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Extensive control of non-resident over Indian entity – A taxing relation!!

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Introduction

A recent ruling by the Authority for Advance Ruling on Income Tax (AAR) in the case of *FRS Hotel Group (Lux) S.a.r,l,* [(2018) 94 taxmann.com 23 (AAR- New Delhi)] on the issue of operation and management contract for the hotels has brought a question mark on such contract. In the hotel industry, the involvement of foreign players for operation and management of hotel properties is a common phenomenon. The far-reaching implications of such contracts were never envisaged until this ruling came out.

Accordingly, in this article we have endeavoured to discuss the key points of the judgement while discussing the applicable provisions.

The AAR Ruling

The Applicant in this case being a company within the FRHI Group, was incorporated in Luxembourg, and was engaged in providing services in connection with hotel management including all services that were necessary for hotel operations. The Applicant, in the instant case, entered into an agreement called Centralized Services Agreement (in short 'CSA') with an Indian hotel owner, under which the Applicant had agreed to provide Indian hotel owner a number of services in relation to hotel through different agreements. These services were global reservation services, centralized services, corporate design & construction services and purchasing services.

The Applicant had approached the AAR in respect of only one category of services being the Global Reservation Services (GRS) to determine whether the payments for the same was chargeable to tax in India as Fees for Technical Services (FTS) or royalty under the domestic tax provision read with relevant Double Taxation Avoidance Agreement (DTAA). The revenue contended before the AAR, that all streams of income including income from GRS was taxable under the Act as business income since there was a business connection and also the source of income was for the operation of the hotel in India. The revenue further contended, that the Indian hotel constituted the Permanent Establishment (PE) of the Applicant in India and profits attributable to such PE were taxable as business profits as per Article 5 of Indian-Luxembourg DTAA.

The AAR based its ruling on the tests for fixed place PE, as laid by the Apex Court in the case of *Formula One World Championship Ltd.* These tests were a) existence of a fixed place b) fixed place being at the disposal of the non-resident c) non-resident carrying on its business (wholly or partly) through such fixed place. For satisfying these tests, the AAR placed reliance on the terms of not only the GRS agreement but also other agreements which were not even placed before the AAR by the Applicant initially. The AAR observed that right from the inception, i.e. the construction of the hotel, the Applicant was given the control and authority over the Indian hotel under different agreements. The AAR further observed that pursuant to construction, some of the core aspects of operations and management of the hotel rested with the Applicant along with no right of interference by the hotel owner. Not only this, the final decision-making power with respect to operations of the hotel were also with the Applicant and the Indian hotel owner was bound to take advice and be under the supervision of the Applicant. AAR also observed that the Indian Hotel owner was also barred from contacting directly any of the hotel staff appointed by the Applicant.

Based on the above findings, the AAR was of the view that since the Applicant had in substance taken over all the important functions in relation to operation and management of the Indian hotel under various agreements, the fixed place being the Indian hotel was rightly at the disposal of the Applicant through which its business was carried on. It was held by the AAR that the Indian hotel constituted fixed place PE of the Applicant in India and the income received under different agreements by the Applicant were taxable in India as business profits.

In short, where the person enters into multiple agreements for a particular project (including agreements which are ancillary in nature), all the agreements are to be read together as a whole because reading of the agreements in isolation may lead to absurd and incongruent results. Where from the reading of the agreements, it was clear that the foreign service provider was entrusted with exclusive authority over the operations and management of the hotel in India, then the risk of constituting PE cannot be avoided.

Author's analysis

Article 5(1) deals with fixed place of business through which the business is carried on and is similarly worded both in OECD model and UN model convention. The phrase used in Article 5(1) "through which the business of the enterprise" is a matter which requires due consideration. The Authority, referred to the ruling of *Formula One* for the purposes of determining the scope of this phrase. In *Formula One* judgement, the Apex Court referred to the provisions of the Act which provides that the word 'through which' include 'by means of', 'in consequence of' or 'by reason of'. The Apex Court further relied on the interpretation of the phrase as given in Klaus Vogel's commentary, to emphasize that the place of business qualifies as PE only if the place is 'at the disposal' of the enterprise. The word disposal is further equated with the control that an enterprise needs to have, before a place could be used as an instrument for carrying on business.

The words 'through which' have also been discussed under OECD commentary as words of wide meaning applicable in any situation where the business activities are carried on. It further states that such business must be carried on at a particular location which is at the disposal of that enterprise. Further, particular location does not restrict the movement of activity between that location merely but refers to a single place of business and such single place of business may have multiple locations in it.

Article 5 (1) also uses the word 'fixed'. The word fixed is also discussed in OECD commentary by associating it with a certain degree of permanency. However, it also takes care of the exception of a very short period where the nature of business is the reason for such short period of time.

Lastly, for the purposes of Article 5(1) the term 'carried on' has to be taken in the context where the business is undertaken by the employees or the dependent agents. The non-existence of the power to conclude contract with the dependent agents shall not be impediment for the purposes of Article 5(1).

In case of multiple contracts, even if the assessee had certain agreement(s) for preparatory or auxiliary services along with other commercial contracts, such preparatory agreement would not have given any beneficial conclusion for the assessee. It is only where the services are restricted to preparatory or auxiliary alone, that the benefit of Article 5(4) can be claimed.

Conclusion

Reading all the discussions above in a holistic manner, one can say that Article 5(1) is an inclusive provision of wide amplitude. In the above discussed ruling where an assessee entered into multiple contracts for a common purpose of hotel operations and management, the conclusion of AAR can have far reaching consequences where such contracts are actually required to be entered individually due to certain commercial purposes. Further, where such contracts are entered by way of a single contract also, no beneficial conclusions can be achieved.

It is also to be noted that the tax planning of split contracts has been addressed by India by entering into MLI (Article 14), but where such splitting of contracts is not for the purposes of splitting the number of days of residence and is on account of certain commercial and legal reasons, then one may take the argument of genuine commercial reasons as a reason for such multiple contracts.

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Circular

Raising of monetary limits for filing of appeals by the department

The monetary limit for filing of appeals by the department have been revised. Circular No. 3/2018 dated 11-7-2018 issued in this regard states that appeals and Special Leave Petition shall not be filed by the department in case where the tax effect is lower than the prescribed limit. For filing of appeal before the Appellate Tribunal the limit has been revised to Rs. 20 lakhs against the existing limit of Rs. 15 lakhs. The limit for filing appeals to High Court is now Rs. 50 lakhs and for appeals to Supreme Court, the limit is Rs. 1 crore. Circular also notes that filing of appeal has to be decided on the basis of merit. It also provides that the monetary limit shall not apply in case tax effect is not quantifiable or not involved as in case of trusts or institutions under Section 12AA etc. Further, the limit would also apply to cross appeals. It is also stated that pending appeals below this limit may be withdrawn.

Ratio Decidendi

Transfer pricing - Rejection of comparables does not give rise to 'question of law'

In the instant case, the Revenue raised a question before the High Court against the rejection of some comparables for the TP adjustment by the ITAT. The assesse, however, challenged the question stating that no substantial question of law arose for determination by the High Court. The High Court in this regard held that an appeal will lie to High Courts only if it is established, on the basis of cogent material which was also available with the Authorities below, that the findings as given by the Tribunal were perverse and exhibit a total non-application of mind. The appeal could not lie before the Court merely on account of dissatisfaction caused on account of reversal or modification by the Tribunal of the order given by the lower Authority. It also held that even if different views were taken by different Benches it could not be said that order passed by the Tribunal was perverse. The Court, in the instant case, held that since picking up of comparables, short listing of them, applying of filters, etc., are all fact- finding exercises, therefore the final order passed by the Tribunal are binding on the lower authorities of the Department. The High Court also observed that the Tribunal being the final fact finding body remains so for the Special Chapter X of the Income Tax Act also. Accordingly, the Court dismissed the appeal of Revenue as it was devoid of any substantial question of law. [*PCIT* v. *Softbrands India P. Ltd*. - (2018) 94 taxmann.com 426 (Karnataka)]

Interest payable for non-deduction of TDS even if assessee not an 'assessee in default' as per Section 201(1)

The assessee had made certain purchases from its parent company in US. The US Company also had a branch office in Bangalore which constituted a fixed place PE. The assessee did not deduct taxes while making payments to the US Company. Accordingly, the Revenue initiated proceedings under Section 201(1) and 201(1A) of the Act for *'assessee in default'* and levy of interest respectively. The assessee pleaded that since the US company suffered losses for which return of income declaring loss had also been filed, assessee could not be treated as *'an assessee in default'.* The assessee also argued that when no tax is payable by the US Company, there could not be any loss to the exchequer and therefore levy of interest which is compensatory in nature could not be sustained. The Revenue accepted that the assessee was not in default in terms of Section 201(1) but sought to levy interest under Section 201(1A) of the Act, for non-deduction of tax at source.

ITAT Bangalore while passing the Order relied upon the judgement of the Madras High Court in the case of *Chennai Metropolitan Water Supply and Sewerage Board* [348 ITR 530] wherein the Madras High Court dealt with similar facts and came to the conclusion that liability to pay interest under Section 201(1A) of the Act was mandatory. Further, the ITAT also made difference between a case where the amount paid was chargeable to tax but the payee had suffered loss or did not have positive income, from the case where the payments were not chargeable to tax at all. Thus, the Tribunal held that since, the case of assessee fell in the first case, i.e., where there is no positive income chargeable to tax, the same would absolve the assessee from being an assessee in default but not from paying interest under Section 201(1A) of the Act. Accordingly, levy of interest was upheld. [*Power and Control Systems* v. *DCIT* – Order dated 4-6-2018 in ITA No 883 to 887/Bang/2018)]

Exercising revisionary jurisdiction over CIT (A) order when not justified

The Karnataka High Court has held that the Commissioner of Income Tax is not justified in exercising revisionary power under Section 263 of Income Tax Act to upset the Order passed by Assessing Officer which had merged with the Order passed by CIT (Appeals). The Revisionary Authority had disallowed the expenses claimed by the assessee under the heads, 'labour charges', 'expenses of commission' and 'work in progress' with a direction to the Assessing Officer to enhance the total income in terms of the findings by him for the Assessment Year 2008-09. These development expenses had already been considered by Assessing Officer and concluded by Appellate Commissioner after re-consideration. The High Court has held that when the development expenses as considered by Assessing Officer were the subject matter of appeal and the Commissioner of Income Tax (Appeals) had confirmed the expenses for both the Assessment Years, the same question cannot be re-opened by the Revisionary Authority exercising power under Section 263. The Court observed that if revenue was aggrieved by Order of Appellate Commissioner, the only remedy was to file an appeal to the Tribunal or to re-open the assessments. [*Pr. CIT* v. *H. Nagaraja* – Judgement dated 29-5-2018 in ITA No. 604/2017, Karnataka High Court]

Commercial benefits relevant to distinguish capital and revenue expenditure

The Madras High Court has held that expenses incurred even if from capital account are not capital in nature when there is no creation of any new asset of enduring nature. It was observed that even test of enduring benefit may fail while distinguishing capital and revenue expenditure, hence, consideration should be placed upon nature of advantage in commercial use.

The assessee had entered into arrangement with the banks and co-promoters and took action for acquisition of land, import of machineries, etc., though no new venture was established. The venture, which was to be taken over by the assessee and operated did not fructify, not on account of the conduct of the assessee, but on account of the decision by the Government of Tamil Nadu. The Government of Tamil Nadu had ordered closure of the implementation of the chemical beneficiation project and as a consequence major portion of intangible assets were shown as revenue expenditure. The Assessing Officer while completing the assessment held that the expenditure is capital in nature as assessee had utilised money from the capital account and aid from the Government of Tamil Nadu termed as 'capital work-in-progress'.

The High Court, however, was of the view that the AO fell in error in going by the fact that the expenditure was incurred from the capital account forgetting that the test applied to ascertain as to whether the expenditure is revenue or capital is not based on where the funds were drawn from, rather there should be an enduring benefit which should accrue to the assessee and there should be a creation of new asset. Hence, it was held that expenses incurred from capital funds of venture taken over by assessee, which was later closed by Government, is not capital expenditure. [*Tamil Nadu Magnesite* v. *Asst. CIT* – Judgement dated 5-6-2018 in T.C. (Appeals) Nos. 907 and 908 of 2007, Madras High Court]

Income from exercising voting rights in a company in a particular way is capital receipt

Observing that income obtained for exercising voting right in a particular manner was one-off in nature and not recurring source of income, the Calcutta High Court has held that the receipt is a capital and not revenue receipt.

The Indian company was a joint venture between the RPG group in India and Tyco, USA. The assessee, a non-banking financial company, holds 50% of the paid up capital in the company. An agreement was entered into by the relevant subsidiaries of Tyco, USA under which the assessee was to vote in a particular manner at a general meeting of the company such that Tyco's specialised business was no longer carried on in India by it. In consideration for voting in the manner agreed, Tyco, Dubai paid certain sums to the assessee.

The High Court in this regard observed that income from such consideration is to be regarded as a capital receipt. The Bombay High Court decision in *Old Spice* was relied upon. It was also held that since the income was a consequence of the investment of the assessee in the company, income has to be regarded as a capital receipt. [*CIT* v. *Carnival Investment* – Judgement dated 18-6-2018 in ITAT 160 of 2013, Calcutta High Court]

Penalty under Section 271(1)(c) not tenable when disclosed particulars are accurate

Interpreting phrase, 'furnishing inaccurate particulars of income' under Section 271(1)(c) of the Income Tax Act, 1961, the Delhi High Court has held that legislature does not intend to penalise every person whose claim is disallowed. The Apex Court decision in *CIT* v. *Reliance Petroproducts* where words 'particulars' and 'inaccurate' were bifurcated, was relied to hold that when all particulars of income are disclosed without it being held bogus or false, penalty is not sustainable.

The assessee company had set up a project for which the company imported some machinery. The Company was unable to mobilize funds for the machinery and as a result the machinery could not be removed from the port. Due to worsening in the financial position, the assessee dropped the idea of setting up such manufacturing unit. The decision of the management to write off the project was disclosed in the annual accounts of the company, and was approved by the assessee's directors and shareholders in the Annual General Meeting. The Assessee, in the present case, claimed revenue loss on purchased machinery which according to them never capitalised and were eventually written-off. The AO accepted that there was a loss but declined to accept it as a revenue loss, subsequently, initiated penalty proceeding under Section 271(1)(c) of Income Tax Act on the issue of the writing off of capital work-in-progress.

The court held that the legislature does not intend to penalize everyone who makes a wrong claim for deduction. Observing that the genuineness of the loss incurred and disclosure of all particulars on part of assessee were also not at question, it was held that condition for imposing penalty under Section 271(1)(c) does not exist as it is not automatic in nature. [*Pr. CIT* v*. Samtel India* – Judgement dated 9-7-2018 in ITA 43/2017, Delhi High Court]

Ironing, packing, etc. of garments is manufacture - Deduction under Section 10B

The Calcutta High Court has allowed deduction under Section 10B of the Income Tax Act, 1961, observing that activity of ironing, packing, affixing bar code labels and stickers, emblem graphics, affixing stickers, putting silica gel pouch inside the packets, putting heat treated emblem, etc., on semi-finished garments amounts to 'manufacture' under the provisions relating to Export Oriented Undertakings. The Court noted that the assessee has performed some functions on the garments received by it, though all functions were not performed on all the garments but some or the other functions were performed on all the garments.

It also noted that the definition of 'manufacture' under clause 9.32 of rules and regulations relating to EOUs framed by the Government of India includes re-packing, re-conditioning, re-furbishing, etc., and it goes to the extent of refrigeration, hence, the definition is very wide and includes large number of functions and activities. Further, the High Court was of the view that activities on semi-finished garments is also manufacture though no consumption of raw material takes place. [*Pr. CIT* v. *A. P. Export* – Judgement dated 27-6-2018 in ITAT No. 156 of 2015, Calcutta High Court]

Portfolio Management Fees not deductible while computing capital gains on sale of shares

The assessee had earned capital gains on sale of shares and mutual funds and claimed fee paid under Portfolio Management Scheme (PMS) as a deductible expense. The AO disallowed the claim stating that under Section 48, income chargeable under the head "Capital Gains" is computed after allowing deductions viz. (i) expenditure incurred wholly and exclusively in connection with such transfer, (ii) cost of the acquisition of the asset and (iii) cost of any improvement thereto from full value of consideration received or accruing as a result of the transfer of the capital asset. Since, the PMS fees fell neither under transfer fees nor under cost of acquisition or any improvement, it could not be claimed as expenditure while computing capital gains. Placing reliance on catena of judgements including *Capt. Avinash Chandra Batra* v. *Dy. CIT* and *Homi K. Bhabha,* the ITAT held that fee paid for PMS could not be claimed as a deductible expense while computing capital gains as the same was unrelated to profits or loss under the head capital gains. Also, such fee was held not to have direct nexus with purchase and sale of shares as the same was payable even without there being any purchase or sale of shares in a particular period. [*Mateen Pyarali Dholkia* v. *DCIT* - (2018) 94 taxmann.com 294 (Mumbai -Trib.)]

Section 50C cannot apply in case of transfer of booking rights

The assessee, in the instant case, entered into an agreement for purchase of unconstructed flats. Accordingly, the assessee acquired certain rights to purchase the said flats. However, before the flats were completed, he sold the rights so acquired, and the consideration received was declared as long-term capital gains. The AO contended that for calculating gains on transfer, the stamp duty value should be applied in the light of Section 50C of the Act. In response, the assessee submitted that since no land or building had been transferred, Section 50C which applies only to land or building, could not be invoked. While adjudicating the matter, the ITAT relied on the judgement of the ITAT Ahmedabad in the case of *ITO* v. *Yasin Moosa Godil*. In the aforesaid case, it was observed that the assessee had transferred booking rights and received back the booking advance, which in no way could be equated with the capital asset. Accordingly, it was held that since the subject matter of transfer was not land or/and building, therefore deeming provisions of section 50C could not be applied. [*Baniara Engineers Pvt. Ltd* v. *ITO*, Order dated 4-7-2018 in ITA No. 635/Kol/2018, ITAT Kolkata]

'Corporation established by an Act' includes institution notified under the Act

The assessee had paid interest on FD/Deposits to the New Okhla Industrial Development Authority (NOIDA) without deducting TDS under Section 194-A of the Income-tax Act, 1961 in view of the provision providing exemption from deduction of tax on payment of interest to notified corporation established 'by' a Central, State or Provincial Act for this purpose. Revenue was of the view that NOIDA is a corporation established 'under' the Act and not 'by' the Act and as such the exemption available to a corporation established by the Act could not be extended. However, the assessee argued that since the Statute itself provided establishment of the Authority by virtue of a notification by the State Govt., the Authority had to be treated as established **by** the Act.

The Supreme Court referred to various judgements and differentiated between the concept *established by* and *established under* the Act. Some of the illustrative examples being a company is said to be created **under** the provisions of the Companies Act and not by the Act. Another being an executive committee which was covered by the Statute framed by the Agra University, could be said to be established by the Statute as the Agra university itself was established by the Statute. The Supreme Court in the case of *Dalco Engineering* has held that when the words "by and under an Act" are preceded by the words "established", the reference was to the corporation established, that is brought into existence, by an Act or under an Act. The word established had been interpreted by the SC to mean coming into existence by virtue of an enactment as against the body after coming into existence being governed by the provisions of the law.

Thus, it held that the emphasis should be on the word 'established' in addition to the words 'by or under'. Applying the same to the facts of the case in hand, Supreme Court, referring to the preamble and Section 3 of the 1976 Act held that wherein the constitution (by way of notification by the Govt.) and composition of the Authority were provided in the Act itself, the fact that the Authority was constituted by the Act could not be denied. Accordingly, the appeal of the Revenue was dismissed. [*CIT (TDS)* v. *Canara Bank* – Judgement dated 2-7-2018 in Civil Appeal No. 6020 of 2018, Supreme Court]

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