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 May 2024:

Income tax rulings

Choice of valuation method prescribed for unquoted equity shares under Rule 11UA solely with the taxpayer

- Agra Portfolio Pvt Ltd v Principal Commissioner of Income Tax[1]

The taxpayer issued equity shares bearing face value of INR 10 at a premium. For the purpose of valuation of such equity shares in accordance with Section 56(2)(viib) of the Income Tax Act, 1961 ('the Act'), the taxpayer placed reliance on the valuation report by a merchant banker computing the Fair Market Value ('FMV') of such shares using the Discounted Cash Flow ('DCF') method. The tax officer conducted independent valuation of equity shares using Net Asset Value ('NAV') method, rejecting the valuation adopted by the taxpayer on the following grounds:

i. Unrealistic valuation report considering the growth and stature of the company, without giving reasons for assumptions made in the report;

ii. Deviation in the actual figures in comparison to the estimates considered at the time of valuation

iii. Failure on part of taxpayer to substantiate the basis of valuation adopted in the valuation report.

The Delhi High Court ('HC') unequivocally confirmed that under Section 56(2)(viib) of the Act read with Rule 11UA of the Income Tax Rules, 1962 ('the Rules'), the option to choose the valuation method is exclusively vested with the taxpayer. The Delhi HC relied on the past judgements of Bombay HC in case of Vodafone M-Pesa[2]. The Delhi HC also made reference to various Tribunals[3] which have consistently followed the Bombay HC ruling. These precedents consistently upheld the principle that the valuation method chosen by the taxpayer must be respected by the tax officer. The Delhi HC further held that though the statute grants the right to the tax officer to scrutinise the valuation report submitted by the taxpayer, the scrutiny must be conducted within the confines of the chosen method and the tax officer cannot arbitrarily reject the chosen method and substitute it with a different method.

[1] ITA 1385/2018 (Delhi HC)
[2] ITA No 1037/Mum/2019
[3] ITA No 2945/Mum/2022, ITA No 115/Hyd/2021, (2022) 94 ITR (Trib) 596, ITA No 161/Bang/2020

In this case, the Delhi HC remitted matter back to the tax officer for a fresh valuation exercise. Further, the Delhi HC allowed the tax officer to appoint any independent valuer for conducting the valuation exercise but within the chosen method i.e., DCF and the tax officer cannot deviate from this mandate.

***JMP Insights** – The above ruling underscores the principle that the right to choose the valuation method lies with the taxpayer. This highlights the importance of empowering taxpayers and respecting their autonomy in determining the valuation of their assets. The tax authorities are bound to respect the method adopted by the taxpayer for valuation. While the tax officer has the authority to scrutinize the valuation report submitted by the taxpayer, this scrutiny must occur within the parameters of the chosen valuation method.*

The case law provides clarity on the legal framework governing valuation methods in tax assessment, ensuring that both taxpayers and tax authorities understand their rights and obligations.

- **Mere uploading of notice on the e-portal not sufficient, electronic/physical communication of notice mandatory**

  - Munjal BCU Centre of Innovation and Entrepreneurship v. Commissioner of Tax Exemptions, Chandigarh[4]

The Commissioner of Income Tax (Exemptions) ['CIT(E)'] had issued a show cause notice on the taxpayer for initiating proceedings under section 12A(1)(ac)(iii) of the Act in connection with its provisional registration under section 12AB of the Act.

The said notice was uploaded on the e-portal of the Income-tax department only and it was not communicated to the taxpayer electronically/ physically. Subsequently, two reminders in respect of the aforesaid show cause notice were also uploaded on the e-portal.

During the appellate proceedings before the Punjab & Haryana HC, the CIT(E) contended the following:

i. Once a notice is uploaded on the income tax e-portal, it can be said that the notice has been communicated electronically to the taxpayer.

ii. Since taxpayer had submitted his form (for registration) online on the income tax e-portal, it can be presumed that taxpayer had knowledge of the said notice which were placed on the e-portal.

The HC observed that it is essential that before any action is taken, the notice of communication must be sent to the taxpayer in accordance with the provisions of section 282(1) of the Act read with Rule 127(1) of the Rules. Further, the Punjab & Haryana HC indicated that these provisions do not mention that communication can be 'presumed' by simply uploading notice on the income tax e-portal. The Punjab & Haryana HC directed that a

[4] 2024:PHHC:030865-DB

pragmatic view has to be adopted in such circumstances. The Punjab & Haryana HC also emphasised that the principles of natural justice are inherent in the provisions of the Act and the same are to be necessarily followed.

The Punjab & Haryana HC allowed the Writ Petition filed by the taxpayer and held that sufficient opportunity of being heard was not provided. Therefore, the order passed earlier was quashed and set aside. The CIT(E) was directed to provide an opportunity of being heard to the taxpayer and to pass a fresh speaking order.

JMP Insights *– This ruling emphasises the importance of communicating any notices/ orders to the taxpayer. The taxpayer is not required to monitor the income tax portal for any new communications. However, communications delivered electronically should be duly noted and attended to.*

- **Offshore supplies in a composite contract are taxable in India**

  - J.M. Voith SE & Co. KG v. DCIT, Circle 3(1)(1) International Tax[5]

The taxpayer, a German company engaged in the design and manufacturing of paper machines, entered into contracts with four Indian entities for the design, manufacture, supply, erection, installation, and commissioning of paper machines/equipments. Further, the taxpayer also had a Project Office ('PO') in India. The taxpayer did not offer income from offshore supplies to tax in India, citing that operational activities related to offshore supplies were conducted outside India. However, certain amounts received as Fees for Technical Services and Royalty were offered to tax in its income tax return filed for Financial Year ('FY') 2014-15.

The tax officer observed that the contract with one of the Indian entities required performance guarantee test and the issuance of a takeover certificate by the contractee. The tax officer concluded that unless the equipment is commissioned and a satisfactory test run is performed, the contract is not complete and the taxpayer's obligation does not get discharged. Thus, the tax officer determined that the contract was a composite contract.

The tax officer observed that the taxpayer was involved in the entire activities starting from design to manufacture, supply, erection, commissioning, test run of the entire plant and machinery. Thus, the taxpayer has a Permanent Establishment ('PE') in India in the form of supervisory PE. Further, the PO involved in onshore supplies constituted a fixed place PE in India under Article 5 of the India-Germany Double Taxation Avoidance Agreement ('DTAA').

The tax officer ultimately concluded that though the equipment needed for the paper mill were manufactured in Germany, the equipments were utilised in India, hence a part of the profit earned from offshore supplies was attributable to PE in India. The tax officer invoked Rule 10 of the Rules and attributed 25% of the total offshore receipts from all four contracts as income of the PE. He further estimated profit at 10% of such attributed income of the PE.

[5] ITA No. 4862/Del/2019

On appeal, the Commissioner of Income-tax (Appeals) ['CIT(A)'] upheld the order passed by the tax officer but reduced the estimated profit of 10% to 5%.

On further appeal, the Delhi Income Tax Tribunal ('Tribunal') agreed with the tax officer and concluded that the examined contract is a composite contract. It was thus held that the receipts from offshore supplies concerning the examined contract are taxable in India.

The Delhi Tribunal noted that the profit estimation followed by the tax officer lacked a solid basis, especially when the taxpayer had provided evidence of a global profit rate of 2.28% in the paper division. The Delhi Tribunal censured the tax authorities for not thoroughly examining all contracts entered into by the taxpayer and disregarding the global profit rate while estimating the profit percentage. The Delhi Tribunal held that without a thorough analysis of the PE's involvement in the manufacture and supply of plant and equipment, attributing 25% of the total receipts from all four contracts to the PE on an ad hoc basis was unwarranted.

The Delhi Tribunal restored the matter to the tax officer for fresh further adjudication.

JMP Insights – *Article 14 of Multilateral Convention under the OECD BEPS project determines the various parameters to address the issue of artificial splitting up of construction contracts to avoid formation of PE.*

The taxpayers should carefully draft contracts to differentiate the offshore supply elements from onshore services which can help ensure efficient project execution and potentially minimize tax exposure in India. This will allow for a clearer picture of taxable income attributable to Indian operations.

- **DTAA benefit on salary income allowed to the taxpayer on the basis of return of income filed**

  - Yogesh Kotiyal v ACIT[6]

The taxpayer, an employee of Nokia India was exercising employment by rendering services to Nokia Australia for the period August 2017 to March 2020. For the FY 2019-2020, since the taxpayer was physically present in Australia, he qualified as a non-resident as per the Act and a resident of Australia as per the Australia tax laws. The taxpayer filed the revised return for FY 2019-20 claiming the benefit of Article 15(1) of India Australia DTAA.

The tax officer denied the exemption to the taxpayer under the DTAA on the following grounds:

i. The taxpayer had an employer-employee relationship with Nokia India even while working in Australia. The taxpayer continued to received salary in India for his employment carried out in Australia.

ii. The contract of employment was executed in India and employment was based in India.

[6] ITA No 391/Del/2023 (Delhi ITAT)

iii. Tax Residence Certificate ('TRC') was not submitted before the tax officer during the tax assessment proceedings.

iv. Taxpayer has not demonstrated that taxes have been paid in Australia for employment services rendered by him in Australia.

The tax officer denied the benefit of the DTAA in the absence of TRC issued by the Australian tax authorities. However, tax officer disregarded the additional submissions made by the taxpayer evidencing tax residency in Australia.

The Delhi Tribunal noted that the taxpayer has submitted his TRC along with various documents including his passport, assignment agreement and Australia tax return evidencing payment of taxes in Australia to justify his argument of being a resident of Australia for FY 2019-20.

The Delhi Tribunal placed reliance on various Tribunal and HC rulings wherein it was clearly held that where the taxpayer is a non-resident and rendered services outside India, salary received from an Indian company could not be taxed in India.

The Delhi Tribunal further assessed the taxability of salary received by the taxpayer under the provisions of the Act and concluded that income earned under the head 'Salaries' is taxable in India only 'if it is earned in India'. Since in the present case, the taxpayer has rendered services outside India, no taxability arises on salary received by the taxpayer.

JMP Insights – *The Tribunal has held that taxpayer is eligible to claim the benefit of the DTAA without furnishing the TRC issued by the tax authorities, if the taxpayer is able to substantiate its residency in Australia on basis of alternate evidence such as the return of income.*

The discussion on requirement of TRC for availing benefits of DTAA has been a matter of discussion. The view adopted by the Tribunal in the given decision may be challenged by the tax authorities.

Circular and Notification

- **India and Mauritius sign a protocol amending the India-Mauritius DTAA**

A Protocol dated 7 March 2024 has been signed between the Government of India and Government of Mauritius proposing to amend the India-Mauritius DTAA.

The following amendments are proposed in the DTAA:

i. Preamble to India Mauritius DTAA

The current preamble is being proposed to be replaced to expressly prevent opportunities of non-taxation or reduced taxation through treaty shopping arrangements aimed at obtaining reliefs for indirect benefit of residents of a third country. Further, the phrase "for the encouragement of mutual trade and investment" has been omitted in the proposed preamble.

ii. Insertion of Article 27B

In line with the minimum standard under MLI, it is proposed to insert the Principal Purpose Test rule vide Article 27B – ‘Entitlement of Benefits’, wherein benefit under this convention shall not be granted if it is reasonable to conclude that obtaining the benefit under this convention was one of the principal purposes of any arrangement or transaction.

iii. Date of entry of Protocol

Each of the contracting state is required to notify to the other on the completion of the procedures required by its law for bringing this Protocol into force. Once the notifications are issued, the Protocol will enter into force on the date of the later of the two notifications. Further, the provisions of the Protocol shall have effect from the date of entry into force, without regard to the date on which the taxes are levied or taxable years to which the taxes relate.

JMP Insights – *India adopted the Multilateral Convention (MLI) in 2019 with a view to implement tax treaty related measures to prevent Base Erosion and Profit Shifting (‘BEPS’). This allowed several tax treaties to be amended based on adoption of specified MLI positions without the need for bilateral treaty negotiations including the introduction of the Principal Purpose Test (PPT), to prevent treaty abuse. The India-Mauritius DTAA had not been a Covered Tax Agreement (‘CTA’) under MLI provisions and has had bilateral negotiations for amendments.*

The key reasons for the proposed amendments to the India Mauritius DTAA are to align it with the proposal of OECD on the BEPS minimum standards and to introduce PPT rule to prevent treaty abuse.

With this change, the benefits of the DTAA can be denied by the tax authorities even if one of the principal purposes of the transaction/arrangement is to obtain a tax benefit under the convention.

Historically, Mauritius has been a major jurisdiction contributing to the flow of foreign investment into India due to nil taxation on capital gains earned on shares (acquired prior to 1 April 2017). The language of the amendments proposed in the protocol hint at applicability of the amendments retrospectively, creating ambiguity whether the amendment would impact exemptions currently available on investments in India.

The Indian Tax Authority on 12 April 2024 clarified that any concerns therein will be addressed as and when the protocol comes into force. While the clarifications are awaited, the taxpayers who may be impacted by the protocol are advised to evaluate such impact and take necessary action.

DID YOU KNOW?

CBDT has granted relief to the taxpayers by specifying that the tax deductors/ collectors are not required to deduct/collect the tax at a higher rate for transactions entered into upto 31 March 2024 where the PAN becomes operative (as a result of linkage with Aadhaar number) on or before 31 May 2024.

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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About JMP Advisors

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