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International Tax and Transfer Pricing

Judicial Decisions

Active involvement of the employees of the Indian subsidiary in bidding process as well as conclusion of contracts on behalf of foreign company with its Indian customers, was held to constitute a permanent establishment (PE) of the foreign company in India

Huawei Technologies Co. Ltd. vs. ACIT (149 taxmann.com 77) (Del.)
In favour of revenue

Facts

The assessee, a foreign company was incorporated in China. It was engaged in sales of telecom equipment to customers in various countries, including India. The assessee had earned revenues from India through sale of non-terminal products and terminal products aggregating to Rs. 1,210 crores. The assessee also provided technical consultancy services to its Indian subsidiary. The Indian subsidiary was involved in the provision of integration installation and commissioning services in relation to telecom network equipment supplied by the assessee from outside India. The AO concluded that Indian subsidiary constituted a fixed place PE, installation PE, service PE and dependent agent PE based on the following facts:

Fixed place PE

The assessee was carrying on business in India and was sending employees to India. The employees of the assessee performed these activities from the office premises belonging to the Indian subsidiary. The Indian subsidiary and the expatriates of the assessee operated from the premises of the Indian subsidiary, were virtual projection of the assessee in India. The assessee had shown the Indian subsidiary's address as the local address for correspondence and later on wanted to hide its local address in India.

Installation PE

The employees of the assessee visited India to perform activities / supervisory activities relating to the installation projects which lasted for more than 183 days, thereby creating Installation PE in India.

Service PE

The employees of the assessee had rendered services in India, other than technical services, and that such services have continued in India for more than 183 days, thereby creating 'Service PE' in India.

Dependent agent PE

The process of joint bidding done by the assessee and the Indian subsidiary does result into Dependent Agency PE. The business of the assessee in India is being conducted with active involvement of the employees of the Indian subsidiary. Such employees of the Indian subsidiary along with employees of the assessee had jointly prepared bidding documents for contracts, negotiated and concluded the contract on behalf of the assessee with the Indian subsidiary.

The AO worked out the weighted average net operating profit of the assessee at 2.51%, attributed 20% out of such profits to the PE in India.

Held

Taking note of the above observations made by the AO, the Indian subsidiary was held to constitute a PE of the assessee in India and profit attribution as worked out by the AO was confirmed.

Indian PE was allowed deduction of interest paid to overseas branches while computing its income, whereas Interest received by overseas branches was held as not taxable in India

Credit Suisse AG vs. DCIT (148 taxmann.com 409) (Mum.)
In favour of assessee

Facts

The assessee, a foreign company, was a tax resident of Switzerland. The Singapore branch office of the assessee was registered with the SEBI as a Foreign Institutional Investors (FII) to conduct portfolio investments in Indian securities. The assessee also had a branch office in Mumbai which was registered with the RBI, for undertaking banking operations in India.

The Indian branch had procured loans of USD 2,000,000 from the Singapore branch and London branch, for which interest was paid. The said interest was not offered to tax by these branches on the basis that the assessee and the branches are one and the same enterprises. The assessee, however claimed the interest paid to the branches, as a deduction, while computing the business profits of the Indian branch.

The AO held that interest paid by the PE to the branches is an interest sourced in India and therefore, taxable in India in view of explanation to section 9(1)(v).

Held

Since the assessee has a PE in India, the interest paid to the branches would be allowed as a deduction, while computing the business profits of the Indian branch office. As per Article 7(2) of the India-Swiss Tax Treaty, the profit attributed to the PE shall be determined which it might be expected to make, if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is the PE. However, interest paid by the Indian branch to the overseas branch is not taxable in India, as per the Act, being payment to self. The fiction of hypothetical independence of the PE and branches cannot be extended to the computation of the profit of the assessee.

The same is restricted only for computation of profit attributable to the PE. The interest income was held as not taxable in the hands of overseas branches, even though the Indian branch was allowed deduction of interest paid, while computing its income.

Where the assessee was unable to provide evidence in support of the arm's length price (ALP) of the second-hand assets purchased from its associated enterprises (AEs), the TPO was justified in treating the cost of such assets at Nil

Flextronics Technologies (India) (P.) Ltd vs. ACIT (148 taxmann.com 334) (Chennai)
In favour of revenue

Facts

The assessee had imported various fixed assets from its foreign AEs. The assessee benchmarked the transaction of purchase of fixed assets using transactional net margin method (TNMM) as most appropriate method by stating that the depreciation charge with respect to the assets has been included in operating costs, which confirms to ALP. The TPO rejected the assessee's stand stating that depreciation is not the international transaction, but asset purchased was the international transaction on which ALP was required to be established. The assessee was required to demonstrate the ALP of the assets purchased from AEs, through competitive quotes. The assessee had not filed any details before the Transfer Pricing Officer (TPO) in respect of purchase value of the asset originally purchased by the AE, how long they have used, what was the cost of the asset after using, etc.

The TPO had adopted purchase cost of fixed assets at Nil and made TP adjustment of Rs.1.15 crores.

Held

No details were brought on record to substantiate the purchase of fixed assets. In absence of any details filed, the TPO was correct in making the TP adjustment by valuing second-hand machinery at Nil.

Markup of 5% for the IT support services provided by the foreign AE was considered as an acceptable markup for benchmarking the international transaction

DCIT vs. BMW India Financial Services Pvt Ltd [TS 68 ITAT 2023(Del)TP]
In favour of assessee

Facts

The assessee was engaged in providing financial services. The assessee obtained IT support services from the AE of Rs.10,50,27,270. IT support services from its AE were obtained at a cost plus 5% markup.

The TPO held that the AE merely performs coordination services and adds no value to the functions that the third party performs. The AO held that third party cost, in anyway, has been allocated to the Indian entity which includes a mark-up. Therefore, a double mark-up was not justified. The Group ensured that an appropriate arm's length return was earned by all the group entities for functions, assets and risks involved in the performance of business.

For the recovery of costs by AE, a full cost approach was followed, whereby all direct and indirect attributable costs were charged. For providing the IT support services, the costs incurred by the AE were recharged to the assessee along with a mark-up of 5%. The AE recovered from the assessee, the costs incurred by it in relation to IT support services, which *inter alia*, also included the purchase cost of certain IT products/licenses from third parties.

Held

The software/IT support services cannot be charged at par. A markup of 5% for the IT services rendered was an acceptable markup by international guidelines and as per the EU Joint Transfer Pricing Forum. It cannot be expected that the parent organization would supply support services, without charging anything for such services rendered. The markup of 5% was

considered sufficient to recoup the expenditure involved by the AE in exploration, inspection, testing and finalization of suitable software.

Where the assessee was unable to establish actual rendering of services /incurring of expenditure to have a live nexus with India, the TPO was justified in determining the ALP at Nil, even where the expenditure was reimbursed on cost-to-cost basis

Yanfeng India Automotive Interior Systems (P.) Ltd. vs. JCIT (148 taxmann.com 332) (Ahmedabad)
In favour of revenue

Facts

The assessee, a subsidiary of a company incorporated in China, was engaged in the business of manufacturing and selling automotive trim components. The assessee was awarded contract by another Indian company for launching a new product for its Indian operation. The assessee took the assistance of AE in China. The employees of AE visited Germany, Brazil, China etc. and subsequently visited the assessee in India, to share their experience and assist the assessee in initial phases. It was contended that the majority of activities carried out by employees of the AE were for the purpose of development of tools for the new product. Before the TPO, the assessee submitted that employees of AE incurred certain expenditure such as ticket cost, lodging cost, air fare, meal expense, visa application cost etc. These expenses were reimbursed by the assessee to the AE on a cost-to-cost basis, without any mark up. It was explained to the TPO that the transactions represented actual cost to cost reimbursement of actual amount incurred by AE towards third party expenses on behalf of the assessee and therefore, does not require separate benchmarking, in absence of any mark-up charged by the AE.

The TPO determined the ALP of the reimbursement of expenses at Nil and made a downward adjustment amounting to Rs. 3.07 crores. The TPO noted that the assessee had not submitted any supporting documents in support of its claim that the expenditures were incurred for the purpose of the assessee's business. Merely submitting copy of agreement between the assessee and the Indian party, designation and department of employees, copies of email communications of the employees of AE who travelled to other countries was not sufficient in absence of proving live link with the Indian business.

Held

There was no agreement with the AE to whereby the AE can invoice the assessee. As the assessee was unable to prove the actual rendering of services/expenditure in respect of the assessee's business, either by way of producing the necessary agreement in respect of rendering of services, or in the form of any other communication which could convincingly/ conclusively establish such rendering of services, the TPO was justified in determining the ALP at Nil.

Circulars

Key implication of increase in tax rate of Royalty/ Fees for technical services earned by non-resident from India from 10% to 20% with effect from 1st April 2023

The Finance Bill 2023 was introduced by the Finance Minister in the Lok Sabha on 1st February 2023. While presenting the Finance Bill 2023 in the Lok Sabha, no modification was proposed on taxation of income from Royalty/ Fees for technical services (FTS) earned by the non-resident from India.

While moving the Bill for approval before Lok Sabha on 24th March 2023, tax rate on payment of Royalty/ FTS was increased from 10% to 20% without any debate or discussion thereon. The Finance Act, 2023 has been enacted with the increased tax rate.

Key implications of the increase in tax rate on taxation of royalty/ FTS are discussed hereunder:

- Section 90(2) of the Act provides a choice to the non-resident, to offer income earned, as per the provision of the Act or Tax Treaty, whichever is more beneficial. A valid Tax Residency Certificate **(TRC)** is mandatorily required to be furnished by the non-resident to claim Tax Treaty benefits. Before the amendment made by the Finance Act 2023, the tax rate on Royalty/ FTS was 10% as per section 115A as increased by surcharge and education cess was almost at par with the tax rate as per certain Tax Treaty entered by India. In view of insignificant difference in the tax rate as per the Act and the Tax Treaty, several non-residents were not furnishing a TRC and were paying taxes as per section 115A of the Act. In view of increase in tax rate, there would be substantial difference between the tax rates as per the Act and Tax Treaty. Therefore, non-resident may now want to claim benefit of lower tax rate as per relevant Tax Treaties by furnishing a valid TRC, Form 10F etc.
- In addition to the furnishing of TRC, non-resident would also have to satisfy multiple anti-abuse tests such as beneficial ownership test, substance, Principal Purpose Test (PPT), Limitation of Benefits (LOB) and General Anti-Avoidance Provisions (GAAR) etc. This would increase compliance burden on non-residents, and they would be required to maintain robust documentation to justify eligibility.
- Tax rate on Royalty/ FTS paid to a non-resident belonging to country with which India has not entered into Tax Treaty or where there is doubts on Tax Treaty eligibility, the tax rate would increase from 10% to 20% plus applicable surcharge and education cess.
- Certain Tax Treaties entered by India viz. Tax Treaty with US, Canada, UK, Belgium etc. provides for tax rate of 15%/ 20% on income from royalty/ FTS. Accordingly, for the taxpayer from these countries, the earlier tax rate of 10% as per the Act was always more beneficial than the Tax Treaty rates. However, in view of the increase in tax rate as per the Act, the Tax Treaty rate may be more beneficial. Accordingly, tax rate on royalty/ FTS paid to the resident of these countries would stand increased to 15%/ 20%, where a valid TRC is furnished and would be 20% plus surcharge and education cess in absence of TRC.
- Section 115A of the Act currently grants exemption from filing of Indian tax return to non-resident earning income from royalty/ FTS from India and on which withholding tax has been deducted at the rates which is not lower than that specified in section 115A of the Act. In view of the tax rate as per most of the Tax Treaty at 10% which was same as per section 115A of the Act, non-resident on whose tax has been withheld at 10% was not required to file tax return in India. However, with the increase tax rate of 20% as per section 115A of the Act, non-resident availing concessional tax rate as per the Tax Treaty would now be required to file tax return in India.
- Before the increase in the tax rate, the non-resident having the Indian PAN was taxed on royalty/ FTS at 10% plus applicable surcharge and education cess as per the Act. In case of non-resident not having Indian PAN, the applicable tax rate was flat rate of 20%. Accordingly, there was double tax rate applicable where the non-resident did not have the Indian PAN. After the increase in the tax rate from 10% to 20%, the tax rate applicable to non-resident on royalty/ FTS would be 20% plus applicable surcharge and education cess as per section 115A. Where non-resident is getting taxed as per section 206AA because of not having Indian PAN, the taxability would be at flat rate of 20%. Accordingly, there seems to be some ambiguity. Further, after the increase in the tax rate, the tax rate remains the same for the non-resident and the fact whether he holds Indian PAN or not does not make any difference.

Requirement of mandatory furnishing of electronic version of Form 10F postponed for certain non-residents till 30th September 2023

Notification No. 13420 dated 28th March 2023

The Finance Act, 2012 inserted section 90(4) to provide that a non-resident shall not be entitled to the Tax Treaty benefits unless such non-resident obtains a TRC from the government of the country of which he is a resident. Section 90(5) was inserted by the Finance Act, 2013 along with Rule 21AB of the Rules which provides for furnishing a self-declaration in Form 10F in case the TRC, obtained from the government of a particular country, does not contain certain details.

The CBDT vide its Notification No. 03/2022 dated 16th July issued by the Directorate of Income Tax (Systems) New Delhi mandated furnishing of Form 10F, electronically. For obtaining electronic version of Form 10F, one is required to create a login id and password on the Income-tax portal, for which obtaining a PAN is mandatory. This requirement creates a hurdle for non-resident payees, as in certain cases, a non-resident payee is not required to obtain PAN.

The CBDT considering the practical challenge being faced by non-resident taxpayers, not having PAN as well as not required to obtain PAN, had postponed the mandatory electronic filing of Form 10F till 31st March 2023. Such non-resident taxpayers could file Form 10F till 31st March 2023 in manual form.

The said deadline has been further extended till 30th September 2023. Such category of taxpayers may make statutory compliance of filing Form 10F till 30th September 2023 in manual form.

KEY TAKE AWAY

- Active involvement of the employees of the Indian subsidiary in bidding process as well as conclusion of contracts on behalf of foreign company with its Indian customers, was held to constitute a PE of the foreign company in India
- Indian PE was allowed deduction of interest paid to overseas branches while computing its income, whereas Interest received by overseas branches was held as not taxable in India
- Where the assessee was unable to provide evidence in support of the ALP of the secondhand assets purchased from its AEs, the TPO was justified in treating the cost of such assets at Nil
- Markup of 5% for the IT support services provided by the foreign AE was considered as an acceptable markup for benchmarking the international transaction.
- Where the assessee was unable to establish actual rendering of services /incurring of expenditure to have a live nexus with India, the TPO was justified in determining the ALP at Nil, even where the expenditure was reimbursed on cost-to-cost basis
- Increase in tax rate of Royalty/ Fees for technical services earned by non-resident from India from 10% to 20% with effect from 1st April 2023
- Requirement of mandatory furnishing of electronic version of Form 10F postponed for certain non-residents till 30th September 2023

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