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 March 2024:

Income tax rulings

- **Non-constitution of Fixed PE or Dependent agent PE in the absence of control and dependence**

  - CIT vs ESPN Star Sports Mauritius S.N.C ET Compagnie[1]

The taxpayer is a tax resident of Mauritius. The taxpayer had entered into distribution agreements with its Indian subsidiary companies, ESPN Star Sports and ESPN Software India Private Limited ('Indian Distributors') for distribution of Star Sports and ESPN channels in India. During scrutiny proceedings, the tax officer contended the following:

- The taxpayer has a fixed place Permanent Establishment ('PE') in India and hence, 70% of the gross distribution revenue was liable to be treated as the taxpayer's business income in India.

- The taxpayer had complete control over sale of Indian Distributors, bore commercial risk on behalf of the Indian Distributors, and hence the Indian Distributors constituted a Dependent Agent PE ('DAPE') of the taxpayer.

- The subscription and distribution revenues generated under the contracts are taxable as royalty.

The matter was decided in favour of the taxpayer by the Delhi Income Tax Appellate Tribunal ('Tribunal'), which observed that Revenue was not able to establish that the taxpayer was given any kind of control over the business of the Indian Distributors or that the premises of the Indian Distributors were at the disposal of the taxpayer or that the taxpayer carries on any kind of business through the premises of the Indian Distributors. The Tribunal placed reliance on the ruling of the Supreme Court in the case of E-Funds IT Solutions Inc.[2] wherein it was held that the burden is on the Revenue to establish the existence of fixed place PE. It was highlighted that a 100% subsidiary carrying on business in India does not by itself mean that the holding company would have a PE in India.

Further, the Tribunal emphasized on the clauses from the agreement which clearly stated that the transaction is on principal-to-principal basis. It was clear from the agreement that there is no privity of contract between the Indian Distributors and the cable operators or end customers in India. The Indian Distributor has independently entered into contracts with cable operators

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[1] ITA No. 333, 336, 382, 344, 380, 381 & 773/2023

[2] (2018) 13 SCC 294

for distribution of the channels in India and is responsible for breach of contract with cable operators. The Tribunal further observed that factors such as acquisition of airtime and sale of decoders clearly indicate that ESPN India has its independent business and is not a dependent agent of the taxpayer.

On appeal by the Revenue against the order of the Delhi Tribunal, the Delhi High Court upheld the observations of the Tribunal and held that the taxpayer does not constitute a fixed place PE or DAPE in India. Further, the High Court held that there is no royalty arising from distribution since there is no consideration for use or right to use of any copyright, placing reliance on the judgment of the Supreme Court in the case of Engineering Analysis Centre of Excellence Private Limited[3].

JMP Insights – *This ruling emphasizes the importance of the terms executed in contracts that can serve as evidence to support arguments in case of litigation. It is essential that the roles and responsibilities of each entity should be clearly established through contractual terms so as not to leave any ambiguity.*

- **Mere difference in rates of tax not to be a bar in permitting set off of short term capital loss against short term capital gains**

  - JS Capital LLC v ACIT (International taxation)[4]

The taxpayer is a non-resident entity registered as a Foreign Portfolio Investor ('FPI') with the Securities and Exchange Board of India ('SEBI') and engaged in investment activity in Indian capital markets. In the ROI filed for FY 2019-20, the taxpayer had set off Short Term Capital Loss ('STCL') incurred on the sale of listed equity shares taxable at the rate of 15% against Short Term Capital Gains ('STCG') earned on the settlement of derivatives taxable at the rate of 30%.
The taxpayer's return was selected for scrutiny and in the scrutiny order, it was held that the STCL on equity shares taxable at 15% and the STCG earned on derivatives taxable at 30% are not under a 'similar computation' as provided in section 70(2) of the Act. Hence, the taxpayer is not eligible to set off the STCL on equity shares taxable at 15% against the STCG earned on derivatives taxable at 30%.

On appeal, the Tribunal upheld the approach adopted by the taxpayer and held that taxpayer is eligible to set off STCL on equity shares against the STCG on derivatives. In arriving at this conclusion, the Tribunal cited the ruling of the jurisdictional Mumbai Tribunal in the case of GSB Capital Markets Ltd[5] and held that the brought forward loss from the transfer of short-term capital assets could be set off against capital gains in respect of any other short term or long term capital asset. Similarly, the Tribunal drew attention to various rulings of the Mumbai Tribunal wherein it has been highlighted that Section 70(2) of the Act allows taxpayers to set off STCL against STCG under a similar computation, irrespective of whether the transactions are categorized as off market or on market transactions. Further, in the said rulings, it was

[3] (2022) 3 SCC 321
[4] ITA No 3396/M/2023 (Mumbai ITAT)
[5] ITA No 307/M/2014 (Mumbai ITAT)

held that merely because the transactions are taxed at different tax rates, it cannot be concluded that the incomes from these transactions do not arise under a similar computation.

Based on the aforesaid precedents, the Tribunal held that the taxpayer is entitled to set off the STCL on equity shares against the STCG earned on derivatives irrespective of the difference in tax rates, in accordance with the provisions of Section 70(2) of the Act.

JMP Insights – *This ruling clarifies that taxpayers can set off STCL from one capital asset against STCG from another, even if the assets are taxable at different tax rates. Taxpayers have the flexibility to choose the order of set-off that minimizes their tax liability. Further, the computation of capital gains on all types of capital assets is governed under the same provisions of the Act and the Act does not mandate a specific order for setting off STCG/STCL. The difference in tax rates on capital gains cannot be the basis to conclude that the computation of capital gains is not being done under a similar computation.*

- **Physical presence necessary to constitute a Service PE in India in the absence of concept of Virtual PE in the India – Singapore DTAA**

  - Clifford Chance Pte Ltd v ACIT[6]

The taxpayer is a tax resident of Singapore and has filed its Return of Income ('ROI') in India for FY 2019-20 and FY 2020-21, declaring NIL income. The taxpayer had entered into legal consultancy contracts with various Indian clients. Some advisory services under the said contracts were rendered remotely from outside India and in some instances, two employees travelled to India for providing the services. The total stay of the two employees amounted to 120 days in India in FY 2019-20 while during FY 2020-21, none of the employees had visited India.

During scrutiny proceedings, the tax officer made an addition to the taxpayer's income to the extent of the gross receipts earned from Indian contracts. The tax officer contended that the taxpayer constituted a Virtual PE in India for both FYs based on the aggregate duration of services rendered in India and remotely from outside India. The tax officer relied on the concept of Virtual PE mentioned in the OECD Interim Report 2018 ('Report') under the OECD/G20 BEPS project 'Tax challenges arising from Digitalisation' which favours the view expressed by some countries that physical presence is no longer relevant for the application of service PE in a digitized economy.

The Delhi Tribunal observed that in order to constitute a Service PE in India, actual performance of services by employees with their physical presence in India is essential. The Tribunal further observed that the provisions relating to Virtual service PE do not exist under the India-Singapore DTAA ('DTAA'). The Tribunal highlighted the fact that the concept of Virtual Service PE has not been endorsed by India unlike Saudi Arabia. Further, the Tribunal noted that the Report itself mentions that in the absence of any amendments to the DTAA provisions, the Virtual Service PE measures can be challenged by the taxpayers before the courts.

[6] ITA No. 2681 & 3377/Del/2023

In computing the number of days of services rendered by the taxpayer's employees in India for FY 2019-20, the Tribunal relied on the ruling of the Mumbai Tribunal in the case of Linklaters LLP[7], wherein it was held that holidays have to be excluded in computing the threshold limit. The Tribunal held that out of the total stay of 120 days of the two employees, the period of vacation amounting to 36 days should be excluded. Further, the computation of the threshold limit should not be based on man days by including common days of more than one employee. Hence, the common days amounting to 5 days should also be excluded. In addition, a period of 35 days relating to business development activities should also be excluded since it relates to non-revenue generating activity. Thus, the balance days would be 44 days which is lower than the threshold of 90 days provided in Article 5(6)(a) of the DTAA for the constitution of a Service PE in India. Hence, no Service PE would be constituted for FY 2019-20. Since no employees were physically present in India during FY 2020-21, no Service PE was constituted in that year as well.

Thus, the Tribunal ruled in favour of the taxpayer holding that in the absence of a Service PE in India during FY 2019-20 and FY 2020-21, the receipts which are in the nature of business profits of the taxpayer and are not taxable in India.

JMP Insights – *This ruling marks a significant development in international tax law by emphasizing that reliance cannot be placed on international tax developments unless the relevant provisions have been codified in the law/DTAAs. The provisions of the law as they exist in the relevant DTAA should be analyzed and applied accordingly. Further, it is also important to take note of India's stance on specific international tax developments.*

This judgement has also laid down some clear guidelines to compute the stay threshold for Service PE. However, it remains debatable whether business development days can be excluded in computing the stay threshold.

- **Establishing Beneficial Ownership in Cross-Border Transactions**

  - DCIT, International Taxation Circle 2(2), Chennai v. M/s World Part Limited [8]

The taxpayer, an entity incorporated in Cyprus and a tax resident of Cyprus, received capital funds from various shareholders and deployed the funds as investment in Fully and Compulsorily Convertible Debentures ('FCCDs') of a construction company in India.

The taxpayer was subject to reassessment proceedings for FY 2012-13. During the said year, the taxpayer had received interest income on FCCDs which was offered to tax at the rate of 10% in accordance with Article 11 of the India-Cyprus DTAA. Out of the said interest income, the taxpayer paid back the surplus funds to its shareholders to reduce share capital.

The tax officer contended that the taxpayer merely acted as a conduit to facilitate investment of its shareholders in FCCDs and that the taxpayer has been used by the shareholders for the purpose of obtaining unjustified tax benefits, specifically of the rate of tax on interest income,

[7] ITA No. 3250 & 3785/Mum/2006
[8] I.T.A. Nos.740 & 741/Chny/2023

based on the DTAA. The tax officer thus observed that the taxpayer is not a beneficial owner of interest income earned from FCCDs and held that the said interest income was subject to be tax at Maximum Marginal Rate ('MMR') of 40% as other income under the Act.

On appeal, the Commissioner of Income-tax (Appeals) held that the taxpayer was only the legal owner of interest and therefore, the applicable rate of tax would be 20% as per section 115A of the Income-tax Act, 1961 ('the Act').

On further appeal, the Chennai Tribunal observed that the said issue was also subject matter of an appeal for FY 2013-14 wherein it observed that the term beneficial owner needs to be understood in the context in which it was stated internationally since this term is neither defined under the Act nor under the DTAA. The Tribunal further observed that this term is used to mean the entity which is the legal owner of a property and has the dominion and control over the property. A reference was made to the OECD Commentary (2015) which states that the recipient of a passive income is not the beneficial owner, when the recipient's right to use and enjoy the passive income is constrained by a contractual or legal obligation to pass on the payment received to another person.

The Tribunal rejected the tax officer's findings and observed that the mere fact that the investment was funded out of interest free loans from shareholders and share capital does not affect the taxpayer's status as beneficial owner of the interest income since the entire interest income was the sole property of the taxpayer and was at its disposal. Further, the transfer of the surplus funds to the shareholders for reduction of share capital does not imply that the entire interest income has been transferred back to the shareholders to allege that the taxpayer is not the beneficial owner of the interest income. When the taxpayer is not in need of any funds, it is free to pay back to its shareholders to reduce share capital.

Relying on the Tribunal's ruling for FY 2013-14, it was held in the instant case that the taxpayer has absolute control over interest income and the said income was at the disposal of the taxpayer. Further, since the tax officer failed to prove otherwise, the taxpayer was held to be the beneficial owner of the interest on FCCDs and entitled to the benefit of the lower rate under Article 11 of India-Cyprus DTAA.

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This ruling sets a precedent for clarifying the criteria for beneficial ownership in complex cross-border transactions, highlighting the importance of control and economic substance over income. It provides valuable insights for entities engaging in similar transactions, emphasizing the need to establish clear ownership structures to avail of DTAA benefits and mitigate tax risks associated with conduit entity allegations.

DID YOU KNOW?

The Central Government invoked the Most Favoured Nation ('MFN') clause under the India-Spain DTAA vide Notification dated 19 March 2024. As per the said notification, the maximum rate of tax on all types of Royalties and Fees for technical services shall be 10% instead of the existing rate of –

- 10% for royalties relating to the use of or right to use industrial, scientific or commercial equipment and
- 20% for fees for technical services and other royalties with effect from FY 2023-24.

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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