ELP

THE INDIA POST

Judicial Update: India Customs & Taxes Edition

November 2023

Supreme Court judgment in the case of Nestle SA –dated 19.10.2023

The Supreme Court **(SC)** in the recent ruling in the matter of Nestle SA[1] examined the most favoured nation **(MFN)** clause contained in India's Double Tax Avoidance Agreements **(DTAA)** with Netherlands, France, and Switzerland.

Generally, MFN clause provides for favourable tax treatment as provided to another Organisation for Economic Co-operation and Development **(OECD)** country subsequent to signing of tax treaty and thus, results in reduction of taxation at source on dividends, interest, royalties, or fees for technical services **(FTS)** as the case may be, or restriction of scope of royalty/FTS.

The Dispute

Where a DTAA between India and any country contains an MFN clause and subsequently, India enters into a DTAA with another country which provides beneficial treatment, then it was interpreted that such beneficial treatment would automatically apply to the DTAA with the first mentioned country.

The application of MFN clause has been a subject matter of litigation in India over the past few years. The issues arising in the appeal before the SC in this matter were:

- Whether an MFN clause comes into effect automatically or it comes into effect only after a notification is issued by the Indian tax authorities under Section 90(1) of the IT Act.
- Whether an MFN clause can be invoked when a third country with which India has entered into a DTAA was not an OECD member at the time of entering into such DTAA.

Findings of the Supreme Court

The SC has held that to give effect to a tax treaty or to its Protocol changing terms and conditions that alters existing provisions of the law, a notification is required to be issued under section 90(1) of the Income-tax Act, 1961. Further, it is also held that for invoking the MFN clause, the third country should be a member of the OECD when such DTAA is signed and obtaining OECD membership on a later date has no significance.

The Impact

The SC ruling is a significant development in the way tax treaties are interpreted and may have far-reaching consequences. It may impact all pending cases where benefits have been claimed based on an MFN clause and may also trigger reassessment proceedings by the Indian tax authorities. However, such proceedings may be challenged on procedural grounds itself.

Action 15 to prevent Base Erosion and Profit Shifting (BEPS) has resulted into signing and executing Multilateral Convention to Implement Tax Treaty **(MLI)** and due to these, number of DTAAs have already been amended in so far as India's content is concerned. It would be interesting to see whether each amendment would require a separate notification/ratification for DTTA to give effect to MLI? This may not be intended or else the very purpose or intent of MLI would be questioned.

[1] TS-616-SC-2023

Supreme Court judgment in the case of Bharti Hexacom Ltd –dated 16.10.2023

The Supreme Court **(SC)** in the recent ruling in the matter of Bharti Hexacom Ltd[2] has put to rest the decade-old litigation between the income tax department and the telecommunication companies with regards to classification of annual variable license fees payable as capital or revenue expenditure.

The Dispute

In accordance with the New Telecom Policy of 1999, the licensees were required to pay a one-time entry fee up to July 31, 1999, and additionally, an annual license fee on a percentage share of gross revenue which was temporarily fixed at 15%.

The license fees was payable for initial setting and, thereafter for maintaining and operating cellular telephone services during the term of the license. Thus, the payment of license fee was considered partly as capital and partly as revenue in nature. For this, the license fee was divided into two periods i.e., before and after July 31, 1999. The amounts paid or payable upto July 31, 1999 were treated as capital and all subsequent payments were considered as revenue expenditure.

This position was approved by Delhi High Court, Bombay High Court and Karnataka High Court.

Findings of the Supreme Court

The SC emphasized on the nature of 'original obligation test' and held that, where the subsequent payments are towards a purpose which is identifiably distinct from the original obligation of the taxpayer, the same would constitute revenue expenditure. However, where each of the successive instalments relate to the same obligation or purpose, the cumulative expenditure would be capital in nature.

In the present case, the successive instalments related to the same obligation, i.e., payment of license fee as consideration for the right to establish, maintain and operate telecommunication services as a composite whole. Hence, the cumulative expenditure was held to be capital in nature.

The Impact

The Supreme Court has clarified that mere payment of an amount in instalments does not convert or change the capital payment to a revenue payment. What is relevant is the nature of the original obligation and whether the subsequent payment made in instalments relates to or has a nexus with such original obligation or not.

In several instances payment of license fee for purchase of right to manufacture and sell products, obtain rights for broadcasting, using technology, subscription of software licenses, subscription fee for accessing databases and portals, etc. is structured in a composite manner of lump-sum and/or variable periodic payments. Further post pandemic, in view of liberal policies, several overdue statutory payments were converted into installments too. In view of the above decision, taxpayers would be required to revisit the tax treatment of such license fees in their books of accounts. Reclassifying revenue expenditure as capital expenditure would increase the tax liability to a substantial extent.

This decision introduces substantial modifications to both legal and factual dimensions, potentially exerting a profound influence on how both taxpayers and tax authorities would interpret and apply these guidelines.

[2] Civil Appeal No(s). 11128 of 2016

Supreme Court judgement in case of Northern Operating Systems –dated 19.05.2022

The Supreme Court **(SC)** in the matter of Northern Operating Systems[3] examined whether deputation of foreign expatriates in India could be regarded as "manpower recruitment or supply agency" so as to be liable to erstwhile Service Tax.

The Dispute

The case revolved around overseas group entities seconding employees to its Indian arm. Although this, the employees continued on the payroll of the overseas entities for continuity of employment benefits. The secondees, however, worked control and supervision of the Indian entity, which also held a separate employment contract with these employees. Lastly, the payment of salary, bonus, social benefits, out-of-pocket expenses and other expenses was routed through the overseas entities. The overseas entities in-turn recovered these costs from the Indian entity without loading any mark up.

The Indian indirect tax authorities alleged that the secondment constitutes manpower supply services liable to service tax. The proposition led to huge demands being raised and confirmed on the Indian entity. The dispute eventually reached the Supreme Court of India **(SC)**.

Findings of the Supreme Court

The SC narrative was primarily to discover the "real employer". SC held that where proven that the overseas entities are the employers, the arrangement shall qualify as a taxable service to the Indian entity and not otherwise. The top court observed that, while deciding whether an arrangement is a contract "of" service or a contract "for" service, the courts do not give primacy to any single determinative factor and the substance over form test should be applied.

While the seconded employee, for the duration of secondment, is under the control of the Indian entity and works under its direction, the fact remains that they are on the payrolls of their foreign employer. The secondment is a part of the global policy of the overseas employer loaning their employees' services on a temporary basis. On the cessation of the secondment period, they must be repatriated in accordance with a global policy. Accordingly, SC held that the Indian entity was the service recipient of the foreign company and the arrangement would trigger a service tax liability in India.

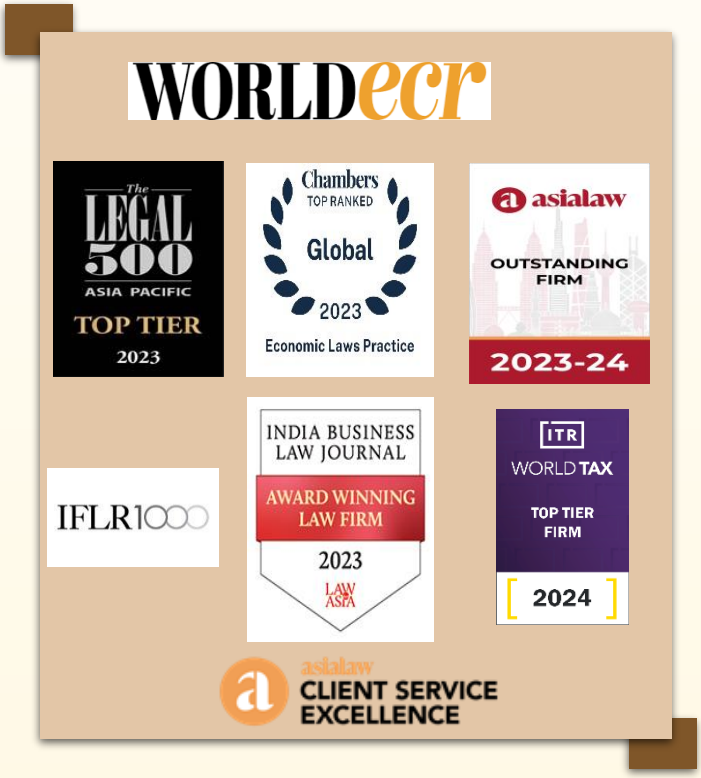
At this juncture it may be noted that (a) the said ruling has been referred to the larger bench of the SC in case of Kumatsu India; and (b) various High Courts are obliging tax payers by granting a stay on assessment proceedings prima facie acknowledging difference in the facts of Norther Operating Systems.

The Impact

The pivotal insight gleaned from the Supreme Court ruling is that, given the absence of a singular paramount factor to ascertain the genuine employer-employee relationship, the specifics of each case remain crucial. In a precise interpretation, the judgment is circumscribed in its application, intended for situations where the Indian entity did not function as the authentic employer of seconded employees, holding the authority to terminate and exert control over the terms of employment.

The tax authorities have, however, taken the issue at face value and are applying the ruling to all international secondment arrangements without delving into detailed facts. The ramifications of the ruling have thus flown to the GST regime as well exposing expat salaries to 18% GST from July 2017. Reportedly, more than 1000 notices have already been issued either seeking data on international secondments and/ or raising the 18% GST demand. The issue thus need careful examination by all MNC's with Indian interest.

[3] TS-216-SC-2022



About Us

Economic Laws Practice

Economic Laws Practice (ELP) stands as a premier Tier 1 full-service law firm in India, offering comprehensive legal support to clients in the realms of advisory, litigation, and regulatory affairs.

ELP's Customs and trade regulatory practice is widely regarded as one of India's most esteemed trade practices. Our expertise extends to various facets, including import/export policies, tariff classification, valuation, country of origin matters, export controls, and trade regulations such as BIS, ROHS, e-waste regulations, legal metrology, and related compliance issues.

Our team maintains close collaboration with Indian policymakers, actively engaging in policy formulation, tariff rationalization, and providing advocacy assistance. Members of the firm are regularly invited to be part of high-level advisory committees formed by the Ministry of Commerce & Ministry of Finance and regularly assist clients on advocacy matters.

We also have the distinction of successfully representing the Government of India in several disputes at the WTO.

For a more in-depth and nuanced perspective on any of the topics discussed in this edition, please don't hesitate to contact our Tax, Customs & Regulatory Practice Partners:

Rohit Jain
E: rohitjain@elp-in.com

Nishant Shah
E: nishantshah@elp-in.com

Harsh Shah
E: harshshah@elp-in.com

Kumar Visalaksh
E: kumarvisalaksh@elp-in.com

Connect with us on:

Elplaw.in

Economic Laws Practice (ELP)

ELPIndia