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 February 2024:

Income tax rulings

- **Discounts offered by Telecom companies to franchisee/distributors not in the nature of commission**

  - Bharti Cellular Limited v ACIT[1]

The present ruling deals with a common issue in the case of appeals filed by the Revenue and the taxpayers who are mobile phone service providers. The taxpayer, a telecom company had entered into franchise or distribution agreements with several parties for sale of start-up kits which include SIM cards, recharge vouchers, etc. As per the agreement, the telecom company provides the start-up kit to the distributors at a discounted price. The distributors are allowed to sell the start-up kit at any price not exceeding the printed price of the kit. The tax officers are of the opinion that the difference between the sale price and the discounted price is in the nature of commission and therefore, liable to TDS under Section 194H of the Income-tax Act, 1961 ('the Act').

On appeal, the Honourable Supreme Court ('SC') has analysed the following:

i. Whether a Principal-Agent relationship exists between the telecom company and the distributors
ii. Whether there is a direct or indirect payment of commission from the telecom company to the distributor

i. <u>Principal-Agent relationship</u>

The SC held that the law of agency is technical and whether a relationship between parties is that of a principal-agent should be answered as per the provisions under the Indian Contract Act, 1872. Further, the SC laid down certain factors to be considered to examine whether the relationship is that of a principal and agent, which are as follows:

a. an agent is vested with the legal power to alter his principal's legal relationship with a third party;
b. a certain degree of control is exercised by the principal over the agent;
c. the task entrusted by the principal to the agent should result in a fiduciary relationship;
d. the agent should be liable to render its accounts to the principal.

[1] Civil Appeal No 7257 of 2011 & Ors (SC)

Revenue contended that the Sim Cards were not the property of the distributor, and no right, title or interest was transferred to the distributor. The Honourable SC held that non transfer of title to the distributor was as per the mandate and requirement of the license issued by the Department of Telecommunications. The contractual obligations of the distributor do not reflect a fiduciary character of the relationship, or the business being done on the principal's account. The distributors buy the goods on their own account and sell them in their territory. Therefore, the SC held the relationship between the telecom company and the distributor to be as an independent contractor and not as principal-agent.

ii. Payment of commission by the Telecom company

Revenue referred to the expression 'payment received or receivable directly or indirectly by a person acting on behalf of the other person' in section 194H and argued that even if the distributor receives payment in the form of income from the customer, the telecom company will be required to deduct tax at source under section 194H.

The SC held that the income of the distributor is the difference between the sales price and discounted price paid to the distributor when the kit is sold to the end customers. The Telecom company does not at any time credit the income by way of commission or brokerage to the distributor. Further, the expression 'direct or indirect' used in this section is meant to ensure 'person responsible to pay' cannot dodge the obligation to deduct tax. It cannot be extended to business transactions where the telecom company is not the person responsible for crediting the income. Further, the telecom companies are not aware at the price at which the distributors sell the kit to deduct tax on the differential amount.

Reliance by the Revenue on the decision in the case of Singapore Airlines Limited[2] was distinguished by the SC as the question as to whether there was a relationship of a principal, and an agent was not in dispute in that case since the airline was already deducting the tax on the standard commission.

JMP Insights – *This ruling puts to rest a long standing controversy in the telecom industry and also sets a precedent for companies with similar business models involving distributors or franchises. Understanding how the court categorized the taxpayer's case can help similar companies assess their own withholding tax obligations.*

The ruling also highlights the importance of clear and well-drafted agreements between entities and their distributors/franchises. The agreements should explicitly define the nature of the relationship, pricing structure, and responsibilities of both parties. Clear documentation can strengthen a taxpayer's position in case of future disputes with tax authorities.

[2] [2022] 449 ITR 203 (SC)

- **HC affirms tax deductibility of payments to non-residents, providing benefit under Non-discrimination clause of the DTAA and holding that chargeability to tax is paramount for applicability of withholding tax**

  - The Commissioner of Income-tax-II v. Mitsubishi Corporation India P. Ltd v.[3]

During FY 2005-2006, the taxpayer, an Indian company, had entered into several international transactions with seven group companies (four based in Japan and one each in USA, Thailand and Singapore) for the purchase of goods and to provide intra-group services.

The tax officer contended that since one of the group companies (Metal One – Japan) had a Liaison Office (‘LO’) in India, it constituted a Permanent Establishment (‘PE’) in India. Further, the business model of the remaining group companies being identical, the other six group companies also have a PE in India. As a result, the tax officer made a disallowance under Section 40(a)(i) of the Act for failure to withhold tax under Section 195(1) of the Act on purchase of goods.

The disallowance was upheld by the Dispute Resolution Panel (‘DRP’) but was overturned by the Tribunal. The tax officer filed an appeal with the Delhi High Court (‘HC’) against the decision of the Tribunal. The ruling of the HC was a split decision wherein both the judges had divergent views and hence, the matter was referred to a Third judge.

In connection with the payments made to the group companies in Japan and USA, the taxpayer invoked Article 24(3) and Article 26(3) of India-Japan Double Tax Avoidance Agreement (‘DTAA’) and India-USA DTAA respectively and argued that the withholding tax provisions under section 40(a)(i) of the Act for non-residents are not at par with those under section 40(a)(ia) of the Act for residents. The HC observed that the provisions of section 40(a) underwent major changes vide Finance Act, 2004 and Finance Act, 2014. The amendments made by Finance Act, 2004 covered only certain payments to residents and payments for purchase of goods were not included. The amendment to cover all payments to residents thereby removing the discrimination was introduced only with effect from 1 April 2014. Therefore, the third Judge ruled that for the year under question i.e. FY 2005-06, the non-discrimination clauses of the India – Japan and India – USA DTAA would apply to the payments for purchase of goods made to the five entities based in Japan and USA.

In respect of the remittance made to the remaining two group companies based in Thailand and Singapore, the third Judge held that these group companies did not have a PE in India and thus the business income would not be taxable in India. Accordingly, there is no obligation to withhold tax and hence, there cannot be any disallowance under section 40(a)(i) of the Act.

JMP Insights - *This ruling provides guidance on the applicability of non-discrimination clause under the treaty in respect of disallowance of section 40(a)(i) of the Act. It highlights the importance of international agreements in resolving taxation disputes and ensuring fair treatment for taxpayers having cross-border transactions.*

[3] ITA No.180/2014

- **Allowance of benefit of forex fluctuation as well as cost inflation index in computation of capital gains amounts to double benefit to taxpayer, not in accordance with the law**

  - ICICI Bank Ltd v. The Deputy Commissioner of Income-tax- 2(3)(1)[4]

The taxpayer[5], an Indian bank, claimed long term capital loss of INR 9,967.50 million in its return of Income ('ROI') filed for FY 2014-2015. The taxpayer had earlier remitted Indian Rupees ('INR') to acquire shares of its overseas subsidiaries based in UK, Canada and Russia. These shares were denominated in Foreign Currency ('FCY'). The shares pertaining to subsidiaries in Canada and Russia were sold to non-residents outside India. Further, the UK subsidiary bought back its shares and the taxpayer was offered a buy back price.

The taxpayer contended that since shares were acquired in subsidiaries abroad, it constitutes assets acquired in FCY and hence, the benefit of computing capital gains in accordance with Rule 115 of the Income-tax Rules, 1962 would be available. Thus, while computing the capital gains on the shares sold/extinguished, the taxpayer converted the acquisition cost of the shares in INR to FCY, applied Cost Inflation Index ('CII') on this FCY converted amount, and compared this with the sale consideration received in FCY. As a result, there was a capital loss on transfer of shares of all three subsidiaries which was converted back to INR by the taxpayer and claimed in its ROI.

During scrutiny, the tax officer enquired about the said issue and based on the explanation from the taxpayer, the capital loss was allowed to the taxpayer.

The Principal Commissioner of Income Tax ('PCIT') issued a revisionary order under section 263 of the Act, considering the allowance of capital loss of INR 9,967.50 million as irregular and contending that taxpayer has been allowed an excess capital loss of INR 5,026.20 million which is prejudicial to the interest of the Revenue.

On appeal, the Mumbai Income Tax Appellate Tribunal ('Tribunal') observed that the taxpayer has not invested in FCY but in INR. The Tribunal also affirmed the PCIT's findings that CII is with reference to the Indian economy and it is to be applied only on the INR amount of the asset and not on its equivalent FCY amount. Thus, the Tribunal held that the taxpayer has got the dual benefit of foreign exchange fluctuation as well as CII, which is not in accordance with the Act. Accordingly, the excess claim was rejected.

JMP Insights – *As per clause (a) of Explanation 2 to section 263 of the Act, an order passed by the tax officer shall be deemed to be prejudicial to the interests of the Revenue only when it is passed without making inquiries or verifications which should have been made. It is unclear in this ruling as to how the conditions laid down in the explanation was satisfied as the taxpayer appears to have made detailed submission on the issue under appeal.*

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[4] ITA No.738/Mum/2021

[5] The ruling includes other issues such as the allowance of bad debts and provision for special reserves, depreciation on investments in subsidiaries and transfer pricing adjustment. However, in this newsflash we have discussed only the critical issue of disallowance of long term capital loss.

Further, it is to be noted that the appeal has been filed against the directions under section 263 of the Act and not against the order of the tax officer passed to give effect to the directions issued under section 263 of the Act.

- **Consideration for software embedded in hardware and installed in cars not taxable as royalty**

  - SAIC Motor Overseas Intelligent Mobility Technology Co Ltd v ACIT (International transaction)[6]

The taxpayer, a tax resident of China entered into a license agreement with MG Motors India Private Limited ('MG') for supply of its automobile related software which is incorporated into a separate hardware and installed in cars in India. The taxpayer has filed a NIL Return of Income for the FY 2019-2020 considering the receipts from sale of software as business income.

The tax officer was of the view that taxpayer has imparted information concerning industrial, commercial or scientific experience and proceeded to assess such income as royalty and taxable in India under the Act as well as under the India-China DTAA.

After analysing the terms of the License agreement and End User License Agreement ('EULA'), the Tribunal inferred that the objective was to provide a standard/off the shelf software to MG, where the software is incorporated into a separate hardware which is then installed in the car, MG only acts as a reseller of such software. This can be evidenced from the License agreement which states that the taxpayer is granted a non-transferable, non-exclusive and non-assignable license to incorporate software into the vehicles. The EULA is signed between the taxpayer and the end user of vehicles to restrict access to rights in the license.

The term *"imparting of information concerning industrial, commercial or scientific experience"* should be interpreted in light of various judicial precedents and commentaries, which generally alludes to the concept of 'know-how'. From the factual and legal scenario, the Tribunal held that the taxpayer does not provide any know-how to MG. Reliance has been placed on the SC ruling in the case of Engineering Analysis Centre of Excellence Pvt Ltd[7], wherein, supply of non-transferable and non-exclusive license to software was classified as business income and held as not being taxable in absence of a PE in India.

JMP Insights – *There are various rulings including a Supreme Court ruling relied by the Tribunal, wherein a distinction between transfer of a copyright and transfer of a copyrighted article have been discussed. Since the term 'copyright' has not been defined in the Act or under and the DTAA, guidance must be taken from the Copyright Act, 1975.*

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[6] ITA No 2194/Del/2023 (Delhi Tribunal)

[7] 432 ITR 471

Transfer of a copyright generally includes transfer of partial or all rights to the recipient for the purpose of commercial exploitation. In the above scenario, the taxpayer only acts as a reseller of the software and the rights in the software continue to remain with the taxpayer.

DID YOU KNOW?

The Mauritius Cabinet has agreed to the signing of a Protocol to amend the Double Taxation Avoidance Convention between Mauritius and India in order to comply with the Base Erosion and Profit Shifting minimum standards of the Organisation for Economic Co-operation and Development.

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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