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 January 2024:

Income tax rulings

- **Taxable Permanent Establishment of a foreign company established through a Strategic Oversight Service Agreement**

  - Hyatt International-Southwest Asia Ltd. v ACIT (International Taxation)[1]

Hyatt International-Southwest Asia Ltd is a company incorporated in Dubai, United Arab Emirates (UAE). The taxpayer is a tax resident of UAE as per the India-UAE Double Taxation Avoidance Agreement (DTAA). The taxpayer had entered into a Strategic Oversight Services Agreement ('SOSA') with Asian Hotels Limited, India ('AHL') for hotels in Delhi and Mumbai. Under the SOSA, the taxpayer agreed to provide strategic planning services and know-how to AHL. The taxpayer had filed a Return of income ('ROI') in India for FY 2008-09 declaring NIL income and claimed a refund of INR 8,799,091.

The Tax Officer concluded that the taxpayer had a Permanent Establishment (PE) in India under DTAA. Further, receipts from a part of the activities were taxed as royalties at 10% under DTAA. The Dispute Resolution Panel confirmed the order of the Tax Officer. The taxpayer filed an appeal with the Delhi Tribunal. The Tribunal examined the terms of SOSA and upheld the view of the Tax Officer.

The taxpayer further appealed to the Delhi High Court (HC). The HC, after a detailed study of the SOSA and Hotel Operation Services Agreement (HOSA) held that the revenue's contention of taxing the receipts as royalties cannot be accepted as the written information and technical know-how were only incidental and ancillary to the services provided. Mere access to these for furtherance of services cannot lead to the conclusion that the receipts are royalties as per DTAA. The fees received by the taxpayer are not Fees for Technical Services but in consideration for a wide range of services. The taxpayer is in the business of providing such services for the management of hotels and hence, the HC held that the income is required to be classified as income from business.

Based on the SOSA, the HC observed that the taxpayer was required to render services in the area of strategic planning, maintaining Hyatt Operating Standards, handling of Operating Bank Account(s) for operating the Hotel, recruiting, assigning its employees temporarily to discharge the functions of full-time members of the Hotel executive staff. The taxpayer had an overarching role in the management of the Hotel at the policy level overseeing its implementation and ensuring it is operated commensurate with Hyatt Operating Standards. Hyatt India was also required to implement the strategic policies as set out by the taxpayer.

[1] ITA 216/2020 and other connected matters

The taxpayer exercised control in respect of all activities at the Hotel by framing the policies to be followed in respect of every activity, and by further exercising control to ensure that the said policies are duly implemented by Hyatt India. Hyatt India was placed in control of the day to day operations of the Hotel in terms of Hotel Operation Services Agreement (HOSA).

Further, the taxpayer had pervasive control over the hotel as it entered into a SOSA with AHL. Parallel AHL entered into a HOSA with the Hyatt India that required to follow the policies laid down by the taxpayer for operations of the hotel and ensure the policies were implemented without any recourse to the taxpayer. Thus, the taxpayer had extensive control on the operations and management of the hotels of AHL which constituted a fixed place of business forming a PE in India as per Article 5(1) of the DTAA.

While on the question of attribution of profits to PE due to losses at an entity level, the matter has been referred to a Larger Bench by the HC.

JMP Insights - *This judgment has significant implications for multinational companies operating through service agreements in India, expanding the definition of a Permanent Establishment (PE). It also outlines the importance of agreements which include strategic plans, policies, processes, guidelines, etc, which play a vital role in determining whether it constitutes PE in India. This decision is an important development, which could affect many companies operating through service contracts.*

- **Loss on reduction of shares is a capital loss and is eligible for long-term capital loss**

  - M/s. Tata Sons Limited vs Commissioner of Income Tax[2]

The taxpayer had purchased equity shares of Tata Tele-Services Company Ltd (TTSL) at various points in time. TTSL is an Indian company engaged in the business of telecom services. Prior to FY 2008-09, TTSL had incurred substantial losses in its business. Due to such losses, a Scheme of Arrangement and Restructuring was entered into between TTSL and its shareholders, which was approved by the Hon'ble Delhi High Court. The said arrangement resulted in a reduction of share capital cum cancellation of shares thereby reducing the taxpayer's share to half. No consideration was paid by TTSL to the shareholders in lieu of the cancelled shares.

The taxpayer had filed its Return of Income (ROI) for FY 2008-09 and claimed Long Term Capital Loss (LTCL) of INR 20,470 million (USD ~ 246 million) on the cancelled shares due to the extinguishment of rights in shares. The taxpayer's case was selected for assessment and the Tax Officer had allowed the LTCL. However, the Principal Commissioner of Income Tax (PCIT) issued notice under section 263 of the Act to revise the assessment order passed by the Tax Officer. The PCIT relied on the ruling of Mumbai Tribunal in the case of Bennett Coleman and Co. Ltd[3] and argued that the computation provision of section 48 did not apply in the case of capital reduction, leading to the disallowance of LTCL.

The taxpayer filed an appeal before the Mumbai Tribunal challenging the order passed by the PCIT. The Tribunal ruled that there is a capital loss to the taxpayer on account of reduction of

[2] ITA No. 3468/Mum/2016
[3] ITA No. 12/ITR(T)/97/Mum/2011

capital invested. The Tribunal relied on the ruling of the Gujarat High Court in the case of Jaykrishna Harivallabhdas[4] wherein it was held that even if the sale consideration is 'Nil' then also computation of capital gain can be made. It also relied on the decision of the Hon'ble Supreme Court in the case of CIT vs. Mrs. Grace Collis And Others[5] wherein extinguishment of rights in a share will amount to transfer as per Section 2(47) of the Act.

Based on the principle laid down in the above decisions, the Tribunal emphasized that the reduction of capital constitutes an extinguishment of rights, amounting to a transfer under section 2(47) of the Act. Therefore, it was held that the taxpayer has not received any consideration on reduction of capital and its investment has reduced resulting into a capital loss. Thus, the Tribunal held that while computing the capital gain, capital loss has to be allowed or set-off against the other capital gain.

JMP Insights – *The above judgement primarily focuses on the complex aspects of share capital reduction, capital loss claims, and the associated legal and financial ramifications within the framework of the Scheme of Arrangement and Restructuring. It highlights that in cases of capital reduction wherein no consideration is paid to the shareholder, the extinguishment of rights in shares results in capital loss.*

- **Self-employment considered as employment for the purposes of determining residential status**

  - Assistant Commissioner of Income Tax v Nishant Kanodia[6]

The taxpayer is an individual, Indian citizen. He went to Mauritius in August 2012 as an investor in a company named Firstland Holdings Ltd., in Mauritius fully owned by him. A search and seizure was conducted in the case of Matix (Nishant Kanodia) Group. In response to notice under section 153A of the Income-tax Act, 1961 ('the Act), the taxpayer filed a Return of Income (ROI) claiming residential status as 'Non Resident' considering his stay in India was 176 days during FY 2012-13 and offered to tax only income sourced from India and not his global income.

During the course of assessment proceedings, the Tax Officer contended that the taxpayer left India as an "Investor" on a business visa, making him a resident for Indian tax purposes and added offshore income of INR 281,464,628 (equivalent to USD 5,175,000) to the total income. The taxpayer argued that he left India for employment in Mauritius and therefore, qualified as a non-resident under Explanation 1(a) to section 6(1)(c) of the Act.

The taxpayer submitted Appointment letter which laid down his role and responsibilities as Strategist - Global Investment alongwith payslips to support his argument that he was in employment with Firstland Holdings Ltd., Mauritius. He had filed ROI with the Mauritius tax authorities for Calendar Year 2012 and 2013 declaring total income and tax deduction on the Mauritius income.

[4] 231 ITR 108 (Gujarat HC)
[5] 248 ITR 323 (SC)
[6] ITA No. 2155/Mum/2023 (Mumbai Tribunal)

The Commissioner of Income Tax (Appeals) agreed with the taxpayer’s view considering the purpose of his stay in Mauritius for employment. The Revenue filed an appeal against this decision.

The Mumbai Tribunal examined the case, emphasizing section 6(1) of the Act, which determines an individual's residential status. The Tribunal relied on the ruling of Kerala High Court in the case of O. Abdul Razak[7] which discussed the whether the term employment outside India includes doing Business by the taxpayer. The Kerala High Court has considered the CBDT Circular[8] wherein it was provided that no technical meaning can be assigned to the word employment used in the explanation and thus, going abroad for employment also includes for self-employment. It also held that the words employment shall not include going outside India for leisure, medical treatment or studies or the like.

Based on the above, the Mumbai Tribunal held that the taxpayer had rightly claimed the residential status as Non-Resident and dismissed the appeal filed by the Revenue.

JMP Insights – *This case expands the definition of employment outside India for determining residential status of an individual in India for tax purposes. Individuals involved in self-employment ventures abroad may benefit from this broader interpretation of the law.*

- **Liaison Office constitutes publisher's PE for active role in printing, deciding cost, titles & margin**

    - Springer Verlag GmbH vs Deputy Commissioner of Income Tax[9]

The taxpayer, a German company, is engaged in publishing scientific, technical, medical books and journals. Upon obtaining approval from Reserve Bank of India (RBI), it opened a Liaison Office (LO) in India to carry out liaison activity and act as a communication channel between the Head Office (HO) and clients in India.

For AY 1999-2000 to 2001-02, the company did not file returns, leading to a survey in FY 2001-02. The company submitted a ‘Nil’ return of income contending that the income from sale of books is not taxable in India in the absence of a Permanent Establishment (PE), and the LO, not engaged in any commercial activities, shouldn't be considered a PE.

The Tax Officer held that the LO is involved in activities which are beyond preparatory and auxiliary services, including working out the cost components, determining margin to be earned and sending price of the books to the HO for approval. In most of the cases, the price and margin fixed by the LO was accepted by the HO. Thus, the Tax Officer concluded that the LO constitutes a PE in India as per Article 5 of the India Germany DTAA (DTAA) and attributed 15% of the total sales in India as income of the LO.

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[7] 337 ITR 350 (Kerala High Court)

[8] CBDT Circular no. 346 dated 30/06/1982

[9] ITA Nos. 643 to 645/2005 & 3660/Del/2009 (Delhi Tribunal)

The taxpayer filed an appeal before Commissioner of Income-tax, Appeals [CIT(A)] challenging the order passed by the Tax Officer. The CIT(A) directed the Tax Officer to compute income as per Rule 10 and granted partial relief on attribution.

The Tribunal found substantial evidence linking the LO's activities to the HO's substantial income from book sales in India. It observed that though the LO may not be involved in direct sales but the facts reveal that the LO's activities with regard to printing of books in India is emphasizing their broader commercial scope and not merely preparatory and auxiliary. The Tribunal dismissed the reliance on the coordinate bench ruling in case of Nagase & Co[10] where the role of the LO was limited to preparatory and auxiliary activities. In view of the above, the Tribunal held that the LO constitutes a PE in India due to the nature of activities that were carried out by the LO.

Regarding attribution, the Tribunal concluded that no part of the income from sale of imported journals and books could be attributed to PE, as the LO was not involved. Further, the Tribunal observed that the taxpayer had incorporated an Indian subsidiary during 2002, that was involved in carrying out similar activities as rendered by the LO. The subsidiary was remunerated by the taxpayer with a mark up of 11% of the total sales.

Based on the above, the Tribunal directed the Tax Officer to allow claims for expenses related to Indian sales and other deductions, attributing 11% profit on 80% of total sales due to the significant role played in the sales made in India.

JMP Insights - *The above judgement presents a comprehensive overview on the role played in carrying out the commercial activities by the LO constituting a Permanent Establishment under the DTAA.*

It is important to note that a LO can be opened in India after obtaining the RBI approval. As per RBI, a LO cannot undertake any trading, commercial or industrial activity without prior permission. By undertaking such activity without RBI permission, it leads to violation of the conditions laid down by RBI and also the provisions of the Foreign Exchange Management Act, 1999.

[10] 96 Taxmann.com 504 (2018) (Mumbai Tribunal)

DID YOU KNOW?

In the Interim Budget, it is proposed to waive outstanding tax demands up to INR 25,000 (~USD 300) for FYs up to FY 2009-10 and up to INR 10,000 (~USD 120) for FYs 2010-11 to 2014-15. However, a taxpayer with outstanding demands for multiple years can seek the withdrawal only if the total demand is capped at INR 100,000 (~USD 1,200).

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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