Tax Matters

Issue No. 2021/09 Date:7th September 2021

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 August 2021:

Income tax rulings

- **Re-domiciliation a way of life for offshore entities, no ground to deny DTAA benefits.**

  - Asia Today Ltd (Mumbai Tribunal) [129 taxmann.com 145 (SC)]

The Taxpayer was registered as an International Business Company in November 1991 in the British Virgin Islands (BVI). Subsequently, on 29 June 1998 the Taxpayer was re-domiciled in Mauritius and the Registrar of Companies issued a 'Certificate of Incorporation by continuation' on the same day. The Taxpayer discontinued its registration in the BVI vide certificate dated 30 June 1998. The Taxpayer had furnished a Tax Residency Certificate ('TRC') dated 6 July 1999 issued by Mauritius, before the Tax Officer. Amongst other things, the claim of the treaty benefit was denied by the Tax Officer, on the basis that it was originally a BVI company.

It was held that re-domiciliation of the company by itself cannot lead to denial of treaty entitlements of the jurisdiction in which the company is re-domiciled. The fact of re-domiciliation of the company could at best trigger detailed examination or the re-domiciled company being fiscally domiciled in that jurisdiction. Based on judicial precedents it was possible to state that once a TRC was issued, it could not be open to the tax authorities to make such investigations.

Further, the Mumbai Tribunal ruled in favour of the Taxpayer with regards to the existence of the Taxpayer's Dependent Agent Permanent Establishment ('DAPE') in India. The Mumbai Tribunal followed its coordinate bench's ruling in Taxpayer's case and held that as long as an agent is paid an arm's length remuneration for services rendered, nothing survives for taxation in hands of DAPE, and DAPE shall be considered as wholly tax neutral.

***JMP Insights**: Considering that the issue of re-domiciliation doesn't have any judicial precedents, it is a welcome ruling on the issue of tax treaty entitlement of an entity that has re-domiciled from its place of incorporation to another jurisdiction having a favourable tax treaty with India.*

The Tribunal also deliberated on the issue of attribution of profit for a foreign entity having an Agency PE in India. This ruling made an interesting analysis on the taxation of DAPE vis-a-vis taxation of income received by the agent in India, and has set out reasons thereof to distinguish agent from the artificial entity being DAPE. However, in the present case successive coordinate benches in the Taxpayer's own case for different assessment years

had upheld the contentions of the Taxpayer and held that once an arm's length remuneration is paid to the agent, nothing further survives for taxation in the hands of the DAPE (as such, effecetively making the existence of a PE in India tax neutral). In view of this and other decisions of High Courts on similar matters, the Tribunal held that even if there is held to be a DAPE, it is wholly tax neutral in as much as the Indian agents have been paid arm's length remuneration, and nothing further can, therefore, be taxed in the hands of the Taxpayer.

- **Issue of debentures against outstanding interest liability as per loan Rehabilitation Plan was allowed as a deduction and cannot be considered as misuse of provisions of section 43B read with Explanation 3C of the Act.**

  - M.M Aqua Technologies Ltd (Honourable Supreme Court) [129 taxmann.com 145 (SC)]

The Taxpayer was unable to pay the interest on the loan from a financial institution and therefore approached the financial institution for approval of its Rehabilitation Plan. As per the Rehabilitation Plan, the Taxpayer issued convertible debentures to the financial institution instead of outstanding interest. The outstanding interest was thus effectively paid. The Taxpayer claimed the deduction under section 43B of the Act of the outstanding interest in its return of income.

The Tax Officer disallowed the interest deduction, by holding that issuance of debentures was not as per original terms and conditions of the loan agreement and therefore would not qualify as a deduction under section 43B(d) of the Act.

The Commissioner of Income Tax ('CIT(A))' held that since the debentures were being accepted by the financial institution as part of the Rehabilitation Plan for effective discharge of outstanding interest the payment was in accordance with section 43B of the Act. The Income Tax Appellate Tribunal upheld the order of CIT(A).

The Revenue again filed an appeal before the Delhi High Court for determining whether funding of interest amount by way of term loan amounts to actual payment as referred in Section 43B of the Act. The High Court concluded that Explanation 3C to Section 43B of the Act was inserted by Finance Act 2006 with retrospective effect from 1 April 1989 and since the present case relates to Assessment Year 1996-97, it is fairly covered by Explanation 3C and as such, the Taxpayer cannot claim deduction under section 43B of the Act.

The Supreme Court set aside of the order of the Delhi High court and held as under:

a) The question raised before the Delhi High court was incorrect, and remarks that the provision of section 43B of the Act was interpreted correctly by CIT(A) and Delhi Tribunal.
b) It was found that the issue of debentures by the Taxpayer was under a Rehabilitation Plan to extinguish the interest liability, and therefore cannot be held that provisions of section 43B of the Act were misused.

c) Retrospective insertion of Explanation 3C to Section 43B of the Act was meant to plug a loophole and cannot be brought to the aid of the Revenue. Three well-established canons of interpretations come to Taxpayer's rescue:
   - Bonafide transactions of section 43B of the Act are not meant to be affected
   - Relying on the Supreme Court decision in the case of *Sedco Forex International (2005) 12 SCC 717*, it was reiterated that a retrospective provision which is "for the removal of doubts" cannot be presumed to be retrospective, even where such language is used, if it alters or changes the law as it earlier stood.
   - Any ambiguity in the language of Explanation 3C shall be resolved in the favour of Taxpayer

In view of the above, it was concluded that issuance of debentures against the outstanding interest liability is allowed as interest actually paid for the purpose of section 43B of the Act.

***JMP Insights**: The said ruling is factually distinguished from the Supreme Court decision in the case of Gujarat Cypromet (2020) 15 SCC 460, wherein a fresh loan was issued in lieu of outstanding interest and hence interest expense was disallowed. While applying the provisions of section 43B of the Act, one will have to carefully examine the facts of each case and the genuineness of the transaction.*

➢ **Amendment in the Payment of Gratuity Act, 1972 ('Gratuity Act') is prospective, benefits received before 24.5.2010 not exempt under section 10(10) of the Income-tax Act ('the Act')**

- Krishna Gopal Tiwari & Anr. (Honourable Supreme Court) [Civil Appeal no. 4744 of 2021]

As per the Office Memorandum issued by the Government of India dated 26 November 2008, the ceiling amount for payment of gratuity to an employee was increased to INR 10 lakh w.e.f. 1 January 2007. Accordingly, the Taxpayers were paid a higher amount of gratuity.

Later, the Gratuity Act was amended with effect from 24 May 2010 which enhanced the ceiling from INR 3.5 lakhs to INR 10 lakhs.

Taxpayer's grievance was that though gratuity was paid to them as per the Office Memorandum, the tax had been deducted at source and income-tax exemption under section 10(10) of the Act, was denied. The Taxpayers, thus, challenged the effective date of applicability of the Amending Act of 24 May 2010. The Taxpayers contended that it should be made effective from 1 January 2007.

The Supreme Court held that section 4(5) of the Gratuity Act protects the employee's right to receive better terms of gratuity and sums paid under the Office Memorandum were covered therein. The income-tax exemption, however, is restricted to the amount calculated under sections 4(2) and 4(3) of the Gratuity Act. The benefit paid to the Taxpayers under the Office Memorandum is not entitled to exemption in view of the

specific language of Section 10(10)(ii) of the Act. What is exempt under the Act is the amount of gratuity received under the Gratuity Act to the extent it does not exceed an amount calculated in accordance with the provisions of sub-sections (2) and (3) of Section 4 of the Gratuity Act. The Gratuity Act contemplated INR 10 lakhs with effect from 24 May 2010, hence the benefit of INR 10 lakhs for the purpose of income-tax exemption cannot be extended to amounts paid before 24 May 2010. It was further held that since this was a one-time payment, having a cut-off date of 24 May 2010 cannot be termed as illegal and held the amendment to be prospective.

***JMP Insights**: The aforesaid ruling makes it clear that even if an employee gets gratuity under the terms of employment which are better than those provided under the Gratuity Act, the tax exemption cannot exceed what is provided under section 10(10)(ii) of the Act.*

- **Interconnected services provided under a unified agreement constitutes PE in India**

  - Telenor ASA (Delhi ITAT) [I.T.A. No.: 1307/Del/2015]

The Taxpayer ('Telenor ASA') is a tax resident of Norway and entered into Business Service Agreement ('BSA') with Unitech Wireless (Tamil Nadu) India P. Ltd. ('Unitech Wireless') for the provision of various services such as Sourcing, Marketing, IT/IS, HR and other contracts, through different Service Order Forms ('SOF') The fees received for providing technical services was offered to tax at the rate of 10% on a gross basis as per Article 12 the India-Norway Double Taxation Avoidance Agreement ('DTAA').

The Tax Officer during assessment held that the Taxpayer had a PE in India under Article 5(2)(l) of the DTAA. The Tax Officer held that the time spent by the employees of the taxpayer in India while rendering services to the Indian company exceeded the threshold provided in the PE Article and attributed 100% of the receipts to the PE after allowing expenses at 40%.

The Taxpayer contended that various functions such as HR and marketing should be treated as separate projects but cannot be aggregated to determine the period of stay for the purpose of 'Duration Test' under Article 5(2)(l) of the DTAA. The Tax Officer contended that Article 5(2)(l) doesn't distinguish between the same or similar types of services. It is an inclusive definition of services and mandates that the services including consultancy services of the same are to be treated as connected projects. SOFs form an integral part of the BSA, and this fact has never been disputed by the Taxpayer.

The Tribunal held that BSA is a single unified agreement. On perusal of the clauses of the agreement, it was observed that no single clause is giving it a shape of multiple agreements. It was observed that the bills were raised on a quarterly basis and consolidated invoices were raised irrespective of the SOFs under which the services were rendered. The common billing by the recipient and the common payments indicated one single contract. Relying on the OECD Commentary with regard to Article 5(2)(i), the Tribunal concluded that the activities consisted of the same and interconnected projects. The Tribunal observed that the activities of the Taxpayer with regard to the recipients for services can be said to be interconnected, interlaced, sequential technical services. It

cannot be said that they are unrelated to each other as none of the activities could stand in isolation from the other activity and no single activity can give rise to performance and achieving of the purpose of the recipient. Thus, it was held that the Taxpayer had PE in India since the aggregated period of stay for the purpose of 'Duration Test' under Article 5(2)(l) of the DTAA was fulfilled.

The Tribunal was, however, in agreement with the Taxpayer that the revenues raised out of the services rendered from Norway cannot be attributed to the PE in India.

JMP Insights: *The OECD Commentary 2017 on Article 5 (Permanent Establishment), while dealing with the taxation of services, provides that the reference to 'connected projects' is intended to cover cases where the services are provided in the context of separate projects carried on by an enterprise but these projects have a commercial coherence. The determination of whether activities are connected will depend on the facts and circumstances of each case. Accordingly, the OECD Commentary provides various factors that may be relevant for this purpose.*

While determining a PE, some of the Courts have treated different projects (which are carrying out different functions) as separate projects, and they have not aggregated the time involved on such separate projects to conclude the existence of a PE.

The Mumbai Tribunal in the case of Valentine Maritime (Mauritius) Ltd [2011] 10 taxmann.com 209 (Mumbai) held that aggregation of time spent by it on various business activities would depend upon the nature of activities, their inter-connection and interrelationship and whether these activities are required to be essentially regarded as a coherent whole in conjunction with each other.

- **Incentive paid to a shareholder-director in recognition of services is tax-deductible expenditure**

  - M/s VVF Limited (Mumbai ITAT) [I.T.A. No.: 6908/Mum/2019]

The Taxpayer had paid an incentive to a Director holding 68% shareholding and claimed a deduction for it from the total income. The Director had played a significant role in growing the Taxpayer's business without drawing any remuneration for 3 years. In recognition of his contribution, an incentive was paid to him. The amount of incentive was approved by a board resolution and a special resolution in the EGM.

The Tax Officer alleged that the incentive was only a device to extend the benefits to a shareholder and avoid dividend distribution tax and thus, denied the deduction under section 36(1)(ii) of the Act.

The Tribunal held that the incentive was paid for the recognition of services rendered by the Director. It was further held that if it was a dividend that was paid in the name of incentive, similar payments would have been made to the other shareholders of the company. However, in this case, the incentive had been paid to the Director only for the services rendered by him and not as a return on the investment made by him.

JMP Insights: *The amount would be deductible for a company if it is paid as an incentive, bonus or commission and not deductible if such incentive, bonus or commission would have otherwise been payable as dividend. However, regardless of whether such amount is deductible in the hands of the company or not, such amount will be taxable for the recipient whether it is considered as an incentive or dividend since dividend is now taxable.*

Income tax notifications, circulars and guidelines

➢ **The Central Board of Direct Taxes ('CBDT') has notified the following:**

- Rule 9D providing for the calculation of taxable interest on Provident Fund contribution via Notification No. 95/2021dated 31 August 2021
- Rule 10RB and Form No 3CEEA for the purpose of claiming relief in tax payable under section 115JB(1) due to operation of section 115JB(2D), by recomputing book profits on account of an advance pricing agreement entered into by the Taxpayer or on account of secondary adjustment required to be made under section 92CE of the Act
- Rule 12AA and Rule 51B prescribing 'any other person' who shall verify income-tax returns under 140(c) and clause (cd) of the proviso to section 140(c) of the Act and who shall be treated as an authorised representative before any income-tax authority as under 288(2) of the Act in case of a company and a Limited Liability Partnership
- 2 boards for Advance Rulings in Delhi and 1 board in Mumbai for the purpose of giving advance rulings on or after 1 September 2021
- Specified banks for the purpose of clause (a) of Explanation to section 194P of the Act
- Form No 12BBA to be submitted by specified senior citizens as per sub-clause (iii) of clause (b) of Explanation to section 194P of the Act

DID YOU KNOW?

Taxpayers facing technical glitches on the new income tax portal can send their greviences (along with PAN and Mobile number) to orm@cpc.incometax.gov.in.

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.

JMP Advisors Private Limited

12, Jolly Maker Chambers II, Nariman Point, Mumbai 400 021, India
T: +91 22 22041666, E: info@jmpadvisors.in, W: www.jmpadvisors.com

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