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tax scout

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Dear Readers,

We are delighted to present the latest issue of Tax Scout, our quarterly update on the recent developments in direct and indirect tax laws for the three months ending June 30, 2024.

In our main story, we have provided a detailed overview of the concept of permanent establishment in light of the rapidly changing business realities and the onset of the digital landscape.

In addition to this story, we have also dealt with other important developments and judicial precedents in the field of taxation for this quarter.

We hope you find the newsletter informative and insightful. Please do send us your comments and feedback at cam.publications@cyrilshroff.com.

Regards,
CYRIL SHROFF

Managing Partner
Cyril Amarchand Mangaldas

India's leading law firm

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Permanence of permanent establishment (PE): Ever-evolving concept of PE with the onset of a digital landscape

Increasing globalisation and rising economic cooperation and participation of MNCs in the creation of global wealth despite geographical, political, or economic barriers has made it imperative for leading world economies to revisit their taxation and statutory principles. One significant way of evaluating this and implementing new principles would be to analyse how MNCs are taxed. However, a deep-dive into the vast concept of PE is essential to understand this, as MNC operations spread across several countries. These MNCs need to be alert and assess in advance their tax exposure in the countries where they conduct their operations or generate any income.

The system of taxation principally hinges on two basic principles: (i) residence-based taxation and (ii) source-based taxation. Most developed countries tax entities that are tax residents of such jurisdictions. However, most developing countries tax entities based on their residence and their source of income because developing economies are entities that import capital, capital goods, technology, and technical services. Hence, these countries expect to increase their tax collection by attempting to tax the entities at their source. Developed economies, however, are entities that export capital, capital goods, technology, technical services and are primarily interested in collecting taxes at their residence to facilitate a decent amount of tax collection. However, this longstanding method has been showing changes. Several developed countries are starting to import the principles of taxation at source from developing countries because they have realised that they are missing the opportunity to collect taxes, as the traditional manner of conducting business has undergone a significant change. The advent of digital businesses and the ability to offer services from anywhere at any time has rendered the physical presence of the service provider unnecessary. This has resulted in developed countries borrowing the principles of taxation from developing countries and trying to tax such income.

1. How PE was taxed in the past

India taxes the income of a foreign enterprise when it arises through a 'business connection' under the Indian IT Act, subject to any beneficial provisions in the DTAAs India enters into with various countries. As per the DTAAs, the business income of a foreign enterprise becomes taxable in India if it arises through its PE in India. MNCs need to be mindful of the various intricacies of PE-related provisions so that they can plan their operations efficiently in various countries. MNCs operating outside their home jurisdiction need to be cautious of their footprint in other countries and PE-related implications, if any, to avoid a long-winded enquiry at the hands of the respective tax authorities.

The concept of PE is recognised by most countries and finds place in their domestic tax provisions and DTAAs. However, since we are making this analysis in the context of India, we will discuss and analyse the various implications of taxation of MNCs in India and the role of PE in that context.

2. Taxation of a PE in India

The elementary rule to analyse the existence of a PE of a foreign enterprise in India is to undertake a functional and factual analysis of the activities it undertakes in India. While the DTAAs India enters into with various countries are separately negotiated and each has its own nuances, the

definition of PE will nevertheless include the following types of PE:

a) Factory, branch, or place of management or any other form of physical presence;

b) Construction PE continuing for a period in excess of 180 days;

c) Oil or natural resources extraction activities for a period exceeding 180 days;

d) Agency PE.

However, as discussed previously, with the referred change in the manner of carrying out business activities and with increasing movement of people and resources across geographies, the following three forms of PE have risen to prominence:

a) Fixed place of PE (which covers almost every type of PE discussed earlier);

b) Service PE (signifying the impact of people and services in the new age economy) ;

c) Agency PE (primarily due to the complexity of this type of PE).

2.1 Fixed Place PE

As per Article 5(1) of most of the DTAAs India has entered into, a Fixed Place PE implies a fixed place of business through which the foreign entity in the host jurisdiction physically carries out the business of a foreign entity, either wholly or in part. Therefore, the basic essential requirements of a Fixed Place PE are as follows:

- there has to be a place of business (**POB**);
- POB must be fixed; and
- business of an enterprise is carried out "through" such place, wholly or partly.

A place – beyond the "bricks and mortar" definition

Primarily, the use of the term "place" in the definition of PE is crucial. The term place needs to be hypothesised in light of the rapidly changing business realities and the onset of the digital landscape. To study the scope and ambit of the term "place", reference may be drawn from noteworthy commentaries on the international tax treaties written by two internationally renowned authors Dr. Philip Baker[1] and Dr. Klaus Vogel.[2] According to Dr. Vogel, the term "POB" is not restricted to immovable assets as it can also cover movable property, and a PE can arise once such property has been fixed to the soil. A single tangible asset can also be sufficient to constitute a Fixed Place PE under a given set of circumstances. For instance, even a workbench in a caravan or a restaurant on permanently anchored riverboat can qualify as a place for constitution of a PE.

As per the OECD commentary on Model Tax Convention[3] on Article 5, a POB covers premises, facilities or installations used for carrying on the business of the foreign enterprise even if not exclusively used for that purpose. A POB can exist even in the absence of proper physical premises such that where only a certain amount of space is at the disposal of the foreign enterprise. Further, a POB can exist even in the absence of any employees. This would imply that any equipment, such as a vending machine, a telephone exchange, a pipeline, etc., which is installed and which can function without the presence of any employees can also constitute a Fixed Place PE, subject to the satisfaction of certain other conditions. However, such a fixed place cannot be of a purely temporary nature. In this regard, reference is drawn to the OECD commentary, which states that the POB, i.e., a fixed place, cannot be of a purely temporary nature but needs a degree of permanency. However, if a POB were setup with the intention of carrying it on for a long time, it would still constitute a Fixed Place PE even if the activities were terminated after a short period due to any reason. The term "permanence" should not be construed as implying that something would continue or last forever, i.e., the right to use the POB need not be perpetual. Further, it is not as if the concept of permanency implies a substantial length of time or duration, rather it underscores the importance of permanency of such fixed place for that much period or duration. In a landmark ruling by the SC in case of the ***Formula One World Championship***,[4] the SC held that the duration of an event for a limited number of days would not be the deciding factor and since during such time, the control of the place lay with the foreign entity, a Fixed Place PE would arise in India.

1 A Manual on the OECD Model Tax Convention on Income and on Capital" by Philip Baker Q.C.
2 Double Taxation Conventions" by Klaus Vogel.
3 OECD Model Tax Convention on Income and on Capital.
4 Formula One World Championship vs. Commissioner of Income Tax (2017) 15 SCC 602.

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Another indispensable and crucial element to constitute a Fixed Place PE is that such fixed POB needs to be at the disposal of the foreign enterprise. According to Dr. Vogel, a POB will usually exist only where the foreign enterprise is free to use the POB:

- at any time of its own choice;
- for work relating to more than one customer; and
- for internal administrative and bureaucratic work.

The preposition "through" in the definition of PE implies that the POB should be at the disposal of the foreign enterprise. The term disposal implies the power or authority to use the POB directly. A fixed place would be treated as being at the disposal of a foreign enterprise if the latter has the right to use such place, has control over it, and does not merely have access to it. It is not necessary that the foreign enterprise be able to exclude others from entering or using the POB. There are no strict standards laid down on the question of control. A taxpayer shall be regarded as controlling the POB where they can employ it at their discretion. Even in the absence of a legal right to use such place, it would meet the control test if the foreign enterprise has sufficient command of the POB in India. It may be noted that what is material is the right to use the place and not the manner in which such right has been secured. As per Dr. Baker's commentary, a PE must have three characteristics, i.e., (i) stability, (ii) productivity, and (iii) dependence. It also cited examples based on international cases regarding what could constitute a PE in a given set of circumstances. For instance, it provided that even a stand at a trade fair occupied regularly for three weeks a year by a foreign enterprise through which it obtained contracts can constitute a Fixed Place PE. Even the house of an individual residing in a country can be said to be at the disposal of a foreign enterprise and constitute a PE when such individual looks after the sales operations of the foreign entity from his house, under a given set of circumstances.

The OECD in its Commentary makes it clear that it is immaterial whether such place is owned, rented, or otherwise at the disposal of the foreign enterprise. For instance, a Fixed Place PE can exist even where a foreign enterprise illegally occupies a certain location where it carried on its business. Skaar in his noteworthy commentary[5] on PE referred to disposal test as the "right of use test" and stated that it would be met if the foreign enterprise can use the place without any limitations or prevention from any other party, i.e., it can freely use the place. In this regard, Skaar also states that where a foreign enterprise has entered into a contract in which it is presupposed that it will use the client's premises, it meets the right of use test of PE. Even Dr. Baker in his commentary stated that a Fixed Place PE need not be owned or leased by the foreign enterprise as long as it has the right to use the premises for the purpose of its own business and not just for undertaking a project for the owner of the premises. The said principles have also been highlighted in landmark ruling by the SC in the case of ***Formula One World Championship (supra)*** wherein it held that the physical motor racing circuit in India from where a motor race was conducted was under the control of and at the disposal of the foreign taxpayer and therefore constituted its Fixed Place PE in India, notwithstanding the duration of the event.

Not preparatory or auxiliary: In most of the DTAAs entered by India there is a general exception to the definition of PE as per Article 5(1) that it shall not include other activities which have a preparatory or auxiliary character for the foreign enterprise. Therefore, it becomes highly important to demarcate what activities form part of the core business of a foreign enterprise and which activities can be construed as preparatory and auxiliary in nature. This is essentially a fact-specific exercise and can often become problematic. In such a scenario, the decisive criterion would be whether a particular activity forms an essential and significant part of the principal activity of an enterprise. For instance, where back-office operations, support services such as market research, advertising, data processing, acting as a communication channel or permitted liaison office (**LO**) activities, etc., do not form part of the main business activity of the foreign entity, they cannot lead to its Fixed Place PE in India. In ***GE Energy Parts Inc.,***[6] the Delhi HC observed that although the taxpayer being a USA-based company had only formed the LO in India with the permission of RBI to act as a communication channel, during the course of survey proceedings, such an LO was found as carrying on the core activities of marketing, negotiating with clients, participating in the finalisation of commercial terms, and selling highly sophisticated

[5] Permanent Establishment: Erosion of a Tax Treaty Principle by Arvid Aage Skaar.
[6] GE Energy Parts Inc. v. Commissioner of Income-tax, International Taxation, Delhi-I [2019] 101 taxmann.com 142 (Delhi).

equipment, it constituted a Fixed Place PE in India. Dr. Vogel in his commentary had explained the rationale for such exclusion of preparatory and auxiliary activity from the ambit of Fixed Place PE, stating that such activities may contribute to the productivity of the foreign enterprise but not towards the actual realisation of profits, in which case it would be anyway difficult to allocate any profits to such a POB.

2.2 Service PE

The provisions related to Service PE are also found in Article 5[7] of the various DTAAs entered by India. A Service PE is an international tax concept under which services provided by a non-resident may give rise to a PE in source country if services are provided through employees or personnel in the source country beyond a certain period irrespective of a fixed presence. The crux of Service PE lies in the provision of services through employees or other personnel engaged for such purposes within the source country for a duration exceeding a specified threshold; for instance, 90 days or 183 days within a 12-month period or fiscal year, as the case may be. A Service PE is formed if the following conditions are satisfied:

- The services are furnished within a source state.
- The services are furnished by foreign enterprise through its employees or other personnel.
- The period of furnishing of services exceeds the specified threshold time.
- The services are not taxable as royalty or FTS.

The establishment of a Service PE enables the source country to exercise its taxing rights by levying taxes on the profits attributable to the activities of the Service PE as these activities are performed and income is earned in the source country. The specific rules and thresholds governing Service PE may vary across different DTAAs entered into by India, yet the overarching objective remains consistent, i.e., to ensure a fair allocation of taxing rights between the contracting states involved. Various DTAAs entered by India contain different periods of threshold for constituting a PE. For instance, 90 days in any fiscal year as per Article 5(6) of India Singapore DTAA, with a lower threshold of 30 days if the services are performed for a related enterprise, whereas such a threshold is 90 days within any 12-month period as per India–USA DTAA and no threshold is prescribed for a related enterprise.

Service PE–related implications could arise in cases of typical secondment arrangements where the foreign entity furnishes services in India through its personnel. However, there are several instances where the personnel of the foreign enterprise travel to India but perform services in India at the behest of and under the control and supervision of the Indian entity instead. In such cases, various courts or tribunals have regularly emphasised that since these personnel are not performing services in India on behalf of the foreign enterprise as their deputation itself was not for rendering of any services by the foreign enterprise, which is an essential requirement, a Service PE is not formed, as also explained in ***Tekmark Global Solutions LLC.***[8] Further, it was also pointed out that no income of the foreign enterprise was arising in India in this regard.

To determine a Service PE, it is important to first analyze the nature of activity undertaken in India. For instance, there are various stewardship-related activities undertaken by a foreign company in India with the primary objective of protecting its interests such as monitoring the activities of the Indian entity, ensuring compliance with the group's policies, conducting quality checks on its goods and services, reviewing its business activities, etc. Such activities undertaken for quality control purposes cannot be termed as equivalent to furnishing of services by the foreign enterprise and therefore have been held to be outside the ambit of a Service PE as also held in ***Morgan Stanley & Co.***[9] Further, determining the question of existence of control or supervision of the foreign company over the personnel in India is a fact specific exercise that must be undertaken basis concrete material. For instance, if the Indian company is responsible for work, salary, appraisal, reporting, etc., of the personnel seconded by the foreign enterprise, it shows control and supervision of the Indian company, and a Service PE cannot arise in India. Further, mere reimbursement of the salaries or emoluments of such personnel by the foreign enterprise due to administrative convenience does not by itself imply that a Service PE arises in India.

[7] For instance, Article 5(6) of India Singapore DTAA, Article 5(2)(k) of India UK DTAA or Article 5(2)(l) of India USA DTAA. Service PE clause is not present in certain DTAAs entered by India for instance India France DTAA.
[8] Deputy Director of Income-tax, (II)-2(1), Mumbai v. Tekmark Global Solutions LLC [2010] 38 SOT 7 (MUM.).
[9] DIT (International Taxation) v. Morgan Stanley & Co. [2007] 292 ITR 416/210 CTR 419/162 Taxman 165/201 Taxation 160 (SC).

2.3 Dependent Agent PE (DAPE)

As per the relevant provisions[10] of the DTAAs entered by India, a DAPE arises when a person, other than an independent agent, acts in a Contracting State on behalf of an enterprise of the other Contracting State and does the following:

- habitually exercises in the first-mentioned State an authority to conclude on behalf of the foreign enterprise, or
- habitually maintains in the first-mentioned State a stock of goods for regularly delivering them on behalf of the foreign enterprise, or
- habitually secures orders in the first-mentioned State, wholly or almost wholly for the foreign enterprise

There are several crucial aspects to be considered to ascertain the constitution of a DAPE of a foreign enterprise in India. Firstly, an agent in India should be authorised to conclude contracts on behalf of the foreign enterprise. The authority given to an agent may be general, specific, or limited. However, it is essential that the agent's action be binding on the foreign enterprise. Also, such authority should necessarily be with respect to business of the foreign enterprise. For instance, negotiation of contracts by an agent in India that is eventually subject to the approval of the foreign enterprise would imply that he does not have powers to bind the principal and therefore would not constitute a DAPE in India. Conversely, where an agent in India performs all actions necessary for the negotiation and conclusion of contracts, which are binding on the principal, and merely the signing of the contract is held outside India, the agent would still be said to have the requisite authority to conclude contracts and constitute a DAPE in India. Further, the question of authority is one of substance over form. The authority to bind the principal should be for purposes essential and significant to the principal's business and not for mere administrative purposes. such as conclusion of contracts for stationery, rent, office, manpower contracts, etc.

Secondly, the agent should habitually exercises such authority, i.e., in a repeated manner and not merely in certain isolated instances. For instance, where as per the agreements, purchase orders, copies of contract, etc., the employees of Indian company were actively involved in conclusion of contracts on behalf of the foreign enterprise and habitually secured orders in India wholly or almost wholly for them, a DAPE shall arise as held in ***Huawei Technologies Co. Ltd.***[11]

Thirdly, a DAPE shall not arise in case of an independent agent. In case of an independent agent, two conditions are usually satisfied:

- The agent is both legally and economically independent of the foreign enterprise (**dependency test**).
- The agent is acting in the ordinary course of its business in carrying out activities on behalf of the foreign enterprise.

Legal dependence can be construed from the nature of arrangement or agreement between the foreign enterprise and its agent. An agent shall be considered independent if the risk and return of the business done by the agent fully accrues to the agent. Further, to ascertain the question of economic dependence, it may be analysed if the foreign enterprise is the only customer the agent serves as part of his agency business. If the agent's activities are not wholly or exclusively devoted to the foreign enterprise and the services are being remunerated at arm's length, then the agent would be considered as an independent agent. In ***Adobe Systems Software Ireland Ltd.,***[12] the agreement was framed in a manner that shows that the actions of Adobe India were not binding on Adobe Ireland. However, Adobe India was actually acting as the sole representative of Adobe Ireland in India and performed market development and various other activities contributing to the earnings of Adobe Ireland in India and was legally and economically dependent on Adobe Ireland to survive. Therefore, it was held as constituting a DAPE in India. However, where an agent does not accept orders frequently on behalf of the principal nor frequently represents to the clients as having the authority to bind the principal, a DAPE will not arise as held in ***Krones Aktiengesellschaft***.[13]

The discussion around the constitution of one or more PEs would not be complete without evaluating it in light of emerging new technologies and remote operations

[10] For instance, Article 5(4) of India USA DTAA, India UK DTAA or Article 5(8) of India Singapore DTAA.
[11] Huawei Technologies Co. Ltd. v. Asstt. DIT (2014) 44 taxmann.com 296/149 ITD 323) (Delhi - Trib.).
[12] Adobe Systems Software Ireland Ltd. v. Assistant Commissioner of Income-tax (International Taxation)* 2023] 155 taxmann.com 397 (Delhi - Trib.).
[13] ITA No. 2617/DEL/2017.

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gaining momentum over the past many years. Section 4 later in the text encapsulates a detailed discussion in this regard. Further, to comprehend the extent of tax impact pursuant to existence of a PE in another jurisdiction, it is important to understand the concept of profit attribution to a PE as explained subsequently.

3. Attribution of profits

If a PE of a foreign enterprise exists in India, only so much of the profits as reasonably attributable to such a PE in India can be considered as business income and taxed in India under the IT Act. Attribution of the profits can be done based on actual profits made by the PE based on its books of accounts. In case a PE arises in India, if the transfer pricing analysis adequately reflects the FAR (function, asset, and risk) analysis of the Indian entity and is already remunerated at arm's length by the foreign enterprise, no further profits need to be attributed to such PE, as also held in landmark ruling of the SC in the case of ***Morgan Stanley & Co.***[14] However, if certain functions performed and risks assumed by the Indian entity are not adequately captured in the FAR analysis, further profits would need to be attributed in this regard. This highlights the importance of undertaking a proper FAR analysis of the Indian party.

In cases where the AO opines[15] that profits cannot be ascertained due to various reasons, the profits may be attributed as a reasonable percentage of the turnover or proportional to the total receipts or in other suitable manner, as deemed fit. It may be appreciated that there is much room for exercise of discretion by the tax authorities for attribution of profits. However, in a given set of facts and circumstances, it is up to the taxpayer to demonstrate using suitable evidences or explanations that the profits be attributed on a reasonable basis.

4. From virtual or server PE to remote services: the taxpayer faces a myriad of challenges

With the development of internet and a digital ecosystem for conduct of business activities, correlation between the size of business and nature and extent of physical presence in the source country has virtually vanished. Physical presence is no longer essential to carry out operations in another country. Therefore, MNCs are tapping into foreign markets at a much increased pace without having to physically cross the borders. The businesses have also realised the benefits of and are adapting to a virtual landscape to the extent possible. They are also taking long strides in this direction. This has also led to some interesting developments regarding taxing such businesses in India.

As per the OECD commentary on Model Tax Convention, a computer equipment set up at a location (for instance, a server) is a piece of equipment having a physical location.

[14] DIT (International Taxation) v. Morgan Stanley & Co. [2007] 292 ITR 416/210 CTR 419/162 Taxman 165/201 Taxation 160 (SC).

[15] Rule 10 of IT Rules. The CBDT also constituted a Committee and published its report for public consultation vide F. No. 500/33/2017-FTD.I dated April 18, 2019 to recommend suitable methods for profit attribution.

It can constitute a fixed POB and a PE where it is at the disposal of the foreign enterprise and located at a certain place for sufficient period so as to become "fixed" and is used to carry out the business functions of the foreign enterprise. Such PE implications arising due to presence of physical server of a foreign enterprise have also been discussed in ***Right Florists***.[16] Even in case of ***Amadeus IT Group Sa***[17] and ***Travelport Inc.,***[18] it was held that computer equipment or hardware of the foreign entity situated in India for providing connectivity to the travel agents constituted Fixed Place PE in India. In ***Galileo International Inc.***[19] it was held that the foreign enterprise exercised significant control over the computers installed at the premises of the subscribers in India; therefore, they constituted a Fixed Place PE in India. In ***Mastercard Asia Pacific Pte. Ltd.,***[20] it was held that Mastercard network consisting of transmission towers, leased lines, fiber optic cables, nodes internet, etc., at the disposal of the foreign enterprise constituted its PE in India. Tested on the anvil of the principles of a Fixed Place PE elaborately discussed earlier, the presence of physical equipment in India such as servers, etc., that satisfy the requisite conditions can be held to be a Fixed Place PE within the confines of the existing provisions of the tax treaties entered by India.

Further, on the subject of Service PE a rather unprecedented ruling of the Bangalore ITAT in the case of ***ABB FZ-LLC***[21] held that the physical presence of employees is not required in the source country for a Service PE to come into existence, as services still become furnished in the source state. Such an interpretation can lead to catastrophic consequences, is extremely draconian in nature, and could have far reaching implications on the global business operations of MNCs operating in multiple jurisdictions. The relevant provisions for Service PE in the DTAAs entered by India use the term "within" the other contracting state. Ordinarily, in English the preposition "within" denotes a physical location; for example, in the house or in the lake. Therefore, in order to furnish services in the source country, the presence of such employees in that host country is mandatory. However, the interpretation adopted by the ITAT in ***ABB FZ-LLC (supra)*** seems implausible as it enlarges the scope of Service PE to include every long-term cross-border transaction, whereby a non-resident renders services to a customer in the source country beyond the stipulated threshold period under the tax treaty. Further, the OECD Commentary also contemplates the physical presence of the employees or personnel in the source country for the constitution of a Service PE. Relying on the preceding ruling in ***ABB FZ-LLC (supra)***, the income tax authorities in ***Clifford Chance PTE Ltd.***[22] alleged that a virtual Service PE was constituted in case of the assessee. However, the ITAT Delhi held that a virtual PE of assessee did not arise on account of the rendition of legal advisory services to clients in India in the absence of such provisions in the India–Singapore DTAA and because physical presence of the employees in India was required. The ITAT also relied upon OECD Interim Report 2018,[23] which states that unless the tax treaties are amended in this respect, taxpayers could challenge such actions before a court of law. It also held that the concept of virtual PE in the preceding OECD Report has not been endorsed by India. Therefore, it can be said that the tax treaties, as they stand today, shall not be completely sufficient to impute taxes by alleging a PE in the other jurisdiction merely due to rendition of services in a remote manner from outside the source country.

The advancements in technology are occurring at a rapid pace, whereas the tax regulations and court settled jurisprudence are only trailing. At the same time, the government is also striving to provide an environment of certainty to the businesses to attract the big international players and bring them on board. The traditional PE concept based on physical presence and agency is facing new challenges with the onset of remote services, international servers, and increased reliance on digital means. However, the tax treaties are yet to undergo a comprehensive makeover to address the unique challenges posed by a digital economy, as the far as the concept of PE is concerned. The traditional rules for PE may become obsolete and may not be sufficient to tackle the challenges of the coming times. However, unless the treaties are re-negotiated to incorporate provisions to extend the taxing rights even to a pure virtual presence, the tax authorities (Indian) will need to abide by the existing provisions and jurisprudence laid down by the various courts and exercise their powers in a reasonable manner and within their limits. As famously

[16] Income Tax Officer v. Right Florists, [2013] 25 ITR(T) 639 (Kol. – Trib.).
[17] Amadeus IT Group SA Vaish Associates v. ACIT [2023] 155 taxmann.com 427 (Delhi - Trib.).
[18] Director of Income-tax v. Travelport Inc. [2023] 149 taxmann.com 470 (SC).
[19] DIT v. M/s. Galileo International Inc. [2011] 336 ITR 264 (Delhi).
[20] MasterCard Asia Pacific Pte. Ltd., In re. [2018] 94 taxmann.com 195 (AAR - New Delhi).
[21] ABB FZ-LLC v. Dy. CIT (International Taxation), [2017] 83 taxmann.com 86/166 ITR 329 (Beng - Trib.).
[22] Clifford Chance PTE Ltd. v. ACIT [2024] 160 taxmann.com 424 (Delhi - Trib.).
[23] OECD Interim Report 2018 under the OECD/G20 BEPS Project Titled "Tax challenges arising from Digitalisation".

stated by Benjamin Franklin – "Nothing is certain except death and taxes". Therefore, it is also important that MNCs looking to avoid a chase from the tax authorities at a later stage introspect on their form, presence, and manner of functioning in other countries.

Ease of doing business versus prolonged litigation

Ironically, while India as a country has been conscientiously introducing reforms aimed to provide a business-friendly environment to new and upcoming businesses, the tussle between various MNCs and the Indian government on the issue of PE has been endless. The ITD has pursued aggressively several multi-national entities on the issue of PE, notwithstanding the little or non-existent evidence it might have in some cases or the years of fruitless and prolonged litigation that follows. However, these businesses have no option but to defend their position for years to come and, in the process, strategic and useful business ideas for growth take a backseat. While relief is generally available from the Courts, this process takes a lot of time, effort, energy, and resources, sometimes compelling the businesses to exit the country. Therefore, it is imperative for both sides, i.e., the taxpayer and the income tax department, make conscious efforts to avoid the drudgery of litigation.

Conclusion – way to forward

When a foreign enterprise decides to conduct its business activities in another country, it should carefully analyse the nature and mode of carrying out such activity in another jurisdiction. During the course of entering into any understanding or arrangement or agreement in relation to carrying on such activity, it should evaluate the potential exposure or possibility of giving rise to a PE, as per the various principles explained earlier. Where a PE does not arise as per the facts of a certain case, the terms and conditions of the underlying agreements (a service agreement, rental agreement, etc.) should be drafted in a clear and concise manner so that they do not lead to any PE exposure unnecessarily. Further, while undertaking actual operations in India, a foreign enterprise should evaluate any PE-related exposure in advance and be reasonably prepared so that it should not come as a surprise if its case is selected for a detailed scrutiny. Undertaking a comprehensive and complete FAR analysis of the activities of counter parties in India is also of utmost importance, in cases where they can be remunerated at arm's length as explained in Section 3. Since PE determination is a fact-based exercise, non-resident taxpayers are well advised to plan their commercial arrangements and the rights they seek from their Indian counterparts or other affiliates in a careful manner.

Similarly, it is high time that the Ministry of Finance and the CBDT prepare certain standard operating procedures that the tax administrators should adhere to while initiating allegations against the taxpayers regarding the existence of a PE. To avoid initiation of litigation merely at the hands of over-enthusiastic tax officers handling these cases, it is advisable to set up a committee consisting of senior revenue officials, who should be able to adopt a nuanced neutral opinion, before the concerned AO proceeds to pass an adverse order. Similarly, a mechanism may be devised to appropriately reward tax officers who are able to generate additional revenues for the government and put obstacles in the promotion of those who initiate unwarranted litigation. Tax authorities should also be encouraged to look for ideas to generate additional revenue and not unnecessary litigation.

Income from the sale of subscription-based research products under the reseller agreement is 'royalty' under Article 12 of India–Ireland DTAA

Introduction

In the case of ***Gartner Ireland Ltd.,***[24] the ITAT Mumbai has held that sale of subscription-based research product under reseller agreement is royalty under Article 12 of India-Ireland DTAA.

Facts

Gartner Ireland Ltd. (**Assessee** or **GIL**) was a non-resident company incorporated in Ireland and was engaged in the business of selling subscription-based research products and related services, i.e., periodicals, reports, and publications that highlight industry developments. Prior to the year under consideration, customers in India could purchase and access the products over the internet from the Assessee's data server located outside India. However, during the year under consideration, the Assessee incorporated its Indian subsidiary, Gartner India Research and Advisory Services Private Limited (**Gartner India**). The Assessee entered into a "reseller agreement" under which Gartner India purchased the products for resale to its customers in India. The Assessing Officer (**AO**) issued a draft assessment order proposing to treat the revenue generated from the sale of online subscription as 'royalty' income taxable in India.

The Assessee approached the Ld. Dispute Resolution Panel (**DRP**) who dismissed the objections by relying on ITAT's ruling in the Assessee's own case for previous assessment years in which the ITAT had relied on Karnataka HC's judgment in ***Wipro Ltd***.[25]

Issue

Whether income from sale of online subscription-based product for resale is "royalty" or "business income" for tax purposes under the IT Act and the India-Ireland DTAA?

Arguments

The Assessee argued that it sold products to Gartner India, who merely resold such products to the end customers in India and, thus, the transaction was a pure sale/purchase of the products. Hence, the income derived by it should be regarded as "business income" and not be taxable in India as per the beneficial provisions of the India–Ireland DTAA in absence of a PE in India. The Assessee further submitted that the subscription-based research products by the Assessee to Gartner India are copyrighted and their access was restricted for internal use only. Hence, no copyright was given to Gartner India and, thus, the said transaction is merely sale of copyrighted article, which is not taxable as royalty/FTS.

On the other hand, the Respondent argued that in the case of ***Wipro Ltd (supra)***, Wipro Ltd. had subscribed online research product of the Assessee and the payment was made by Wipro Ltd., which was upheld by the Karnataka HC as in the nature of "royalty" income liable to withholding tax. The Respondent further referred to the decision of co-ordinate bench in Assessee's own case for certain years, wherein the issue was decided against the Assessee.

[24] Gartner Ireland Ltd., v. DCIT, ITA No. 2460/MUM/2022 [ITAT Mumbai].
[25] CIT v. Wipro Ltd. (2011) 203 Taxman 621 (Karnataka).

Decision

The ITAT noted that the Assessee's income from the sale of subscription-based products comprised (i) sale to Gartner India, which was subsequently resold by Gartner India to its customers in India on a principal to principal basis under a "reseller agreement" and (ii) sale to Gartner India for its internal use in exchange for a research access fee under a research access agreement. It also noted that income from the sale of subscription-based products under the "reseller agreement" is royalty, since Gartner India did not maintain any stock. It further noted that the Assessee had failed to correlate the sale of each product to Gartner India with the further sale by Gartner India to its customers and that the Assessee had raised only one-time quarterly invoices, whereas Gartner India had the option to resell the same product multiple times. The ITAT concluded the sale by the Assessee to Gartner India as a sale of copyright in the subscription-based products.

It went on to compare the action the Assessee had undertaken as the sale of one copy of the magazine to Gartner India, who got copies of those printed and sold the same multiple times to its customers. Thus, in substance, the Assessee had sold copyrights in those products, which was akin to royalty under Article 12 of the India–Ireland DTAA.

Having decided the preceding, the ITAT remitted the matter back to AO to ascertain whether there was any exploitation of the copyright by Gartner India under the research access fee. It further directed the AO to determine whether the income of the Assessee from the sale of the subscription-based products comprised payments received for information concerning industrial, commercial, or scientific experience and asked the AO to examine the existence of the Assessee's PE in India, if required.

Significant Takeaways

The issue pertaining to the sale of a copyrighted article for sole internal use versus the sale of copyright is settled in view of the decisions of the SC and Bombay HC in the cases of ***Engineering Analysis and Centre of Excellence***[26] and ***Dun & Breadstreet Information Services Pvt. Ltd.***[27] respectively, wherein it was held that in terms of Article 12 of the relevant DTAAs, the payments made by resident Indian end-users/distributors to non-resident computer software manufacturers/suppliers, as consideration for the resale/use of the computer software through EULAs/distribution agreements, does not constitute royalty since the payment is not for the use of or the right to use copyright in the computer software. Accordingly, in terms of Section 195 of the IT Act, the payer is not required to withhold tax at source at the time of making payments to the non-resident supplier.

Compared to the preceding, the appeal by the Assessee challenged the classification of its income from subscription-based products as royalty income. The ITAT found merit in reviewing the case based on the specifics of the transactions and the applicability of legal precedents. This is because the Assessee had the specific rights to make multiple copies of the said research product and was authorised to exploit the same commercially, which was not the case in the SC case mentioned previously.

Thus, the present decision highlights the complexities involved in determining the tax treatment of digital transactions involving cross-border sales of subscription-based products, emphasising the need for careful analysis of the facts, in consonance with a nuanced understanding of copyright law and DTAAs.

> **"Sale of subscription-based research products under a reseller agreement is royalty under the India-Ireland DTAA."**

[26] Engineering Analysis Centre of Excellence Private Limited vs. Commissioner of Income Tax and Anr. (2021) 125 taxmann.com 42 (SC).
[27] Director of Income-tax v. Dun & Breadstreet Information Services Pvt. Ltd. [2012] 20 taxmann.com 695 (Bom.).

Amount received by a partner in a firm upon retirement from partnership is capital receipt not subject to tax

Introduction

In ***Smt. Girija Reddy P.,***[28] the Telangana HC held that payment of credit balance received by a partner consequent to retirement from the partnership firm could not be taxed as capital gains under Section 45, read with Section 47 of the IT Act, since there was no specific transfer of a capital asset upon the retirement.

Facts

Smt. Girija Reddy P (**Assessee**) was a partner in the firm, M/s. Montage Manufacturers. The Assessee stood retired from the said firm, whereby the Assessee received a sum of INR 8.2 crores (approx.) towards her share of capital from the firm, which was considered by the Assessee as capital receipt and, hence, non-taxable. However, the AO held that the right of the Assessee in the firm is a capital asset. There is also an extinguishment of the right in the said firm, which is a transfer. The AO held that the receipt was against the goodwill and capital and thus, taxable under Section 45 of the IT Act.

Accordingly, the AO passed the assessment order raising a demand of INR 2.39 crore (approx.). On appeal, the CIT(A) dismissed the appeal preferred by the Assessee. On further appeal, the ITAT also did not provide any relief.

Issue

Whether the payment of the credit balance received the by Assessee upon retirement from the partnership firm in her capital account with the firm is taxable as capital gains under the IT Act?

Arguments

The Assessee submitted that there was no transfer of any capital asset by the Assessee in favour of the firm upon her retirement and that the amount so received by the Assessee was only repayment of the balance of the capital account standing in the name of the Assessee. Additionally, the receipt of the share value of goodwill could not be subjected to capital gains tax, as there was no transfer of goodwill by the Assessee to the firm.

The IRA, on the other hand, argued that the right of the Assessee in the partnership firm was a capital asset and the extinguishment of the right in the said firm was transfer of a capital asset; therefore, the income earned from such transfer was taxable under Section 45 of the IT Act as "Capital Gains".

Judgment

The Telangana HC, while allowing the appeal, primarily relied on the judgment of ***Chalasani Venkateswara Rao,***[29] wherein the division bench of the same HC, under similar circumstances, had held that when a partner retired from a partnership firm taking

[28] Smt. Girija Reddy P. v. Income-tax Officer, [2024] 161 taxmann.com 746 (Telangana).
[29] Chalasani Venkateswara Rao v. Income-tax Officer, [2012] 349 I.T.R. 423.

their share of partnership interest, no element of transfer of interest in the partnership asset by the retiring partner to the continuing partner was involved. It was merely adjustment of the right of the partner and not a transfer for a price.

Accordingly, the HC held that IRA could not tax the amount received by the Assessee upon retirement from the partnership as capital gains because there was no specific transfer of a capital asset being undertaken. Thus, the finding of the ITAT holding that the receipt of share in value of goodwill by the Assessee was taxable as capital gains was not proper.

Significant Takeaways

The HC has reaffirmed the position of law vide the present judgment that no transfer is involved when a retiring partner receives the share in the partnership assets at the time of retirement from the firm. For the purpose of Section 45 of the IT Act, no distinction can be drawn between an amount received by the partner on the dissolution of the firm and that received on retirement, since both of them stand on the same footing.

Interest in a firm is an asset, as any other asset, as recognised by the IT Act and transfer thereof within the meaning of Section 2(47) of the IT Act gives rise to capital gain subject to tax. In a situation where a partner receives a price equated with reference to the market value of the assets of the firm for giving up rights in the firm, it is assumed that the rights and interest had been valued at the market price. When the price exceeds the cost, the language of Section 45(4) of the IT Act (amended in the year 2021) comes into operation to treat the difference between the market price and the cost, being gains on account of transfer of capital asset, leading to levy of tax on capital gains in the hands of firm (and not in the hands of the partners).

Similar view has been taken by the Bombay HC in the case of ***Ramona Pinto***,[30] and by the SC in the cases of ***Mohanbhai Pamabhai,***[31] ***Tribhuvandas G. Patel***,[32] and ***R. Lingmallu Raghu Kumar.***[33] It is relevant to note that while the language has been amended in 2021, this will remain useful for the pending similar cases.

> **"Balance received by a partner consequent to retirement from the partnership firm cannot be taxed as capital gains."**

[30] Ramona Pinto v. Deputy Commissioner of Income-tax, [2023] 156 taxmann.com 282 (Bombay).
[31] ACIT v. Mohanbhai Pamabhai [1987] 165 ITR 166 (SC).
[32] Tribhuvandas G. Patel v. CIT [1999] 236 ITR 515 (SC).
[33] CIT v. R. Lingmallu Raghu Kumar [2002] 124 TAXMAN 127 (SC).

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Consideration received by trustees for relinquishment of trusteeship cannot be treated as a capital receipt, but shall be taxable as individual income of trustees

Introduction

The Kerala High Court in the case of ***Gracy Babu***[34] has held that where trustees of a trust, which was subsequently taken over by a church, received certain sums of money upon relinquishment of their trusteeship, consideration received for such relinquishment would not qualify as a capital receipt and would be treated as individual income of assesses.

Facts

The Carmel Educational Trust, Adoor (**Trust**) was a registered trust and was engaged in the running of educational institutions in engineering and management. Due to personal difficulties, the trustees decided to discontinue the aforesaid activities and entered into an agreement with the Believers Church on March 10, 2009, whereby all the existing trustees resigned and new trustees nominated by the Believers Church were inducted. The agreement between the parties also provided for a payment of INR 375 million to the erstwhile trustees for settling their liabilities as well as completing certain construction activities that they had commenced prior to the agreement. The agreement also provided for the sale of 55.15 acres of land belonging to some of the erstwhile trustees for a consideration of INR 125 million.

A search under Section 132 of the IT Act was conducted at the residence of the trustees, i.e., Respondents, on March 4, 2009, and an unsigned draft agreement dated February 23, 2009, was found, which indicated that the amount envisaged for settlement of liability was INR 435 million and that the value of the rubber estate extending to 55.15 acres of land was INR 65 million.

Placing reliance on the seized documents, the AO found that the erstwhile trustees had in fact received approx. INR 375 million towards consideration for relinquishing their trusteeship. However, they had camouflaged these receipts under different heads by showing the receipt of INR 145.5 million towards the reimbursement of amounts the trustees had paid towards clearing outstanding debts and liabilities of the Trust and for completing certain ongoing constructions they had undertaken. In addition, INR125 million was shown as consideration for the sale of approx. 56 acres of rubber plantation to the Believers Church.

On appeal, the CIT(A) confirmed said order. On further appeal, the ITAT concluded that the consideration for relinquishing trusteeship was a capital receipt exempt from taxation. The ITAT further held that the amounts the trustees received as consideration for relinquishment of their trusteeship would qualify as a capital receipt for the purpose of the IT Act. Moreover, in the absence of any statutory provision under the IT Act for the determination of the cost of acquisition of the asset, capital gains cannot be computed and be taxed in the hands of the trustees.

Issue

- Whether the trustees of a public charitable trust have a right to trusteeship and if they need to be compensated for relinquishing such right?
- Whether the consideration received for relinquishing trusteeship is subject to capital gains tax?

Arguments

The IRA argued that evidence obtained during the course of search proceedings revealed that the said trustees had actually not undertaken any construction work. Hence, the payments they received were nothing but payments received for voluntary relinquishment of trusteeship in favour of certain identified individuals and, thus, must be taxed accordingly.

The Assessee, on the other hand, argued that the audited balance sheet of the trust clearly shows that there was on ongoing construction taking place and, thus, the amount paid by the Church was transferred for the same. Alternatively, the amounts the trustees received as consideration for relinquishment of their trusteeship would qualify as a capital receipt for the purpose of the IT Act, and, in the absence of any statutory provision under the IT Act that provides for the determination of cost of acquisition of the trusteeship, the amount of capital gains cannot be computed and hence, nothing could be taxed in the hands of trustees.

Decision

The Kerala HC partly allowed the appeal by holding that perusal of the trust deed, in the instant case, does not indicate that any power was conferred on the trustees to relinquish their position

[34] Principal Commissioner of Income-tax (Central) v. Gracy Babu, [2024] 162 taxmann.com 116 (Kerala).

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as trustees *en banc*. It further relied on the SC decision in the case of ***Sheikh Abdul Kayum***[35] to hold that a person appointed as trustee is not bound to accept the trusteeship. However, having once appointed as trustee, the person cannot renounce the duties and liabilities except with the permission of the Court or with the consent of the beneficiaries or by the authority of the trust deed itself.

Thus, it concluded that the consideration received by the trustees for such relinquishment cannot be regarded as capital receipt and cannot be taxed as capital gains. The consideration will have to be treated as ordinary income of the trustees and taxes shall have to be deposited under the appropriate head.

Significant Takeaways

The Kerala HC judgment reiterates the legal position that trustees cannot transfer their duties, functions & powers to some other body of people and create them trustees in their own place unless this is clearly permitted by the trust deed, or agreed to by the entire body of beneficiaries, and cannot ask for money for extinguishing such a right. In case they do receive any consideration, the same shall be taxable in their hands.

It is also important that the issues are handled in light of the judicial precedents, and the agreements are made after undertaking due considerations. Further, it is the duty of the tax authorities to analyse the facts, with proper application of mind before commencing with any proceedings under the IT Act.

The issue involved in the present appeal was also raised before the Courts in the past. For instance, in the case of **Jose Thomas**,[36] the Assessee filed a case against reopening of assessment pursuant to search, wherein it was found that the Assessee had received money for vacating post of trustee. The reopening of assessment was held be valid on this aspect.

Most of these trusts function as charitable organisations and, thus, are required to adhere a number of other formalities and procedures. It is, therefore, important to consider all aspects of such a transaction before transfer of ownership of the trust. The terms under which the exemption is granted, generally requires prior approval of the tax authorities before allowing any change in the trusteeship. The tax authorities will have to examine the application carefully and may ask additional questions before being satisfied to grant exemption to such trust.

> **“ Consideration received for relinquishing trusteeship is taxable as income in the hands of the trustees. ”**

[35] Sheikh Abdul Kayum v. Mulla Alibhai AIR 1963 SC 309.
[36] Jose Thomas v. Deputy Commissioner of Income-tax, Central Circle, Kottayam [2016] 76 taxmann.com 36 (Kerala).

No Penalty under Section 11 of FTDR Act can be imposed for non-fulfilment of export obligation

Introduction

In case of ***M/s Embio Limited v. Director General of Foreign Trade & Ors.,***[37] the Apex Court has set aside the penalty levied under the Foreign Trade (Development and Regulation) Act, 1992 (**FTDR Act**) on account of failure to comply with condition of EPCG license.

Facts

Karnataka Malladi Biotics Limited (**KMBL**) obtained an EPCG license to import capital goods at a concessional rate. It was required to complete the export obligations (**EO**) within five years from the date of issuance of the EPCG license. Unfortunately, the Board for Industrial Finance and Reconstruction (**BIFR**) declared KMBL as a sick unit on August 11, 1999.

On April 3, 2002, the IRA issued a demand notice to recover the customs duty from the Appellant on account of non-fulfilment of EO. The IRA partially recovered the said differential duty by enforcing a bank guarantee. Subsequently on June 3, 2003, the BIFR approved a rehabilitation plan for the KMBL. The Regional DGFT on July 16, 2004, passed an order-in-original thereby imposing a penalty under Section 11 of FTDR Act for non-fulfilment of export obligation. Aggrieved by the same, it filed an appeal that was dismissed and a review before the Central Government was also rejected.

KMBL thereafter approached the jurisdictional HC under writ petition. In between, KMBL merged with another entity and the merged entity M/s Embio Limited (**Appellant**) was formed.

The writ petition was dismissed on procedural aspects. Aggrieved by the same, the Appellant approached the SC.

Issue

Whether the non-fulfillment of export obligations amounts to contravention of Section 11(2) of the FTDR Act for imposing of the penalty?

Arguments

The Appellant contended that the BIFR-sanctioned rehabilitation scheme included a waiver of customs duty and applicable interest due to the non-fulfilment of the export obligations. The Appellant argued that this waiver implied that no penalty should be imposed for the same reason.

Further, the Appellant also contended that the penalty imposed under Section 11(2) of the FTDR Act was without authority of law. The Appellant argued that Section 11(2) of the FTDR Act pertains to contraventions involving making or attempting to make exports or imports in violation of the FTDR Act, its rules, or orders. Non-fulfillment of EO is not a contravention of import or export. Hence, it is not a ground for contravention under Section 11(2) of the FTDR Act. Therefore, the order-in-original imposing the penalty was illegal.

[37] M/s Embio Limited vs. Director General of Foreign Trade & Ors 2024 (5) TMI 684 - SUPREME COURT.

On the other hand, the DGFT contended that the BIFR-sanctioned rehabilitation scheme did not provide waiver for penalties for non-fulfillment of export obligations. It further contended that the Appellant violated the terms of the EPCG license by failing to meet the export obligation, which is a policy under the FTDR Act.

Further, the DGFT submitted that due process was followed before confirming the penalty, i.e., a show-cause notice was issued, and the Appellant was given an opportunity to present it's case, and speaking order was issued. Furthermore, they argued that despite the merger, the obligations under the original EPCG license and the associated penalties for non-compliance remained valid and enforceable against the Appellant.

Decision

The SC observed that the rehabilitation scheme sanctioned by BIFR, provided waiver only of customs duties and interest, and not any penalties under the FTDR Act. However, the SC highlighted that penalty under section 11(2) of the FTDR Act does not cover failure on the part of the taxpayer to meet the export obligation under the license. It was not a contravention laid down under Section 11(2) of the FTDR Act as it only covers prohibited exports or imports. The SC observed that as no allegation were made for either attempting or undertaking illegal import or export. Hence, the Appellant has not contravened the provisions mentioned under Section 11(2) of the FTDR Act. Further, the SC held that as the provision is penal in nature, it needs interpreting in a strict manner, and it cannot be liberally interpreted to include violation of EPCG license obligations.

Significant Takeaways

This judgment is favourable to taxpayers as it clarifies the scope of imposing penalties under the FTDR Act. The SC has unequivocally stated that if the grounds for contravention are not explicitly mentioned in the provision, they cannot be interpreted in a manner that benefits the department.

Unfortunately, the judgment leaves the applicability of penal provision hanging where a waiver of customs duty or interest has been granted under a scheme of insolvency and there was no mention of penalty. This could raise substantial concern in future since several companies are undergoing insolvency or bankruptcy proceeding and the scheme passed may not contain any waiver of penalty. It is, therefore, for the lawyer preparing such schemes to incorporate prayers to cover not only payment of customs duty, but also potential liability like fines and penalties leviable under the FTDR Act, etc.

“Section 11 (2) of FTDR Act, being a penal provision has to be strictly construed.”

Tax authorities cannot initiate tax assessment against Company dissolved under Section 59 (8) of the IBC

Introduction

In the case of ***M/S. Hitachi Nest Control Systems Pvt. Ltd. v. Additional Commissioner of Central Tax Bengaluru***,[38], the Karnataka HC held that issuing a show-cause notice and adjudicating the same against a "non-existing" entity is a jurisdictional defect and not merely a procedural defect that can be cured.

Facts

Hitachi Nest Control Systems Pvt. Ltd. (**Petitioner**) was dissolved under Section 59(8) of the IBC vide order dated February 15, 2023 (**Dissolution Order**) passed by the NCLT, Bangalore.

The GST Registration of the Petitioner was already cancelled by the IRA with effect from September 30, 2020. Further, an NOC was also issued from the Income Tax Department in terms of the Dissolution Order.

To everyone's surprise, post dissolution, the IRA issued a show-cause notice September 29, 2023, in the name of the Petitioner, which later crystallised into an order December 27, 2023 (**Adjudication Order**). Aggrieved, by the same the Petitioner filed a writ petition before the Karnataka HC.

Issue

1. Whether IRA can initiate tax assessment proceedings under the provisions of CGST Act against a company that has been dissolved under section 59(8) of IBC?
2. Whether under section 88 of CGST Act, IRA is entitled to proceed against the directors of the Petitioner?

Arguments

The Petitioner contended that the IRA lacks jurisdiction and authority to issue the impugned show-cause notice and pass the Adjudication Order since the Petitioner was dissolved prior to the issuance of the said show-cause notice. It relied on the Dissolution Order, which provided that the Petitioner was dissolved and had ceased to exist.

The Petitioner also relied on jurisprudence dealing with settled position of law that framing of assessment against a non-existing entity/person was a jurisdictional defect. There is no power under CGST Act to assess a non-existing entity.

On the contrary, the IRA contended that under Section 88(3) of CGST Act, IRA has power to recover tax from every person who is a director of such a company at any time during the period for which the tax is due, even in cases where the Assessee, being a private company, is wound up. Hence, the proceedings initiated in the instant case were well within the jurisdiction of the IRA.

Decision

The HC quashed the impugned show-cause notice and the Adjudication Order. It observed that upon final dissolution the Petitioner had become "non-existent" in the eyes of law for all purposes including imposing or fastening any liability under GST. The HC placed reliance on the case of ***Pr. Commissioner of Income Tax, New Delhi v. Maruti Suzuki India***,[39] which held that in the case of an amalgamating company holding issuance of notice post amalgamation, when a company has ceased to exist, is fundamentally at odds with the legal principle that amalgamating entity ceases to exist upon the approved scheme of amalgamation.

It also relied on ***Spice Entertainment v. Commissioner of Service Tax***,[40] which provided that once a company is dissolved it becomes a non-existent party; therefore, no action can be brought in its name. The HC held that as such, the framing of assessment against a non-existing entity/person goes to the root of the matter.

Separately, the HC held that upon a holistic reading of Section 88 of the CGST Act, it is evident that the IRA was required to notify their claims to the official liquidator within 3 months from date on which it receives information regarding appointment of liquidator. In the instant case, the IRA had failed to comply with the same. Hence, liability that was not notified cannot now be imposed on directors. It further clarified that Section 88 (3) of the CGST Act would be applicable only when tax was determined at the time when company was in existence. Thus, the HC held that due to non-compliance of the IRA, issuing the show-cause

[38] M/S. Hitachi Nest Control Systems Pvt. Ltd. v. Additional Commissioner of Central Tax Bengaluru, 2024 (6) TMI 227.
[39] Pr. Commissioner of Income Tax, New Delhi v. Maruti Suzuki India Ltd -2019 SCC Online SC 928.
[40] Spice Entertainment v. Commissioner of Service Tax, 2012 (280) E.L.T. 43 (Del.).

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notice to a not existent company and determining the liability after dissolution and consequently holding directors liable was not valid.

Significant Takeaways

The Karnataka HC's decision has significant implications for directors and companies undergoing dissolution. This ruling provides crucial protection for directors by shielding them from tax liabilities determined after the company's dissolution. It also offers clear guidelines on the jurisdictional limits of tax authorities with respect to dissolved entities, ensuring that legal boundaries are respected. Furthermore, the decision underscores the importance of adhering to established legal precedents when dealing with dissolved companies.

> **“ No tax proceeding can be initiated against a company that has already been wound up. ”**

The purpose and intent behind granting the exemption must be carefully considered while interpreting Exemption Notification

Introduction

The Madras HC in the case of ***Thai Mookambikaa Ladies Hostel v. Union Of India***,[41] has held that hostel services provided in the form of accommodation do qualify as residential dwellings and are exempt from levy of GST.

Facts

Thai Mookambikka Ladies Hostel (**Petitioner**) operates private hostels. It provides residential accommodation and food services to college students and working women. The Petitioner requested an advance ruling from the Tamil Nadu Authority for Advance Ruling (**AAR**) to seek clarity regarding applicability of GST on such services. The Petitioner was of the view that it was covered by entry 12 of Notification No. 12/2017-Central Tax (Rate) dated June 28, 2017 (**Notification**), which exempts services related to renting residential dwellings for use as residences. The AAR held that the services provided by the Petitioner do not qualify as renting of residential dwellings and therefore exigible to GST. Aggrieved by the same the Petitioner has filed a writ petition before the Madras HC.

Issue

a. *Whether the writ petition is maintainable in the light of alternate remedy available under section 100 of the CGST Act?*

b. *Whether the hostel services provided the Petitioner qualify as residential dwelling and are covered under entry 12 of the Notification?*

Arguments

The Petitioner submitted that mere availability of alternative remedy in form of an appeal before the appellate authority would not act as an embargo to file the present writ petition when the Impugned Order is patently illegal. The Petitioner contended that an appeal to appellate authority for advance ruling would be a futile exercise as they would not take a contrary view against the Notification. Hence, the present petition is maintainable.

On merits, the Petitioner contended that the hostels run by them are covered by Entry No. 12 of the Notification. It contended the term "residential dwelling" has not been defined in the GST legislations and, hence, it must be interpreted in the light of trade parlance. The Petitioner also placed reliance on the Karnataka High Court ruling in ***Taghar Vasudeva Ambrish v Appellate Authority for Advanced Ruling, Karnataka 2022 (2) TMI 780 - Karnataka High Court*** (**Karnataka HC Ruling**) wherein the expression "residence" and "dwelling" were interpreted basis common parlance.

The Petitioner contended before the HC that "residential dwelling" means any residential accommodation but does not include hotel, inn, guest house, or like places meant for temporary stay. The Petitioner argued that college students and working women utilising the services are not staying for a temporary but a longer period, i.e., course tenure, job tenure, etc. The Petitioner also relied on multiple judicial precedents dealing with use of hostels, meaning of residential place.

On the other hand, the IRA contended that the Petitioner is renting out a single room to various individual women for different periods of time as part of their business for monetary gain. They argued that the Petitioner was not signing any rental agreements with these individuals to transfer rights to the specified space for a specific time, which meant that such a transaction does not fit within the definition of "residence" as per the Tamil Nadu Rent Regulation Act. Additionally, the IRA contested that typically, renting a residential dwelling does not include services like food, housekeeping, or laundry. In contrast, a hostel is an establishment that offers accommodation services along with these additional services.

Furthermore, the IRA contended that rent received by subletting of property is subject to TDS under section 194(1) of the IT Act, however, the same is not being deducted. The IRA also submitted that the Karnataka HC Ruling is not applicable to the current petition, as it is under consideration by the SC.

Decision

The Madras HC held that the writ was maintainable as the appeal was not an efficacious alternative remedy. It observed that it was unlikely that the appellate authority for advance ruling would take a view against the Notification. It also stated that when a lower authority fails to apply the ruling of superior court, the writ was maintainable.

[41] Thai Mookambikaa Ladies Hostel v. Union Of India, 2024 (3) TMI 1271 - Madras High Court.

The Madras HC held that IRA, while concluding, had failed to consider the actual use of the premises by the hostel residents. It failed to identify whether the property would be used for residential or commercial purposes by the end recipient. The HC held that GST is an indirect tax, therefore, GST on hostel accommodation should be viewed from perspective of the service recipient and not the supplier. The HC observed an exemption can be claimed if the end use is residential, irrespective of the nature of the property.

Further, the HC held that while interpreting the scope of any notification, the authority should first keep in mind the object and purpose of the notification and all parts of it should be read harmoniously in aid of, and not in derogation, of that purpose. The HC held that the entry dealing with commercial property like hotels, motels, inns, guest houses, etc., intentionally excluded hostels. Additionally, The HC emphasised that the purpose of the Notification is to reduce the tax burden on residents occupying residential premises. It held that the Petitioner has met the condition of "residential dwelling for use as residence," and accordingly, upheld the exemption of GST on the renting of hostel rooms.

Significant takeaway

The decision emphasises the end use of the residential property from the perspective of tenants to determine the taxability of hostel services. It clearly distinguishes between hotel services and hostel services, stating that the imposition of GST on hostel accommodation should be viewed from the perspective of the service recipient rather than the service provider. The decision is particularly significant for interpreting exemption notifications. The HC has explicitly emphasised that while interpreting the scope of an exemption, the purpose and intent behind granting the exemption must be carefully considered. This approach ensures that the underlying objectives of the exemption are honoured. Specifically, the HC via an example has articulated that the legislature's intention is never to impose a tax burden on the economically disadvantaged. As such, this decision underscores the necessity of a purposive approach in legal interpretation, especially in contexts where tax exemptions are concerned.

"The issue of levy of GST on residential accommodation should be viewed from the perspective of recipient of service."

cyril amarchand mangaldas
ahead of the curve

REGULATORY INDIRECT TAX UPDATES

The recent GST clarifications mark a significant step towards achieving a more efficient and transparent tax system. They reflect the Government's commitment to reform and the ongoing efforts to create a conducive business climate. The industry, in turn, can look forward to engaging constructively with policymakers to shape a GST regime that is equitable, straightforward, and conducive to growth. Businesses, especially those engaged in cross-border transactions and complex supply chains, stand to benefit significantly from these clarifications. The reduced litigation risk and clearer compliance requirements will likely lead to cost savings and operational efficiencies. The changes have come post the recent 53rd GST Council meeting held on June 24, 2024.

Monetary thresholds for appeals

Vide Circular No. 207/1/2024-GST dated June 26, 2024, the CBIC has introduced thresholds with the aim to prevent unnecessary litigation, focusing only on cases with significant monetary implications. It would ensure utilising judicial resources effectively and bringing only substantive issues before higher forums. No appeal shall be filed if the amount is below the following limits:

- For GST Appellate Tribunal: INR 20,00,000
- For High Court: INR 1,00,00,000
- For Supreme Court: INR 2,00,00,000

However, in some exceptions, the department can file an appeal even if the amount is below the specified limits, i.e., where any provision, rule, notification, circular, etc., has been held *ultra vires*, the issue is related to the valuation of goods or services; or classification of goods or services; or refunds; or place of supply, which is a recurring issue or involves interpretation.

While on the face of it, the clarification seems to be the end of litigation for small taxpayers, a close reading of the exclusion clarifies that the threshold would hardly be applicable on the department, as the exclusion seems to cover a multitude of common issues that are recurring or involve the interpretation of provisions.

Valuation in import of services from a related person

The CBIC, *vide* Circular No. 210/4/2024-GST dated June 26, 2024, has clarified that in cases wherein services are imported from a related foreign affiliate and full ITC is available, the value declared in invoice, even Nil amount, would be deemed as the open market value. This is in line with Circular No. 199/11/2023-GST dated July 17, 2023, that was issued in connection with supplies made by domestic related parties.

The said change would significantly reduce litigation, as various activities, such as manpower supply in case of secondment, management services, account services, undertaken by foreign-related persons have been subject matter of dispute before various Hcs.

GST on employee benefits granted by foreign holding company

The CBIC, *vide* Circular No. 213/07/2024-GST dated June 26, 2024, has clarified that it is very common for an employment package to contain clauses regarding ESOP, ESPPs, and RSUs by foreign holding companies. As such benefits are in the nature of security, no GST shall be applicable where domestic subsidiary reimburses its foreign holding company on a cost-to-cost basis.

However, where additional charges are recovered, such charges would attract GST under RCM.

As there is lack of clarity about what should be treated as cost-to-cost basis, the tax authorities may raise concerns if the price does not tally with the open market value of such securities.

Custodial Services for FPIs

The CBIC, *vide* Circular No 220/14/2024-GST dated June 26, 2024, has clarified that custodial services are not considered to have been provided to "account holders." Thus, the place of supply provisions dealing with banks would not be applicable. Accordingly, custodial services provided to foreign portfolio investors would qualify as export of service.

It provides much-needed relief to custodian banks, who have recently received notices for the department stating that the custodial services they provided to the FPIs do not qualify as export of services, allowing them to focus on their core activities without the constant threat of investigations. However, the impact on custodian accounts who bear interest still remains ambiguous.

ITC on RCM Supplies

The CBIC, *vide* Circular No. 211/5/2024-GST dated June 26, 2024, has clarified that the financial year for calculating the ITC time limit under RCM will be the year in which the recipient issues the invoice, provided the tax is paid and other conditions are met. The same is applicable even for the issuance of invoice for past period.

While the ITC would be available, the liability of interest and penalty if imposed for delayed payment would still have to be adhered.

ITC reversal on post-sale discounts

The CBIC, *vide* Circular No. 212/6/2024-GST dated June 26, 2024, has clarified that the recipients are required to reverse the ITC pertaining to post-sale discounts, where discount is established in terms of an agreement and the supplier intends to reduce the value of main supply. The taxpayers have been facing scrutiny from tax department regarding ITC reversal, as there is no suitable mechanism on the portal to verify. In the interim, CBIC has clarified that a Chartered Accountant/Cost Accountant certificate verifying the recipient has reversed the corresponding ITC would be sufficient. For smaller amounts (up to INR 5,00,000), an undertaking from the recipient would be sufficient.

The said interim solution may open a new document requirement for every credit note issued and in an industry where post sale, target, and volume-based discount are common, it may become a nightmare to get certificates and maintain such records.

No ITC reversal for insurance covering premium associated with investment or savings

The CBIC Circular No. 217/11/2024-GST dated June 26, 2024, has clarified that for life insurance policies, only the part of the premium related to risk coverage is considered the value of

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supply. In other words, the portion of the premium associated with investment or savings is excluded from this value. The value attributed to investment or savings is not an exempt supply, so no proportional reversal of ITC would now be necessary.

ITC for services related to repairs and maintenance of motor vehicles for insurance company.

The CBIC, *vide* Circular No. 215/9/2024-GST dated June 26, 2024, has clarified that in cases where cashless insurance is used, the repair garages provide services and invoice insurance companies and claim full ITC. However, in cases of reimbursement, as the vehicle owner initially pays the bill, the CBIC has clarified the following:

- The insurance company remains eligible to claim ITC in these instances.
- If the insurance company reimburses the full bill amount to the vehicle owner/insured, they can claim ITC for the entire tax paid.
- If only partial reimbursement occurs, the insurance company can claim ITC proportionately to the amount reimbursed.

However, it is essential that car garages invoice insurance companies to avoid mismatch on the portal. Further, insurance companies will have to be cautious regarding the availability of ITC, as it will be dependent on the compliances the workshops undertake, and in case of non-network workshops, the risk of non-compliance at their end is higher.

Loans between related persons

The CBIC, *vide* Circular No. 218/12/2024-GST dated June 26, 2024, has clarified that loans provided without any additional consideration or fees (beyond interest) between related persons is not considered as a supply of services and thereby not subject to levy of GST. The CBIC also clarified that there is no requirement to determine the value of the fees, in cases where loans are provided without any consideration, on the basis of open market value unless any additional fee is being charged towards processing the same.

Charging of additional fees or functioning like a bank or financial institutions, such as undertaking KYC check, financial standing and credibility of the applicant, etc., is highly unlikely for a related entity while issuing such loans.

Clarification in relation to place of supply for goods delivered to unregistered person

The CBIC, *vide* Circular No. 209/3/2024-GST dated June 26, 2024, in relation to goods supplied to unregistered persons, clarified that if the delivery address differs from the billing address, the place of supply will be the delivery address on the invoice. This clarification ensures that the revenue is accrued to the correct State where the goods are ultimately consumed.

GLOSSARY

ABBREVIATION	MEANING
AAR	Hon'ble Authority for Advance Rulings
AAAR	Hon'ble Appellate Authority for Advance Rulings
AO	Learned Assessing Officer
AY	Assessment Year
Customs Act	Customs Act, 1962
CBDT	Central Board of Direct Taxes
CENVAT	Central Value Added Tax
CESTAT	Hon'ble Customs, Excise and Service Tax Appellate Tribunal
CGST	Central Goods and Service Tax
CGST Act	Central Goods and Service Tax Act, 2017
CGST Rules	Central Goods and Service Tax Rules, 2017
CIT	Learned Commissioner of Income Tax
CIT(A)	Learned Commissioner of Income Tax (Appeal)
CVD	Countervailing Duty
DGFT	Directorate General of Foreign Trade
DRP	Dispute Resolution Panel
DTAA	Double Taxation Avoidance Agreement
EPCG	Export Promotion Capital Goods
FA	Finance Act
FMV	Fair Market Value
FTP	Foreign Trade Policy
FY	Financial Year
GST	Goods and Services Tax
HC	Hon'ble High Court
HUF	Hindu Undivided Family
IBC	Insolvency and Bankruptcy Code, 2016
IGST	Integrated Goods and Services Tax
IGST Act	Integrated Goods and Services Tax Act, 2017
INR	Indian Rupees
IRA	Indian Revenue Authorities

GLOSSARY

ABBREVIATION	MEANING
IT Act	Income-tax Act, 1961
ITAT	Hon'ble Income Tax Appellate Tribunal
ITC	Input Tax Credit
ITO	Income Tax Officer
IT Rules	Income-tax Rules, 1962
Ltd.	Limited
NCLT	National Company Law Tribunal
NCLAT	National Company Law Appellate Tribunal
OECD	Organisation for Economic Co-operation and Development
PAN	Permanent Account Number
PCIT	Learned Principal Commissioner of Income Tax
PE	Permanent Establishment
Pvt.	Private
RBI	Reserve Bank of India
SAD	Special Additional Duty
SC	Hon'ble Supreme Court
SCN	Show-cause Notice
SEBI	Security Exchange Board of India
SEZ	Special Economic Zone
SGST	State Goods and Services Tax
SGST Act	State Goods and Services Tax Act, 2017
SLP	Special Leave Petition
TDS	Tax Deducted at Source
USA	United States of America
UTGST	Union Territory Goods and Services Tax
UTGST Act	Union Territory Goods and Services Tax Act, 2017
VAT	Value Added Tax
VAT Tribunal	Hon'ble VAT Tribunal

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