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 November 2022:

Income tax rulings

- **Revaluation of capital assets credited to partners' capital to be considered as 'Taxable Transfer'**

  - CIT v. M/s. Mansukh Dyeing and Printing Mills[1]

During the Financial Year ('FY') 1992-93, the taxpayer, a partnership firm, admitted four new partners to the partnership firm. Shortly thereafter, the taxpayer revalued land and building (held as capital assets) and credited gains on revaluation of capital assets to the capital accounts of all the partners in their profit sharing ratio. Subsequently, two of the existing partners withdrew part of their capital from the partnership firm.

The Hon'ble Supreme Court ('SC') held that revaluation of capital assets of a partnership firm and credit of profits to partners' capital accounts in their profit - sharing ratio is a deemed transfer of such capital assets by the partnership firm to the partners under section 45(4) of the Income-tax Act, 1961 ('the Act') as it stood after amendment in the FY 1987-88.

Section 45(4) of the Act stated that, with effect from FY 1987-88, profits or gains arising from the transfer of a capital asset by way of distribution on the dissolution of a partnership firm or otherwise shall be chargeable to income tax in the hands of the partnership firm.

As per the SC, such revaluation of capital assets and credit of the assets revaluation amount to the capital accounts of the partners is effectively distribution of the assets to the partners and hence to be considered as 'transfer', falling in the category of 'or otherwise', in terms of erstwhile section 45(4) of the Act. While rendering this judgement, the SC has affirmed the Bombay High Court ('HC') ruling in case of A.N. Naik Associates[2], which held that the word 'or otherwise' covers not only distribution of capital assets on dissolution but also cases of subsisting partners transferring the firm's capital assets in favour of a retiring partner. Further, the SC distinguished its earlier ruling in case of Hind Construction Ltd[3] on the premise that the said decision was rendered considering the provisions prior to insertion of section 45(4) of the Act with effect from FY 1987-88.

***JMP Insights** – The SC ruling affirming the Bombay HC ruling will affect all the pending assessments where the taxpayers have taken a stand that withdrawal of capital on*

[1] Civil Appeal No. 8258 and 8259 of 2022
[2] [(2004) 265 ITR 346 (Bombay)]
[3] [(1972) 83 ITR 211 (SC)]

retirement (after revaluation of assets of the partnership firm) is not covered under section 45(4) of the Act. It may even lead to reopening of cases for instances of 'retirement of partners' from partnership firms between FY 1987-88 to FY 2020-21. Further, section 45(4)has been amended from FY 2021-22 onwards.

- **Shares of an Indian company sold by a company which is resident of Mauritius entitle to exemption from capital gains tax in India**

  - MIH India (Mauritius) Ltd. v. ACIT[4]

The taxpayer 'MR' is a tax resident of Mauritius engaged in investment activities. 'NL' a Netherlands based company is the holding company of MR. MR had made an investment by way of acquiring shares in an Indian company 'I Co' in September 2016. NL has a subsidiary in India 'NL India'. In March 2017, MR transferred shares held in I Co to NL India and claimed the short term capital gains as exempt from tax in India as per Article 13(4) of the India Mauritius Double Taxation Avoidance Agreement ('DTAA'). However, the tax officer denied the exemption.

The Delhi Tribunal observed that the provisions of Article 13 of the India Mauritius DTAA have been amended effective from 1 April 2017 stating that the gains arising from transfer of shares of a company resident in India, acquired by a Mauritius based company, on or after 1 April 2017, may be taxed in India. Prior to this amendment, such a transfer was exempt from capital gains tax in India.

The Delhi Tribunal noted that in the case of the taxpayer, since the shares resulting in capital gain were acquired prior to 1 April 2017, the amended provisions are not applicable. The taxpayer has furnished a valid Tax Residency Certificate ('TRC') and hence it is entitled to avail the beneficial provisions of Article 13(4) of the DTAA.

The Delhi Tribunal noted the following facts –

- MR has been carrying on investment activities in India as well as other jurisdictions.
- The audited financial statements of MR indicated that the Company continued to make substantial investments in India.
- The shares of I Co as transferred to NL India continued to be held by NL India and are not sold by it.

The aforesaid facts clearly establish that MR is not a mere conduit company as concluded by the tax officer. Merely because MR availed loans from NL to invest in shares of I Co, ipso facto cannot be a reason to treat the taxpayer as a conduit company.

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[4] Civil Appeal No. 8258 and 8259 of 2022

The tax officer has erred in not following the SC decision in case of Azadi Bachao Andolan[5] wherein the SC has held that the taxpayer is legally entitled to avail the benefits under the India Mauritius DTAA by relying upon the TRC issued by the Mauritius Tax Authorities and Circular[6] issued by the Central Board of Direct Taxes ('CBDT'). Instead, the tax officer emphasized on the Multilateral Instrument ('MLI') signed between the Government of India and Mauritius, which was pending to be ratified by the Government of Mauritius. Hence, pending ratification, the MLI was not effective during the year under consideration when the acquisition/transfer took place.

The Delhi Income Tax Appellate Tribunal (' the Tribunal') further analysed the contention of the tax officer about applicability and drew the conclusion that the provisions of Article 13(4) of the India Netherlands DTAA would be applicable to the instant case, only if the shares derive its value principally from immovable property situated in India. The Delhi Tribunal noted that the tax officer has not demonstrated as to how the condition of Article 13(4) of the India Netherlands DTAA is satisfied. Accordingly, the transfer of shares is exempt from tax in India even if the India Netherlands DTAA is applied with.

Thus, the Delhi Tribunal concluded that the short term capital gain arising on sale of shares cannot be taxed in India.

JMP Insights – *This case highlights that the law as it stands at the relevant point of time is crucial for determining the taxability in the hands of the taxpayer. Subsequent amendments or proposed changes which have not been introduced into law cannot be relied upon by the Tax Department.*

- **Distribution revenue earned by Mauritian Firm from India not royalty; not taxable as business income in absence of a PE in India**

  - ESS Distribution (Mauritius) SNC et Compagnie v. DDIT[7]

In the given case, the taxpayer, a resident of Mauritius, is engaged in the business of distribution of sports and sports related television programs broadcast by ESPN Star Sports, Singapore and of programming service(s) via non-standard television.

The taxpayer has appointed ESPN Software India (P) Ltd. ('ESPN India'), a wholly owned subsidiary of ESPN Mauritius Ltd., as a distributor for distribution of 'Star Sports' and 'ESPN' channels through the network of Indian cable operators. As per the terms of the agreement, ESPN India is required to share 60% of the gross revenue to the taxpayer as consideration for right to distribute the sports channels in the service area.

[5] [263 ITR 706]

[6] No. 789 dated 13 April 2000

[7] ITA No.3412/Del/2010, ITA No.3413/Del/2010, ITA No.4426/Del/2016, ITA No.4543/Del/2016, ITA No.1220/Del/2017, ITA No.6705/Del/2017 & ITA No.5084/Del/2018

The issue under consideration is whether 'distribution revenue' received by the taxpayer from ESPN India is taxable in India as royalty under Article 12 or as business profits under Article 7 of India Mauritius DTAA.

The Delhi Tribunal held that –

- Broadcast Reproduction Right ('BRR') is not 'Copyright' and is a right distinct from Copyright. On a perusal of the agreement, it is clear that the taxpayer has not been conferred with any rights whatsoever with regard to copyright, title or any other proprietary or ownership interest in or to the ESPN service or any elements thereof.

- There is a specific restriction imposed upon ESPN India to distribute the ESPN services in its entirety without any editing, interruption, deletions, additions etc.

- The taxpayer does not have ownership over the copyright and therefore, it cannot transfer copyright or grant licence or right to use copyright. Accordingly, consideration for BRR earned by taxpayer is not taxable in India as royalty in terms of Article 12 of India Mauritius DTAA.

- The distribution agreement between the taxpayer and ESPN India clearly indicates that the transaction is on principal to principal basis. The burden is on the tax authorities to establish the existence of fixed place Permanent Establishment ('PE'). There is no material brought on record by the tax authorities to suggest that the taxpayer has any kind of control over the business of ESPN India or the premises of ESPN India have been given at the disposal of the taxpayer or the taxpayer carries on any kind of business through the premises of ESPN India.

- Insofar as the issue, that ESPN India is a dependent agent of the taxpayer, the agreement between the parties does not make out a case of Dependent Agent Permanent Establishment ('DAPE'). There is no privity of contract between the taxpayer with the cable operators or end customers in India. It is ESPN India who has entered into contracts with cable operators for distribution of the channels in India and responsible for breach of contract with cable operators. Therefore, the consideration cannot be brought to tax as business income under Article 7 of India Mauritius DTAA.

- **Withholding tax applicable on supplementary commission earned by air travel agent**

  - Singapore Airlines Ltd, KLM Royal Dutch Airlines & British Airways PLC v. CIT (TDS) Delhi[8]

The taxpayer is a company operating in the airline industry where the base fare for air tickets to be charged to their customers is set by International Air Transport Association ('IATA'). The fares charged by the airlines could be lower or equal to the base fare set by IATA. The travel agents associated with the airlines would be designated to 7% standard commission on base fare set by IATA. Any amount received by the travel agent over and above the fare quoted by the taxpayer would be retained by the agent as its own income i.e., supplementary commission.

While the taxpayer has been correctly withholding tax on 7% standard commission paid to the travel agents, the issue under consideration is whether the taxpayer is required to withhold tax under section 194H of the Act on the supplementary commission earned by the travel agent i.e., difference between the actual fare at which the ticket is sold by the travel agent less the net fare fixed by the taxpayer.

The SC perused the provisions of Section 182 of the Indian Contract Act, 1872 and observed from the agreement between the taxpayer and the travel agent that several elements of contract of agency are satisfied. On a perusal of section 194H of the Act, the SC observed that there is no distinction made between direct and indirect payments. Further, the expression ‘commission’ in the Explanation to section 194H of the Act is an inclusive definition.

On the argument placed by the taxpayer that it is not practical and feasible for it to withhold tax on the supplementary commission in absence of information on the airfare charged by the travel agent to the customers, the SC held that the details of the price at which the airline tickets are sold by the travel agents to customers are transmitted by the travel agents to Billing and Settlement Plan (‘BSP’) set up under the aegis of IATA. The BSP acts as a forum for the agents and taxpayer to examine details pertaining to the sale of flight tickets. The BSP stores a plethora of financial information including the net amount payable to the aviation companies, discounts and commission payable to the agents.

Thus, based on the aforesaid argument, the SC held that since the information regarding the supplementary commission was available to the taxpayer, there is no doubt that the taxpayer is required to withhold tax under section 194H of the Act.

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[8] Civil Appeal Nos. 6964-6968 of 2015

DID YOU KNOW?

The CBDT noted that those non-resident taxpayers who do not have a Permanent Account Number ('PAN') and are not required to obtain a PAN under the provisions of the Act ('specified class of taxpayers') are facing practical difficulties in electronically filing Form 10F on the income tax portal. Therefore, in order to address this genuine difficulty, the CBDT has relaxed the condition for electronically filing Form 10F for FY 2022-23 (till 31 March 2023) **only for such specified class**

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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