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 December 2024:

Income tax rulings

- **Liaison office engaged in preparatory or auxiliary activities not to be treated as a Permanent Establishment**

  - Director of Income Tax International vs Western Union Financial Services Inc[1]

The taxpayer is a tax resident of the USA engaged in rendering Money Transfer Services ('MTS'). To facilitate these services, the taxpayer has appointed agents in India.

When a person in the USA wishes to transfer money to someone in India such transferor visits one of the taxpayer's branches or outlets in the USA and transfers the amount in USD. The taxpayer then issues a unique Money Transfer Control Number ('MTCN'), which is shared with the recipient in India. The beneficiary in India approaches the representative/agent along with the MTCN. Upon verification of MCTN using software owned by the taxpayer, the transaction is honoured, with the respective agents receiving commissions.

To facilitate its business and promotional activities, the taxpayer established a Liaison Office ('LO') in India, operational until July 31, 2005, after which it was replaced by a subsidiary, Western Union Services India Private Limited.

The taxpayer filed a Return of Income ('ROI') for the Financial Year ('FY') 2000-01 declaring Nil income. However, the tax officer asserted that the taxpayer's income accrued and arose in India, rendering it taxable.

The tax officer concluded that the taxpayer possessed a fixed place of business in India which constituted a Fixed Place Permanent Establishment ('PE') and that the LO's activities constituted a Dependent Agent Permanent Establishment ('DAPE'). It was further observed that the software installed at Indian agents' offices and the connectivity provided would also lead to treating these premises as a PE. The tax officer also noted that the business connection test in India was satisfied, as the Indian agents performed integral business activities generating revenue for the taxpayer.

The taxpayer contended that its LO in India, approved by the Reserve Bank of India (RBI), was solely for communication purposes and did not engage in any commercial activities.

On appeal, the Commissioner of Income-tax (Appeals) ('CIT(A)') upheld the tax officer's approach. The taxpayer filed an appeal before the Tribunal.

[1] ITA 1288/2006 & Connected Matters (Delhi HC)

The Tribunal held that the business connection test was satisfied but ruled in favour of the taxpayer on the issue of Fixed Place PE. The Tribunal noted that the LO was not involved in the remittance contracts and that its activities were merely preparatory or auxiliary in nature, and thus the LO did not meet the criteria of a Fixed Place PE under Article 5 of the India-USA Double Tax Avoidance Agreement ('India USA DTAA'). The Tribunal determined that the software only provided agents with access to servers located outside India. It was the taxpayer's property and mere use of this software did not constitute a PE. Aggrieved by this decision, the Revenue has filed an appeal before the Delhi High Court ('Delhi HC').

The issues before the Delhi HC are discussed below:

Fixed Place PE - business carried out through LO

The Delhi HC referred to the ruling of the SC in the case of *U.A.E. Exchange Centre*[2] and its own ruling in the case of *Progress Rail Locomotive Inc.*[3], and held that the activities of LO, including liaising with government authorities, training personnel, and performing peripheral tasks, were merely preparatory or auxiliary in nature and did not constitute an essential part of the taxpayer's business.

The Delhi HC noted that the transfer of funds was completed in the USA, and Indian agents, not the LO, performed the core functions necessary for these transactions. Further, the LO did not engage in trading or commercial activities. It did not breach the 'preparatory or auxiliary' threshold as embodied in Article 5(3) of the India USA DTAA, and therefore, could not be considered a PE.

Dependent Agent PE - activities of LO

The Delhi HC held that for the LO to constitute a DAPE, it must act on behalf of the taxpayer and fulfill the conditions under Article 5(4) of the India USA DTAA, including habitually securing orders for the taxpayer. As none of the aforesaid criteria were met, the LO did not constitute a DAPE in India.

Fixed Place PE - use of software by Indian agents

The Delhi HC observed that the taxpayer had not installed any hardware at the agents' premises and emphasized that Paragraphs 1 and 2 of Article 5 of the India USA DTAA pertain to tangible premises and establishments. The Delhi HC held that software, being intangible property, does not possess the physical attributes essential to constitute a PE under these provisions.

Relying on the SC's ruling in the case of *E-Funds IT Solution*[4], the Delhi HC held that the deployment of software did not create a PE. The Delhi HC further clarified that the Indian agents' premises could not constitute a PE, as the agents were independent third parties with their business portfolios, failing to meet the test of virtual projection.

Based on a comprehensive review of previous HCs and SC decisions regarding Fixed Place PEs and DAPEs and considering the specific language of Article 5 of the India USA DTAA,

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[2] (2020) 9 SCC 329 (SC)
[3] 2024 SCC OnLine Del 4065 (Delhi HC)
[4] 2014 SCC OnLine Del 555 (SC)

the Delhi HC unequivocally concluded that the LO did not meet the necessary criteria to be considered a PE.

JMP Insights – *This Delhi HC decision is a significant case in the domain of interpretation of what constitutes a PE, specifically with respect to the 'preparatory or auxiliary' exclusion.*

- **Investment in foreign assets eligible for indexation under Section 48 of the Income Tax Act, 1961**

  - Dy CIT v Aarav Fragrances and Flavors Pvt Ltd[5]

The taxpayer, a manufacturer of fragrance compounds and flavours is based in India. The taxpayer has two wholly owned subsidiaries of which one is a foreign subsidiary.

During the year, the shares of the foreign subsidiary were extinguished by the taxpayer under a buyback scheme. The taxpayer claimed a Long Term Capital Loss of INR 22.93 crore in its ROI which was computed by applying the cost inflation index to the cost of acquisition as per the second proviso to Section 48 of the Income Tax Act, 1961 ('the Act'). The tax officer objected to the benefit of indexed cost of acquisition claimed by the taxpayer and recomputed the Long Term Capital Loss to INR 11.53 crore without providing the benefit of indexation.

The taxpayer aggrieved by the order filed an appeal with the CIT(A). The CIT(A) allowed the benefit of indexation to the taxpayer.

Aggrieved by the order of CIT(A), the tax officer filed an appeal with the Mumbai Tribunal.

The Revenue authorities placed reliance on the co-ordinate bench ruling in the case of *ICICI Bank*[6] to support their claim that indexation benefit cannot be availed where the transfer is of foreign capital assets. The taxpayer contended that being a resident it was eligible to avail the benefit of indexed cost of acquisition. Further, the second proviso to Section 48, does not distinguish between the assets in India and outside India. The taxpayer further distinguished its case from that of ICICI Bank's case highlighting the lack of clarity on the currency used for the acquisition of foreign assets.

The Tribunal ruled in favour of the taxpayer and held that while the first proviso to Section 48 dealing with investments in foreign currency under Section 48 is exclusively for non-residents, the second proviso concerning indexation benefits for the transfer of assets does not have such a restriction. Further, it does not distinguish between assets held in India or outside India. Thus, the benefit of indexation was allowed while calculating the capital gain on the sale of foreign assets as per Section 48 of the Act.

JMP Insights – *The tribunal's ruling provides a crucial clarification that an Indian resident taxpayer can avail indexation benefits under Section 48 of the Act for calculating long term capital gains on the sale of its foreign assets.*

[5] ITA No. 546/Mum/2024

[6] 159 taxmann.com 747 (Mumbai-Trib.)

- **ALP adjustment for AE does not automatically require a corresponding adjustment for the other AE**

    - Shell Global Solutions International B.V. vs ACIT[7]

The taxpayer, Shell Global Solutions International BV, is a non-resident and provides research and technical services for a range of petroleum-related industry segments. During the Financial Year ('FY') 2013-14 and 2014-15, the taxpayer rendered various services to two of its Associated Enterprises (AEs) in India - Hazira LNG P. Ltd ('HLPL') and Shell India Markets P. Ltd. ('SIMPL').

The tax officer observed that the average hourly rate charged to HLPL was EURO 371.21 per man-hour which was significantly lower than the rate of EURO 2,267.90 per man-hour charged to a third party, Brunei LNG, for similar services. Similarly, for services provided to SIMPL, the tax officer noted that the taxpayer charged EURO 217.56 per man-hour, whereas a rate of EURO 323.58 per man-hour was charged to a third party. The tax officer used the internal CUP method for benchmarking these transactions and made upward adjustments for both transactions.

On appeal, the Dispute Resolution Panel ('DRP') upheld the tax officer's approach. The taxpayer filed an appeal before the Tribunal.

At the outset, the taxpayer had stated that the issues in appeal were legacy issues and were adjudicated by the Tribunal. However, with respect to the issues raised regarding transfer pricing adjustment made to the international transaction entered into by the taxpayer, there were some distinguishing facts/propositions of law that had to be brought before the Tribunal.

<u>Base Erosion</u>

The taxpayer argued that any upward ALP adjustment to its income should be accompanied with a corresponding adjustment to the income of its Indian AEs. This, according to the taxpayer, would increase the AEs' expenses, thereby, reducing their taxable profits.

The taxpayer contended that this profit reduction would lead to base erosion in India.

The rationale provided was that under the India-Netherlands Double Taxation Avoidance Agreement ('India Netherlands DTAA'), the taxpayer's income is taxed at 10%. Thus, any upward adjustment to the taxpayer's income would be subject to this 10% tax rate. On the contrary, the Indian AEs are taxed at a 33% rate. Consequently, any reduction in their taxable profits would result in a corresponding 33% tax loss on that reduced income.

The taxpayer asserted that this would result in a net tax loss for India, amounting to base erosion. Accordingly, the taxpayer argued that, in light of the provisions of Sections 92(3) and Section 92C(4) of the Act, the upward adjustment could not be sustained.

[7] ITA No.2390/Ahd/2018 with CO NO.20/Ahd/2022 and 1783/Ahd/2019

Mirror ALP

The taxpayer further argued that the principle of mirror ALP should be applied. It was emphasised that the same international transactions had been accepted by the tax officer in the hands of the AEs at the values recorded by the taxpayer.

Therefore, the taxpayer contended that since the transaction values were accepted for the Indian AEs, the tax officer should similarly accept these values in the hands of the taxpayer. Consequently, the taxpayer argued there was no basis for the tax officer to make any adjustment to the taxpayer's income.

Tribunal's ruling

In arriving at its decision, the Tribunal relied on the ruling of the Special Bench in the case of *Instrumentarium Corporation Ltd.*[8] and observed that the Act does not contain any provision requiring an adjustment to the income of the Indian AE as a consequence of an ALP adjustment in the hands of foreign taxpayer. The Tribunal held that there is no base erosion as a consequence of ALP adjustment in the income of non-residents in respect of transactions with the Indian AEs. The Tribunal further emphasised that a part of the Section must not be interpreted in isolation, without considering the impact of the other provisions within the same Section.

While addressing the principle of mirror ALP, the Tribunal referred to the ruling in the case of *Filtrex Technologies P. Limited*[9] and observed that the Revenue has the discretion to determine the total income based on the ALP under Section 92(1) of the Act for one party to the transaction when it would result in a tax base erosion. Conversely, the Revenue may choose not to apply the same in the assessment of the other party if there is no tax base erosion.

The Tribunal rejected the contentions of the taxpayer on Base erosion and Mirror ALP and upheld the upward adjustment in the hands of the taxpayer.

JMP Insights **–** *As per the current legislation, the tax consequences for one AE do not influence whether an adjustment can be made to another AE.*

While it may be ideal that where the income of the foreign and Indian AEs are both taxed in India, there should be some provision under which the assessment of taxpayer and the AE can be made simultaneously to avoid double taxation, currently, there is no provision to make adjustment to that income. However, the AE can possibly claim the benefit of a resolution in MAP proceedings under the respective DTAAs.

[8] TA No.1548 and 1549/Kol/2009

[9] IT(TP)A Nos. 469/Bang/2017

- **Capital gain from the sale of crypto currency, prior to 1 April 2022, is eligible for exemption under Section 54F**

    - Raunaq Prakash Jain v Income Tax Officer[10]

The taxpayer is an individual and a tax resident of India primarily having income from salary. During FY 2020-21, the taxpayer had sold crypto currencies/Virtual Digital Asset ('VDA') for INR 6.69 crore. These VDA were purchased in FY 2015-16 for INR 5.05 lac.

The taxpayer filed the return of income declaring a total income of INR 1.75 crore which included a capital gain of INR 1.66 crore from the sale of VDA. This amount of capital gain was computed after indexing the cost of acquisition of VDA of INR 5.75 lac. The taxpayer had purchased a house property and claimed an exemption under Section 54F of the Act against the capital gains from the sale of Bitcoin i.e. VDA.

The tax officer issued a notice to the taxpayer for availing the exemption under Section 54F of the Act.

The taxpayer referred to the definitions of 'capital asset' and 'transfer' under Sections 2(14) and 2(47) of the Act respectively. According to the definitions, a capital asset includes a property of any kind other than those specifically excluded. A transfer in relation to a capital asset includes sale, exchange or relinquishment or extinguishment of any right therein. The taxpayer cited relevant case laws supporting the contention that gains on the sale of VDA should be treated as capital gains. The tax officer did not agree with the taxpayer's contention. The tax officer issued an order disallowing the benefit claimed under Section 54F of the Act and reclassified the gain from the sale of VDA as Income from other sources.

The CIT(A) upheld the order passed by the tax officer.

Before the Tribunal, the taxpayer cited cases where the head of taxability of gains from VDA was considered as Capital Gains. The Taxpayer argued that the gain from the sale of VDA cannot be considered as Income from other sources merely for the reason that the taxpayer considered it to be capital gains and claimed a deduction under Section 54F of the Act. The taxpayer further referred to the SC decisions in the case of Vegetable Products Ltd[11] and Safari Retreats Pvt Ltd[12] which held that if there are multiple interpretations of the provisions of the tax law then an interpretation that is favourable to the taxpayer may be considered.

The tax officer contended that in VDA there is no asset-backing investments. According to the tax officer, the taxpayer holds a share in 'nothing' and has a right to sell that share in 'nothing'. Furthermore, there is no specific inclusion of VDA in the capital asset definition. Further, the amendment brought in the Act, defined VDA and made provisions specifically to tax such income irrespective of whether the VDA is a capital asset or not. Thus, such income cannot be taxed in any other head of income and shall be taxable as Income from other sources.

The question before the Tribunal was whether, before the amendment was brought with effect from 1 April 2022, could VDA be classified as a capital asset.

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[10] I.T.A NO. 01/Jodh/2024
[11] 88 ITR 192 (SC)
[12] Civil Appeal No.2948 of 2023 (GST)

The Tribunal held that on a plain reading of Section 2(14) of the Act it can be interpreted that all rights are property and thereby the taxpayer's right in VDA is considered as a capital asset. Thus, a gain on the sale of Bitcoin is a capital gain. Further, since the taxpayer has held the VDA for more than 3 years, the gain will be a long-term capital gain. The benefit under Section 54F of the Act is merely consequential to such classification. Thus, the benefit under Section 54F of the Act is correctly taken by the taxpayer.

JMP Insights – *The amendment merely establishes the mechanism to tax the profits arising from the sale of VDA. The amendment does not explicitly classify the head of Income for taxability of the sale of VDA.*

- **Depreciation on goodwill is allowed if it represents excess payment over the fair value of assets acquired in an amalgamation**

  - Dow Chemical International Private Ltd. vs DCIT 14(1)(2)[13]

Rohm and Haas Company, USA, along with all its subsidiaries, was acquired by Dow Chemicals, USA, on April 1, 2019. As part of the Dow Group's global legal entity rationalisation project, which aimed to streamline the number of legal entities and enhance operational synergies, it was proposed to merge Rohm and Haas (India) Pvt. Ltd. into Dow Chemical International Pvt. Ltd. (the taxpayer). The taxpayer was engaged in manufacturing and trading diversified chemicals and had filed its tax return for the assessment year 2016-17.

During the arising, the tax officer disallowed a depreciation amount of INR 16.80 crore on the goodwill from the amalgamation, which was claimed under Section 32(1)(ii) for a total of INR 67.52 crore. The tax officer disallowed the depreciation on goodwill stating that goodwill on amalgamation was only the balancing figure of the purchase consideration exceeding the value of net assets and the taxpayer failed to substantiate the nature of the goodwill acquired in the amalgamation.

The CIT(A) upheld the AO's decision. Being aggrieved, the taxpayer approached the Mumbai Tribunal.

Before the Tribunal, the taxpayer emphasised the key aspects of the Scheme of Amalgamation and the exchange ratio to demonstrate its legitimacy. The taxpayer accounted for the Scheme of Amalgamation as per the relevant Accounting Standard using the 'Purchase Method'. The goodwill recognised by the taxpayer in the process of amalgamation of the amalgamating company with itself falls within the ambit of the expression 'business or commercial rights of similar nature' under Section 32(1)(ii) of the Act. In this context, the taxpayer referred to the decision of the Hon'ble SC in the case of *Smifs Securities Ltd*[14].

The Revenue argued that, according to the provisions of Explanation 7 to Section 43(1) of the Act, when a capital asset is transferred from an amalgamating company to an amalgamated company, the actual cost of the transferred capital asset in the hands of the amalgamated company should be considered the same as it would have been if the amalgamating company had continued to hold the asset for its own business purposes. Further, reliance was also

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[13] ITA No. 3772/Mum. /2023
[14] SC 348 ITR 302/ 2012

placed upon the provisions of Explanation 2(b) to Section 43(6) of the Act which provide that the actual cost of the block of assets in the case of the amalgamated company shall be the Written Down Value of the block of assets in the case of the amalgamating company. Both the aforesaid provisions will have applicability in cases where the amalgamating company had already recorded the intangible assets in its books of account.

In arriving at its decision, the Tribunal relied on the ruling of the Hon'ble SC in the case of *Smifs Securities Ltd*. The Tribunal emphasised that since the Revenue accepted the depreciation of goodwill on amalgamation in the case of *Smifs Securities Ltd,* it cannot challenge a similar basis of computation without just cause.

The Tribunal observed that the reference to the amendment by the Finance Act, 2021 by the Revenue was not relevant as the amendment for disallowance of depreciation on goodwill was effective only from 1 April 2020 onwards.

Further, based on the facts and judicial pronouncements. the Tribunal has allowed the taxpayer's claim of depreciation on 'customer relationship' and 'distribution network' arising from the amalgamation under Section 32 of the Act.

JMP Insights – *Relying on the SC Ruling in the case of Smifs Securities Limited, corporates have been taking the view that goodwill of a business arising during amalgamation is a 'depreciable asset'. However, this ruling did not fully settle the dispute, as the SC did not provide detailed reasoning in its judgment.*

Following the SC ruling, several Tribunals and Courts allowed the claim of depreciation on goodwill; however, a few of Tribunals placed reliance on Section 43 and denied the claim of depreciation. Thus, the opinion of Courts/ Tribunal was divided on this issue.

In order to provide certainty, the Finance Act, 2021 clarified that depreciation on goodwill shall not be allowed. While the Act clearly mentioned that the amendment was applicable from 1 April 2020, the annexure to the Budget speech mentioned that the proposed amendment is a clarification on claim of depreciation on goodwill, which raised a doubt on the retrospective applicability of the amendment.

The decision reemphasises that depreciation on goodwill on amalgamation is available on the goodwill recorded in the books of account in accordance with the accounting standards. The decision is useful to support the claim of depreciation of goodwill on amalgamations for cases prior to 1 April 2020.

DID YOU KNOW?

Switzerland has withdrawn the benefit of the Most Favored Nation (MFN) clause under the India Switzerland DTAA, effective 1 January 2025. This follows the SC's ruling in the Nestle SA case, which held that the MFN clause is not directly applicable without a notification under Section 90 of the Act. The Court observed that MFN benefits only apply if the third country was an OECD member when the treaty was signed. While Switzerland had previously granted lower tax rates under the MFN clause, the lack of reciprocity from India has led to its withdrawal. Consequently, income accruing on or after 1 January 2025 will be taxed at rates specified in the DTAA, irrespective of the Protocol.

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.

We would like to take this opportunity to announce that JMP Advisors has recently been awarded **'Tax Expert of the Year in India – Leaders in Law - Annual 2024 Global awards'** for its outstanding services. We are proud to receive this accolade and endeavour to continue providing high quality services to our clients!

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