC Energy, Denmark ('holding company'), was engaged in the business of providing consultancy and advisory services for industrial computer software systems. The taxpayer incurred expenses towards salaries, travelling expenses, rent and other admin expenses for overseeing and execution of the contracts entered by the holding company. The tax officer held that the taxpayer's expenses were not deductible as a business loss on the following grounds:

i. the taxpayer and the holding company were separate legal entities and expenses incurred by one entity could not be claimed as a deduction by another entity
ii. expenses incurred by the taxpayer were not for their own business but to support the holding company's projects
iii. the taxpayer had not engaged in any independent business activity
iv. the taxpayer failed to provide sufficient evidence to support their claim

The Tribunal relied on the Honourable Supreme Court ('SC') in the case of Saravana Spinning Mills Pvt Ltd[3] wherein it laid down the pre-requisites for allowing the deduction of expenses from business income. The pre-requisites for allowing deduction are as under:

i. the expenditure does not fall within sections 30 to 36,
ii. it should have been incurred in the accounting year,
iii. it should be in respect of a business carried on by the Assessee,
iv. it should not be in the nature of capital expenditure, and
v. it should be spent wholly and exclusively for business

Reliance was also placed on the apex court judgement in case of Chandulal Keshavlal[4] wherein it was held that in order to justify a deduction the disbursement must be for reasons of commercial expediency, which may be voluntary but incurred for the taxpayer's business.

Based on the above rulings, the Tribunal held the expenses to be ineligible and thus disallowed, as the same were not incurred wholly and exclusively for the purpose of taxpayer's business.

[2] ITA No 561 of 2006 (Telangana HC)
[3] [2007] 163 Taxmann 201 (SC)
[4] 1951 SCC 440

The Telangana HC upheld the Tribunal order confirming the disallowance of business loss under Section 37 of the Act and observed that expenditure must be connected with or related to the business carried out by the taxpayer to allow as a business loss.

JMP Insights *– This ruling affirms the principle that expenses incurred ought to be wholly and exclusively for the business of the taxpayer to be claimed as a tax deduction. The court emphasized the separate legal entities of the appellant and parent company, the lack of independent business activity by the appellant, and the appellant's failure to provide sufficient evidence to support their claim.*

- **Compensation for diminution in value of ESOP taxable as perquisite**

  - M/s Nishithkumar Mukeshkumar Mehta vs Deputy Commissioner of Income Tax[5]

The taxpayer, being an employee of Flipkart India Private Limited (‘FIPL’) received ESOPs under a scheme implemented by the parent company of FIPL i.e., Flipkart Private Limited Singapore (‘FPS’). Subsequently, on account of divestment of FPS’s stake in certain business, voluntary compensation was declared to the taxpayer for the diminution in the value of ESOP. Tax was withheld on such compensation paid to the employee treating it as perquisites. The taxpayer contended such compensation to be capital receipt in nature and thus applied for a ‘NIL’ withholding certificate under the Act. On rejection of such application by the tax officer, the taxpayer has applied for a writ petition to the Madras High Court (‘Madras HC’).

The taxpayer contended that compensation received was capital in nature and therefore, not taxable. In order to substantiate this proposition, the taxpayer relied on various judgements, wherein capital receipts were not taxable as income. Further, the taxpayer opined that in the absence of a transfer of capital assets, capital gains tax could not be levied. The taxpayer relied on the recent Delhi HC ruling in the case of an ex-employee of FIPL[6] wherein the Delhi HC concluded one-time voluntary payment to be capital receipt and not taxable as perquisite.

The Madras HC has disregarded the judgement passed by the Delhi HC (supra) and taxed the compensation as a perquisite. The Madras HC has examined the following points in its judgement:

i. Whether ESOPs are capital assets
ii. Whether compensation can be considered as a perquisite

The Madras HC observed that ‘capital asset’ defined under the Act means property of any kind held by the taxpayer. Further, explanation to the definition specifies property to include and deemed to include any rights in relation to an Indian company. Madras HC opined that since the taxpayer had no rights in the Indian company, Explanation 1 is not attracted and therefore, ESOPs held by the taxpayer were not capital assets. Further, Madras HC held that ESOPs are not a source of revenue or profit-making apparatus for the taxpayer and actual

[5] W.P No 26506 of 2023 & WMP Nos 25911 & 25912 of 2023 (Madras HC)
[6] [TS-377-HC-2024(DEL)]

benefit accrues only upon transfer of shares allotted to the taxpayer under the ESOP. Therefore, the compensation shall not be considered as a capital receipt.

On taxability of compensation as a perquisite, Madras HC held that ESOP would qualify as perquisite since the definition under the Act includes specified securities offered under such scheme or plan. Further, Madras HC held that the expressions used under the Act to define ‘perquisites’ is broad enough to encompass discretionary compensation paid to the taxpayer. Merely because method of valuing perquisite does not fit in relevant explanation cannot be sufficient reason for non-taxing of compensation as a perquisite. Madras HC held that monetary benefit was received by the taxpayer at a pre-exercise stage and since the taxpayer did not make any payments towards the ESOPs, the entire amount will be qualified as a perquisite and became liable to tax under the head ‘Salaries’. Accordingly, the taxpayer was not eligible for a ‘Nil’ withholding certificate.

JMP Insights *– The Madras HC has observed that ESOPs are not equivalent to shares but rather represent a contractual right to purchase shares at a future date. Further, the Madras HC observed that capital assets defined under the act include rights only in relation to an Indian company.*

The judgment noted that compensation for the diminution in the value of ESOPs is not a capital receipt thereby differing from the judgement of Delhi HC on similar facts. Unlike compensation received for the loss or transfer of a capital asset, which is typically considered a capital receipt, ESOP-related compensation does not involve the sale or transfer of an asset. The court distinguished ESOP compensation from cases where compensation relates to an actual capital asset that generates revenue or profit.

The judgment emphasized the broad scope of what constitutes a "perquisite" under Section 17(2) of the Act. The court noted that typically, the valuation of ESOPs as perquisites is done at the time of share allotment, based on the difference between the market value and the exercise price. However, even compensation received before the exercise of ESOPs can be treated as a perquisite. This indicates that the taxability arises not necessarily from the exercise of the option but from other benefits provided in connection with the ESOP plan.

- **Discount on ESOP to be allowed as revenue expenditure**

  - Asst Commissioner of Income Tax vs Axis Bank Limited [7]

The taxpayer floated an ESOP scheme for its employees and claimed the deduction of ESOP expense while computing its total income. The expenditure claimed as a deduction was computed as the difference between the market price as of the date of exercise and the exercise price of such option.

The Tax Officer rejected the claim of the taxpayer asserting that expenditure eligible for the deduction shall be the difference between the market value as on the date of grant of the option (which is equivalent to the exercise price) and the exercise price of the option resulting

[7] ITA No 48 & 49/Ahd/2024

in no discount being passed to the employees. The tax officer relied on the Delhi Tribunal judgement in the case of Ranbaxy Laboratories[8] wherein ESOP expense was held to be notional in nature.

The Tribunal had upheld the position taken by CIT(A) and allowed the ESOP expense as a deduction to the taxpayer. The Tribunal relied on the ruling of Biocon Limited[9] which was further confirmed by the Karnataka High Court[10] wherein it was held that issuance of shares at a discount would be an expenditure incurred for the purpose of business as the primary object was to earn profits by securing consistent services of employees. Various tribunals, relying on the judgement of the Karnataka High Court held that ESOP expense, being the difference between the market price as on the exercise date and the exercise price will be allowable expense from its total income.

Further, it was noted that the ESOP scheme formed part of the Annual Report of the taxpayer in the year in which the option was exercised disclosing the ESOP benefits granted to its employees. Thus, it was held that such expenses were not contingent, and taxpayer had claimed the expense at the time of actual exercise by its employees. It is pertinent to note that benefit granted to the employees are taxable as perquisites in their hands and tax at appropriate rate is liable to be withheld on such perquisites. The taxpayer, in the above case, has duly disclosed ESOP expense as a perquisite to the employees and withheld tax at applicable rates.

JMP Insights *- The ruling provides clarity on eligibility of ESOP expense to be allowed as a deduction while computing the taxpayer's total income. The primary objective behind the issuance of ESOP scheme is to retain competent employees for the benefit of the overall business. Therefore, any expense incurred on such ESOP scheme shall be allowed as a deduction to the taxpayer.*

DID YOU KNOW?

The Foreign Exchange Management (Non-Debt Instrument) Rules 2019 have been amended vide Notification No. S.O. 3492(E) dated 16 August 2024 to provide for issue or transfer of Indian company equity instruments in exchange for foreign company equity capital. The amendment aims to simplify cross-border share swaps and facilitate global expansion of Indian companies.

[8] ITA Nos 2613 & 3871

[9] [2013] 35 taxmann.com 335 (Bangalore Trib) (SB)

[10] [2020] 121 taxmann.com 351 (Karnataka)

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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