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## Editorial:

Dear Esteemed Readers,

We are pleased to share with you our latest newsletter covering direct tax & transfer pricing updates in India for the December 2015.

Mid-December 2015 saw the US Federal Reserve raise the range of its benchmark interest rate by 25 basis points, the first hike in 9 years, sending out a positive signal about revival in the world's largest economy. Earlier, between 2004 and 2006, the US Fed had raised interest rates 17 times from — 1 per cent to in June 2004 to 5.25 in June 2006. This had coincided with a period of high growth in Indian economy along with relatively low interest rate regime. The rate hike by US Fed that time resulted in a sharp outflow from Indian debt markets. Foreign Institutional investors (FIIs) pulled out significantly from the Indian debt market. This time around, the Indian Government expects India to be well-cushioned from the Fed rate hike, especially with the inflation coming down, fiscal deficit situation under control and the robust forex reserves.

December ended with the CBDT releasing the much-awaited draft guidelines on the Place of Effective Management ('POEM') for public comments. It may be recalled that the Finance Act, 2015 had amended the definition of residence for companies with the POEM criteria, which had a far reaching impact especially for Indian corporates with overseas subsidiaries. These guidelines seek to lay down an objective 'active business outside India' test to find out whether there was a POEM in India. Certain other considerations such as place of Board meetings, location of Head Office, domicile of senior personnel and so on have also been factored in the draft guidelines. The final draft is expected to be released shortly. Given that the revised residential status has kicked in from April 2015, issuing the guidelines to test the same in January 2016 or later would in our view, put the corporates to inconvenience as they would not have had time and the inkling of what to adapt.

December also saw the Government obtain suggestions from the public for their stated objective to withdraw exemptions and phase out deductions. Continuing our contribution to the Government on policy matters, we conducted our own study of the provisions of the Income-tax Act from this perspective and had provided our thoughts and suggestions. For the benefit of our readers, our suggestions are placed under the 'Articles' section. Actions on these suggestions are expected in the forthcoming Union Budget.

**Tax updates**

In our ‘Tax Controversy’ series, this time, the issue of TDS requirement at the time of purchase of immovable property u/s 194-IA of the Act has been looked at, making out a case for extension of the mechanism of low or nil tax withholding to this section as well.

Amongst income-tax cases, we’ve digested the Supreme Court judgement in case of SI Group India Ltd. where it was held that the difference between deferred sales tax liability and its settlement payment at NPV to SICOM would not be taxable under section 41(1) of the Act.

In an interesting judgement, the Delhi High Court set aside a share purchase transaction, after considering the circumstantial facts. It has observed that the transaction was one designed to earn ‘contrived’ losses and hence was recharacterized as business income in the assessee company’s hands.

The Mumbai ITAT has delivered a judgement wherein it has examined the concept of ‘dependent agent PE’ in the context of India-USA Tax Treaty. In another judgment, the Bangalore ITAT followed the Delhi High Court ruling in case of Centrica India Pvt. Ltd. on the concept of secondment taxation and held that services rendered by highly qualified personnel would tantamount to FTS under the Act.

In a judgement which could be of practical utility for readers who seek a stay of payment of demand from the tax authorities, the Bangalore ITAT has discussed the concepts of ‘prima-facie case’, ‘balance of convenience’ and ‘financial hardship’ while adjudicating on the stay application.

The Mumbai ITAT has reiterated the distinction between the date of set-up and commencement of business for claim of revenue expenditure. In its judgement in case of Reliance Gems and Jewels, the ITAT had held that the fact that expenditure under different expenditure heads had been incurred was indicative of the setting-up of business of the assessee.

On the procedural front, the CBDT has reinforced its intent to go after tax evasion by making quoting of PAN mandatory for various transactions.

The coverage of key decisions rendered by various direct tax appellate authorities and the summary of circulars issued by CBDT have been compiled and presented for understanding, in the usual manner.

We hope you find this of interest. As always, we look forward to your feedback and comments which would enable us to further enhance the content of the newsletter.

Happy Reading!
Yours Sincerely,
Knowledgeware Team
B. K. Khare & Co.

## Articles:

### Contribution of B K Khare & Co on the implementation plan to phase out exemptions and deductions.

Dear Sir / Madam,

Greetings from our Firm. M/s B. K. Khare & Co., Chartered Accountants are a leading and one of the oldest CA firms in India (since 1955). We are headquartered in Mumbai with offices in different cities across India.

We thank you for the opportunity to provide our comments / inputs on the implementation plan to phase out exemptions and deductions from the Income-tax Act, 1961 ('the Act'). At the outset, most of your proposals are welcome ones and definitely steps in the right direction. We were guided by the maxim, 'fewer the tax incentives, fewer the less is the discretionary space available to tax administrators to interpret the law or executive statutes" which served as the beacon in this crucial & seminal exercise.

We have studied the plan proposed by the Government and have provided our comments / inputs in the attached document, for your kind perusal and consideration.

It was with great expectations (albeit some trepidation as to how that would be achieved) that we listened to the Hon'ble Finance Minister's 2015 budget announcement about the rationalization of corporate income-tax rate couple with phasing out of exemptions and deductions. We are proud to acknowledge that our Hon'ble Finance Minister has indeed matched his words/thoughts with actual deeds by giving shape to a well-thought plan of action for the phased withdrawal of exemptions and deductions. The Hon'ble Minister has rightly acknowledged that tax revenue-to-GDP ratio can be increased not by increasing tax rates but by simplifying tax structures, widening the tax base and improving tax administration. The corollary has been proven very often — namely, that scaling back of tax incentives and exemptions have almost always had a positive effect on tax policy, tax revenue, tax compliance and tax administration.

We remain confident that such actions are going to benefit the Indian economy in the coming future.

Should you require any clarifications or have any questions on our comments, please do let us know – we shall be glad to clarify.

Best regards,

B.K.Khare & Co.
Chartered Accountants

**Annexure**

a) It has been proposed that the highest rate of depreciation under the Act (and Rules) shall be 60% for all assets (whether old or new) falling in the relevant block of assets. This proposal suffers from a serious flaw as has been explained below:

The grant of a depreciation allowance under the Act is in recognition of the principle that the true profits of a business cannot be determined without deducting from the gross profits certain sums representing the value of the physical depreciation of the assets the user of which contributes to the profit-earning capacity of the business. In fact, the treatment of depreciation under tax laws today suffer from a serious limitation inasmuch as they do not provide for the factual concept of inflation – that is a different story. The underlying principle behind the grant of deprecation is by way of an allowance for the diminution in the value of capital asset employed by an assessee in his business due to wear and tear.

In the Badiani (PK) vs. CIT [(1976) 105 ITR 642] case, the Hon'ble Apex Court had approved the view that allowance for depreciation is to replace the value of an asset to the extent it has depreciated during the period of accounting relevant to the assessment year and as the value has, to that extent, been lost, the corresponding allowance for depreciation takes its place and therefore, when arriving at the profits for that period the amount of depreciation has to be deducted because the amount of the value lost by depreciation is a capital loss which must be replaced first.

Amidst this backdrop, let us glance through which block of assets, today, command depreciation at rates in excess of 60%:

| | |
|---|---|
| Buildings / machinery acquired on or after the 1st day of September, 2002 for installing machinery and plant forming part of water supply project or water treatment system and which is put to use for the purpose of business of providing infra- structure facilities under clause (i) of sub-section (4) of section 80-IA | 100% |
| Purely temporary erections such as wooden structures | 100% |
| Air & Water pollution control equipment | 100% |
| Solid Waste Control equipment | 100% |
| Wooden parts used in artificial silk manufacturing machinery | 100% |
| Cinematograph films – bulbs of studio lights | 100% |
| Match factories – Wooden match frames | 100% |
| Mines and quarries | 100% |

| | |
|---|---|
| Salt works | 100% |
| Flour mills – Rollers | 80% |
| Iron and steel industry – Rolling mill rolls | 80% |
| Sugar works – Rollers | 80% |
| Energy saving devices and Renewal energy devices | 80% |
| Books owned by professionals, being annual publications | 100% |
| Books owned by assessees carrying on business in running lending libraries | 100% |

A cursory look at the listing above reveals that the higher rate of depreciation, for tax purposes, was in some cases purposive and linked to wear and tear and in others to incentivize investment in specific class of assets.

In view of the proposed restriction on depreciation allowance to 60% in contradistinction to the actual wear and tear suffered by the asset (which could be higher), situations could frequently arise where the block is empty or ceases to exist (as there is no asset physically) while still carrying value, in which case, no depreciation is technically available to the assessee. The resultant loss shall represent short-term capital loss to the extent of the undepreciated written down value in the block.

The above aspects may need to be looked into before painting all items with common brush viz. a uniform upper cap of 60%.

b) Supplementing the above, if the rates of depreciation prescribed under the IT Rules are to be viewed as a fiscal tool, it is recommended that instead of having multiple depreciation rates across various class of assets, one uniform rate of depreciation per block of asset should be fixed, on the lines suggested below:
Buildings – 10%
Furniture & Fixtures – 10%
Plant & Machinery – 25%
Intangibles – 25%
Others – 5%

To this end, useful reference could be drawn upon from the depreciation chart of Companies Act, 2013.

The cap be restricted only to those assets which are claiming investment-linked deductions such as section 80-IA(4)(i) of the Act and that too, to the extent of 50%.

c) In the transition phase, assessees should not be enjoying both incentives and lower rate of tax. Where incentive provisions have been opted for, higher rate of tax should be applied. Also even where commencement of activity happens on or before March 31, 2017 as proposed, the period of incentive should be restricted to a maximum of 5 years.

d) Under the existing Chapter III – Incomes which do not form part of total income, numerous exemptions have been provided. In the table below, we have taken a closer look at some of the exemptions under section 10 of the Act and provided our comments:

| **Section** | **Nature of Exempt Income** | **Our Comments** |
|---|---|---|
| 10(1) | Agricultural income | Exempting agricultural income fosters horizontal and vertical equity. In our view, exemption for agricultural income could continue only for marginal farmers i.e. farmers with small land parcels. Hence, the time has come to set a threshold of say 5 acres, landholding beyond which shall attract income-tax on agricultural income. In the alternate, the basic exemption limit would, as the Task Force on Direct Taxes had hoped, ensure that genuine agricultural farmers would continue to remain outside the tax net. |
| 10(15) | Interest on specified securities | May be discontinued for the reasons mentioned by the Task Force on Direct Taxes in their Report, para 3.8. |
| 10(17) | Daily allowance of members of Parliament or Legislative Assemblies | A MP presently gets a basic salary of Rs 50,000 per month, session or no session. In addition, he/she gets a constituency allowance of Rs. 40,000 per month, session or no session.<br>And he/she also gets a daily allowance of Rs 2,000 for the days he/she attends Parliament while it is in |

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| | | session.<br><br>In our humble view, the Hon'ble Parliamentarians ought to set the tone at the top by demonstrating that they are setting a fine example in giving up tax exemptions themselves. |
| 10(19A) | Annual value of any one palace in the occupation of a former ruler | Considering that we're in the 68th year of independence and that the erstwhile titular rulers are no longer alive, there may be no justification for this exemption to continue. |
| 10(21) | Income of an approved Scientific Research Association | The taxation methodology applicable to charitable trusts should be sufficient to cover entities such as Scientific Research association and as such, separate exemption need not be called for. |
| 10(23BBA) | Income of societies for administration of public, religious or charitable trusts or endowments or of registered religious or charitable Societies. | The taxation methodology applicable to charitable trusts should be sufficient to cover such Societies as well and as such, separate exemption need not be called for. |
| 10(23C) | Certain funds for relief, charitable and promotional purposes, certain educational or medical institutions | The list of entities notified under this section may be scrutinized and pruned to retain minimal items eligible for exemption.<br><br>In our view, the taxation methodology applicable to charitable trusts should be sufficient to cover all such Funds as well and as such, separate exemption need not be called for. |
| 10(26AAB) | Income of an APMC | The taxation methodology applicable to charitable trusts should be sufficient to cover such Committee as well and as such, separate exemption need not be called for. |

| | | |
|---|---|---|
| 10(26B) | Corporation or any other body set up or financed by and government for welfare of scheduled caste/ scheduled tribes/backward classes | The taxation methodology applicable to charitable trusts should be sufficient to cover such Corporation as well and as such, separate exemption need not be called for. |
| 10(29A) | Certain Boards such as coffee Board and others and specified Authorities | The taxation methodology applicable to charitable trusts should be sufficient to cover such Boards as well and as such, separate exemption need not be called for. |
| 10(30) | Subsidy from Tea Board under approved scheme of replantation | This sub-section was introduced vide the Taxation Laws Amendment (Act), 1970 with a view to encouraging replenishment of tea estates in India. In our humble view, the exemption to this subsidy needs to be withdrawn as 1) this exemption has outlived its time & 2) continuation of the exemption would lead to sectoral imbalance as given developments in agriculture since 1970 when this sub-section was introduced, there are other equally deserving sectoral candidates for such exemption. Even the Task Force on Direct Taxes has recommended for elimination of this exemption. |
| 10(31) | Subsidy from concerned Board under approved Scheme of replantation | This sub-section was introduced vide the Finance Act, 1988 with a view to encouraging replenishment of plantation estates in India. In our humble view, the exemption to this subsidy needs to be withdrawn as 1) this exemption has outlived its time & 2) continuation of the exemption would lead to sectoral imbalance as given developments in agriculture since 1970 when this sub-section was introduced, there are other equally deserving sectoral candidates for such exemption. Even the Task Force on Direct Taxes has recommended for elimination of this exemption. |
| 10(37) | Capital gains on compulsory acquisition of | May be discontinued immediately. There are very few farmers holding urban agricultural land and |

| | | |
|---|---|---|
| | urban agricultural land | hence, this exemption may not actually benefit the intended. |
| 10(45) | Perquisite/allowance to members of UPSC | May be discontinued. It may be unfair to utilize taxpayers' money by way of exempting the allowances of Chairmen/Members of the UPSC. In fact, given their stature in seniority in government administration and age, they are expected to be well-settled both financially and family-wise too. |

e) The stated aim of the cited exercise is to simplify the tax laws in order to bring about transparency and clarity. If you refer the current Act, as it is, one common plaint you'll hear from tax practitioners (old and fresh) and the administrators is that it is bulky, filled with obsolete sections and sub-sections which cause confusion and make the Act difficult to read, navigate and make use of.

Keeping the aim in mind, in general, it is suggested that inoperative sections and sub-sections be removed from the Act and the remaining, operative sections be renumbered. A list of inoperative sections with their date of ineffectiveness in the context of Chapter III – Incomes which do not form part of total income, has already been enumerated in the table above.

The following is the list of such inoperative sections pertaining to computation of 'income from profits and gains of business' under the Act as amended by Finance Act, 2015:

1. Section 32A [Investment allowance]
2. Section 32AB [Investment Deposit Account]
3. Section 33 [Development Rebate]
4. Section 33A [Development allowance]
5. Section 33AC [Reserves for shipping business]
6. Section 33B [Rehabilitation allowance]
7. Section 34 [Conditions for depreciation allowance and development rebate]
8. Section 34A [Restriction on unabsorbed depreciation and unabsorbed investment allowance for limited period in case of certain domestic companies]
9. Section 35(2A)[Contribution to scientific research association before March 1, 1984]
10. Section 35(2B) [Capital expenditure on scientific research before March 1, 1984]
11. Section 35A [Expenditure on acquisition of patent rights or copyrights]
12. Section 35AB [Expenditure on know-how]
13. Section 35CCA [Expenditure by way of payment to associations and institutions for carrying out rural development programmes]
14. Section 35CCB [Expenditure by way of payment to associations and institutions for carrying out programmes of conservation of natural resources]
15. Section 36(1)(xi) [Expenditure on non-compliant Y2K computer programmes]

16. Section 40A(10) and (11)[Expenses or payments not deductible in certain circumstances]
17. Section 44D [Special provisions for computing income by way of royalties, etc. in the case of foreign companies]

The above list does not include the inoperative sub-sections under various sections.

Similarly, one could consider removing the whole of **“Chapter VIII A – Rebates and Reliefs”** from the Act as the sections (listed below) thereunder barring section 87A are no longer effective:
Section 88 [Rebate on life insurance premia, contribution to provident fund, etc.]
Section 88A [already omitted by the Finance (No. 2) Act, 1996]
Section 88B [already omitted by the Finance Act, 2005]
Section 88C [already omitted by the Finance Act, 2005]
Section 88D [already omitted by the Finance Act, 2005]
Section 88E [Rebate in respect of securities transaction tax]

In the same vein, those sections under “**Chapter VI-A – Deductions to be made in computing total income”** which are inoperative may be considered for removal from the Act.

If really required, these inoperative sections and sub-sections could be placed in a separate schedule, for reference especially in continuing, unfinished litigations.

## Tax Controversy - TDS under Section 194-IA – A Jarring hit to the Aam Aadmi

Consider the curious case of Mr. Propertywala. He is a super senior citizen (aged 81 years), lives in Mumbai, does not have any taxable income, and sustains himself from below-taxable pension drawn from the Central Government and monthly pocket-money provided by his daughter, Ms. Treasurywala. He intends to sell the <u>only</u> flat which he owns in upmarket Colaba to a local builder and plans to <u>reinvest fully</u> in a flat in the city outskirts where he will invite his daughter to stay with him. All seems good so far, until this story is given a rude jolt by the taxman seeking his pound of flesh, by way of <u>TDS</u>.

Section 194-IA was inserted into the Income-tax Act, 1961 with effect from June 1, 2013. It said that every purchaser is liable to deduct tax at-source @ 1% from the sum payable as consideration for transfer of any immovable property to a resident transferor. If the seller does not furnish his PAN, then by virtue of section 206AA, the TDS could be upto 20%! The only exceptions to application of this section were threshold limit of Rs. 50 lacs and rural agricultural land.

Now, as we’re all aware, the long-term capital gains arising from sale of immovable property used by an individual for residence shall not be taxable if it is reinvested in toto in another residential property. Applying this logic, Mr. Propertywala wanted to contend that since there would be no LTCG chargeable to tax in his case and considering that he did not have any other income to offset the TDS, he would like to explore the possibility of getting some kind of certificate or authorization from the tax department asking the purchaser not to deduct TDS from sale proceeds. Alas, to his horror, he found that there was no such possibility!

Mr. Propertywala's CA was banking upon section 197 (certificate for nil deduction or at lower rate) or section 197A(1C) (special TDS provision for senior citizens) to get him the intended relief. However, reality dawned on them, albeit in a hard way, that leave aside these 2 sections, there is no relief provided anywhere in the holy book called income-tax act for such cases.

Left with no alternative, Mr. Propertywala had to consider gifting the property to his daughter as an alternative approach.

**Rationale for introducing section 194-IA**

When the Hon'ble Finance Minister introduced[1] this draconian section 194-IA, he had remarked that transactions in immovable properties were usually undervalued and underreported. He quipped that one-half of the transactions did not carry the PAN of the parties concerned. He felt that section 194-IA was the panacea and brought it in with a view to improve the reporting of such transactions and the taxation of capital gains!

In the present scheme of things, viewed from a standalone angle, there is no capital gains tax upon reinvesting the long-term capital gains into residence.

Perhaps making PAN mandatory to register the documents at the Registrar's office and cross-verification of the same on the IT department's website would have been a better solution. One could think of many more such alternatives to make PAN compliance for immovable properties more effective. Alas, however, TDS on the immovable property sale could well be a classic example of the proverbial instance where for want of a horseshoe nail, a kingdom was ultimately lost.

Mr. Propertywala sincerely wished that the Courts might view the argument of section 194-IA as being a back-door means of taxing exempt long-term capital gains and hence, was liable to be struck down. If only wishes were horses, ………

**Hardship for the Aam Aadmi**

Currently section 197 (guiding applicability of nil or lower TDS) is applicable to transactions covered under sections 192, 193, 194, 194A, 194C, 194D, 194G, 194H, 194-I, 194J, 194K, 194LA and 195. In other words, section 197 caters to practically the whole gamut of transactions covered under TDS machinery, except this section.

Various Circulars issued by the CBDT reflect the official thinking on the need to obviate the unintended hardship caused by TDS provisions on deserving cases. For instance, circular no. 716 issued on August 9,

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[1] See Appendix 1 for the Finance Minister's Budget Speech excerpt on introducing section 194-IA & also Appendix 2 for the Memorandum (excerpt) explaining the rationale for introducing section 194-IA

1995 explaining why section 197 was extended to many of the TDS sections mentioned above including section 194A, 194C, 194J and 194K makes interesting read:

"As a result of these changes, TDS is also required to be made from ………

These changes are likely to affect a large number of persons some of whom may not have taxable income. Persons having income below the taxable limit may apply to the AOs for issue of certificates for non-deduction of tax. There may also be cases where assessees may apply for deduction of tax at a lower rate. Provision has also been made for making suo motu declarations to the payers for non-deduction of tax from interest on time deposits and income in respect of units.

In pursuance of the aforesaid new provisions, necessary amendments in the Rules and Statutory Forms have been carried out.

……….

Instructions have been issued to the AOs that the amended provisions relating to TDS are implemented in such a manner that they do not cause any hardship or inconvenience to the members of the public.

………

If a person has any difficulty in the matter, he may approach the Chief Commissioner of Income-tax concerned for redressal of the grievance. If necessary, he may also approach the CBDT."

What then explains the reason for keeping the beneficial reach of section 197 out of bounds for transaction envisaged under 194-IA. Could be oversight? If yes, then the same needs to be remediated.

**Bring in the 'Acche Din'**

While one would argue for a complete withdrawal of this inequitable requirement, there are some steps that the Government could take, in the least, to assuage the concerns of genuine assessees' such as Mr. Propertywala. For starters, the beneficial rays of section 197 should be made to fall upon section 194-IA with immediate effect to obviate the hardship of kosher/bonafide assessees.

Especially after the flip-flop over the MAT on FIIs and the recent bungling resulting in the last minute extension of the tax return filing due date, here is a chance for the Government to be seen as heeding to just grievances of the genuine taxpayers.

Till then Mr. Propertywala is anxiously waiting for your response, Mr. Finance Minister!

**Appendix 1 - Finance Minister's Budget Speech on February 28, 2013**

"Transactions in immovable properties are usually undervalued and underreported. One-half of the transactions do not carry the PAN of the parties concerned. With a view to improve the reporting of such transactions and the taxation of capital gains, I propose to apply TDS at the rate of one percent on the value of the transfer of immovable property where the consideration exceeds Rs. 50 lakhs. However, agricultural land will be exempt."

**Appendix 2 - Memorandum Explaining the Reasons for Introduction of section 194-IA in the Act**

E. WIDENING OF TAX BASE AND ANTI TAX AVOIDANCE MEASURES

Tax Deduction at Source (TDS) on transfer of certain immovable properties (other than agricultural land) There is a statutory requirement under section 139A of the Income-tax Act read with rule 114B of the Income-tax Rules, 1962 to quote Permanent Account Number (PAN) in documents pertaining to purchase or sale of immovable property for value of Rs.5 lakh or more. However, the information furnished to the department in Annual Information Returns by the Registrar or Sub-Registrar indicate that a majority of the purchasers or sellers of immovable properties, valued at Rs.30 lakh or more, during the financial year 2011-12 did not quote or quoted invalid PAN in the documents relating to transfer of the property.

Under the existing provisions of the Income-tax Act, tax is required to be deducted at source on certain specified payments made to residents by way of salary, interest, commission, brokerage, professional services, etc. On transfer of immovable property by a non-resident, tax is required to be deducted at source by the transferee. However, there is no such requirement on transfer of immovable property by a resident except in the case of compulsory acquisition of certain immovable properties. In order to have a reporting mechanism of transactions in the real estate sector and also to collect tax at the earliest point of time, it is proposed to insert a new section 194-IA to provide that every transferee, at the time of making payment or crediting of any sum as consideration for transfer of immovable property (other than agricultural land) to a resident transferor, shall deduct tax, at the rate of 1% of such sum.

In order to reduce the compliance burden on the small taxpayers, it is further proposed that no deduction of tax under this provision shall be made where the total amount of consideration for the transfer of an immovable property is less than fifty lakh rupees. This amendment will take effect from 1st June, 2013.

## Supreme Court:

### Difference between deferred sales tax liability and its settlement payment at NPV to SICOM would not be taxable under section 41(1) of the Act

**Facts and Issues:** The assessee had set up a unit at Raigad in Maharashtra which was a notified area. By virtue of packaged incentives scheme by Government of Maharashtra, the assessee was entitled to collect sales tax from customers and defer its payments to the State Government. Under the aforesaid scheme, the assessee was entitled to pay the sales tax so collected in five equal installments starting from April 20, 2010. Taking benefit of the said scheme, the assessee made one time settlement payment to SICOM at the Net Present value of the deferred sales tax liability.

The AO applied section 41(1) of the Act and brought to tax, the difference between sales tax liability and its NPV as benefit arising to the assessee.

The High Court observed that section 41(1) of the Act provides for chargeability of benefit arising to the assessee on account of remission or cessation of trading liability. The High Court decided the issue in favour of the assessee and deleted taxability under section 41(1) of the Act. Aggrieved by the High Court order, the income tax authorities preferred an appeal before the SC.

***Observation of the SC:***

The main contention of the assessee before the High Court was that the principal requirement for the applicability of section 41(1) of the Act was that the assessee must obtain a benefit in respect of a trading liability by way of a remission or cessation thereof. In the present case, there was no cessation of the liability of the assessee in respect of the payment of the sales tax dues. The High Court took note of the fact that the issue pertaining to the sales tax liability was decided by the Sales Tax Tribunal declining to grant credit of payment which was made to SICOM and therefore, it cannot be said that there was cessation of the liability of the assessee. Even if there was such a cessation, no benefit was obtained by the assessee.

**Decision:** The above facts clearly demonstrate that the assessee had not been granted the benefit of the said cessation for the AY in question. The High Court rightly held that one of the requirements for the applicability of section 41(1)(a) of the Act viz. there has to be cessation of a trading liability, had not been fulfilled. Difference between deferred sales tax liability and its settlement payment at Net Present value to SICOM would not be taxable under section 41(1) of the Act.

**Citation:** CIT vs. SI Group India Ltd. (TS-703-SC-2015)(SC)

### Mandatory on part of AO to change the value of opening stock if he is not satisfied with the valuation of closing stock

**Deduction for expenses towards share buy-back as revenue expenses since no change in capital structure**

**Facts and issue**: Assessee was following method of valuation of work-in progress at material cost and of finished goods at prime cost (i.e. direct material +direct labour) from its inception consistently. Since the work in progress did not include cost of direct labour and overheads cost and cost of finished goods did not include overhead cost as required by the Accounting Standard 2, the statutory auditor in his report for the year under consideration qualified the accounts and stated that the profit for the year was understated by Rs 137 million.

AO during the assessment proceedings noted that the inventory valuation was not in accordance with the provisions of Accounting Standards, Companies Act and Income Tax Act and therefore the profit disclosed by the assessee was not true profit but distorted profit. The AO accordingly recomputed the value of closing stock and profit for the year by including appropriate amount towards labour and overhead costs. Thereafter AO also gave the benefit of revised valuation of current closing stock in subsequent year. However AO rejected contention of the appellant that the opening stock of the year under consideration should also be revalued on uniform basis. On appeal, Tribunal held that once the valuation of closing stock is changed for the year the corresponding value of opening stock for the year also has to be changed.

The assessee had formulated a proposal to buy back equity shares from existing shareholders and had incurred expenses towards professional charges and other expenses of Rs. 33.83 lakhs towards the same. AO held that the expenditure incurred was towards restructuring of share capital with a view to improve return on equity over a period of time and it has resulted in an enduring benefit. Thus the said expenditure was held to be capital expenditure and was disallowed. On appeal the Tribunal held that the expenditure was revenue in nature and therefore was allowable. Being aggrieved by the order of the Tribunal department filed appeal with High Court.

**Decision**:

**Issue of Inventory valuation**: HC noted that the method of valuation may change in two circumstances. Firstly, the assessee may change the method of valuation of the closing stock even though the opening stock was valued in a different manner. In such case if the change is bonafide and is accepted by the revenue then the question of changing the opening stock would not arise.

However, if the AO rejects the assessee's valuation of the closing stock and recomputed the value in a different manner, then, to arrive at the correct figure of profit, the AO should also value the opening stock in a similar fashion. If the assessee's valuation of the opening stock is accepted and at the same time his valuation of closing stock is rejected then a highly distorted figure of profit will be arrived at. The provisions of section 4 which is the charging section of the Act states that the income shall be charged for the year in respect of the total income of the previous year. Therefore, if the basis for arriving at the valuation at the end of year is changed by AO without correspondingly changing the valuation of the opening stock then it results in charging income on a distorted figure which is not permitted in law. Accordingly, HC held that when the AO changes the closing stock it becomes obligatory that the opening stock valuation is also correspondingly changed in order to arrive at correct figure of income which is chargeable to tax under section 4 of the Act.

**Claim of expenditure towards buy back of shares**: Assessee contended that the effect of buy back of shares resulted in shrinking of the capital and thus there was no expansion of the capital structure of the company. HC noted that in case of General Insurance Corporation ( 286 ITR 232) Hon'ble Supreme Court held that issue of bonus shares does not result in any change in the capital structure of the company and also does not result in expansion of the capital base of the Company. In case of buy back of shares the sum equal to the nominal value of the shares is transferred to the capital redemption reserve account. The consequence of buy back of shares is that the capital base of the Company gets reduced and the capital structure goes down. Accordingly taking an analogy from the said SC decision HC had held that such expenditure did not give any benefit of enduring nature and therefore such expenditure was not capital expenditure. Thus in such case where there was no flow of funds or increase in capital employed the expenditure incurred would be revenue expenditure.

**Supreme Court Decision**: The Supreme Court has now dismissed the SLP filed by the department against the order of the Delhi High Court.

**Our Comments:**

In the facts of this case, the HC has considered buy – back as not expanding the capital base of the Company.

Allowance of claim of expenses relating to buy-back of shares, as revenue in nature, seems to have been settled, at least for now with this judgment of the Apex Court.

**Citation**: Motor Industries Co. Ltd ( SLP 17909 / 2015), Supreme Court of India

## High Court

### High Court Rejects Group's 'subterfuge' of contrived losses; Applies 'reasonable business purpose'

**Facts and issue**: The assessee company was an investment company. It held shares and other securities of various companies in the Jindal Group including shares of JSL, JISCO and Nalwa Steels Ltd. These shares were treated and reflected as stock in trade till 31st March 1991. During the year under consideration i.e. AY 1992-93, the assessee passed a board resolution on 4th April 1991 and converted the shares and securities held in group companies from stock in trade to investment. Purportedly such a resolution was passed to reflect the intention to hold these shares and securities in group companies as investments for a long term.

Subsequently the assessee company in August 1991 sold 60,000 shares of JSL for a consideration of Rs 1.72 crores and the resultant gain of Rs 91.35 lakhs was offered for taxation as long term capital gain.

One company of the Jindal Group namely JISCO had floated a rights issue of Partly Convertible Debentures (PCDs). Since the assessee held shares of JISCO it was entitled to subscribe to 5 PCDs for every four shares held by the assessee. The PCD was subsequently to be converted into one share of JISCO.

The above right issue of PCDs was opened on 14th February 1992 and the assessee renounced its entitlement for subscribing to 1,29,688 PCD's in favour of JSL (another group company) immediately on next day at a consideration of Rs 30 per PCD. The shares of JISCO were quoted at a cum right price @ Rs 625 per share on 3rd January 1992 and were quoted ex right @ Rs 425 per share on 6th January 1992. On the basis of the above prices the assessee claimed the cost of acquisition of the rights to subscribe PCDs @ Rs 200. Accordingly the assessee claimed that it had incurred a loss of Rs 1.68 crores (after setting off consideration received) on renouncing the rights of subscribing PCDs.

During the assessment proceedings AO noted that the renunciation of right was quoted on stock exchange at a price ranging from Rs 260 to Rs 280 per PCD as against the price of Rs 30 received by assessee from group company. Thus the sale was made below the market price.
AO noted that consideration for renunciation of rights was not received in the financial year and also noted that renunciation of rights below market price and the renunciation of rights to subscribe PCDs were sham transactions designed to purchase losses.

AO also noted that the other companies of Jindal Group, in order to reduce the taxable profits had renounced similar rights to subscribe to securities in favour of other companies belonging to the same group at a price much below the market value. Further on the basis of the notional cost of acquisition those companies also claimed a loss which was sought to be set off from the profits earned on sale of shares of other group companies namely JSL, JISCO and Saw Pipes Ltd. Despite opportunity given by AO assessee did not provide any explanation as to why it had sold the right to subscribe PCD's at below the market price.

AO held that both the transaction entered by assessee i.e transfer of shares from stock in trade to investment and renunciation of rights to subscribe to PCD's in favour of other group company at price below market were sham transactions to purchase losses. Accordingly, the gain on sale of shares and amount received on renunciation of PCDs was assessed as business income.

CIT(A) held that it was amply clear that the assessee had entered into collusive transactions along with sister concerns and was indulging in such transactions regularly to evade proper payment of taxes and accordingly upheld the decision of AO.

However, Tribunal accepted assessee's contention that shares of JSL or JISCO held by the assesse were investments and not trading assets. Tribunal noted that sale of shares of JSL by assessee was to preserve its assets and this action also indicated that assessee was interested in subscribing to PCD's of JISCO. Accordingly following decision of Hon'ble Supreme Court in case of Dhun Dadabhoy Kapadia (63 ITR 657) , Tribunal held that the assessee was entitled to compute the cost of acquisition of rights to subscribe PCD's and held that income was to be taxed under the head Capital Gain.

**Decision**: HC while addressing the question as to whether the income from sale of shares of JSL and rights entitlement of PCDs was chargeable as capital gain or business income noted that the assessee had held shares of JISCO as stock in trade utpo AY 1991-92. In earlier years the assessee had valued such stock at net realizable value / market price which was less than the cost and thus had claimed loss while computing the business income. Even though Board of Directors vide resolution dated 4th April 1991 decided to retain shares and debentures held by it as investments on a long term basis substantial shares of JSL were sold within 4 months. The HC also noted that the assessee in subsequent year had acquired 40,000 shares of JISCO and had sold it in the same financial year at a loss. The assessee had held itself as engaged in business of sale and purchase of shares and was also assessed under business income. The amount received on sale of shares of JSL of Rs 1.72 crores was advanced to JSL and were not kept for subscribing to PCD's of JISCO. These conducts of the assessee did not reflect the assessee's intention to hold shares on long term basis. The board resolution to convert shares from stock in trade to investment was a sham and the action of assessee was also contrary to such resolution. Accordingly, HC held that income received from sale of shares of JSL and renunciation of rights to subscribe to PCDs of JISCO was rightly held as business income by AO.

Hon'ble High Court in coming to the aforesaid conclusion highlighted the salient aspects as follows:

1. Though resolution dated 4th April, 1991 specifically stated that the shares and debentures of Rs. 82,55,810/- be transferred to investments in the Balance Sheet as at 31st March, 1992 the quantity of 60,000 shares of JSL was sold in August 1991 immediately after the passing of said resolution and the said shares which were shown as stock in trade were never reflected in the Balance Sheet as Investments as at 31st March, 1992 as the said shares were sold prior to year end i.e. 31st March, 1992. Also JSL shares were not held as capital assets by the assessee prior to 4th March, 1991 and therefore the assessee could not claim the gain on sale of shares as 'long term capital gain'
2. None of the statutory filings with Registrar of Companies reflected the shares in question as investments
3. The assessee was not a widely held company as 50% of the capital raised out of the public offering had been surrendered as undisclosed income of the assessee and the

shareholding was fictitious and undisclosed income of the promoters. In the circumstances the A.O. was rightly skeptical as to the resolution dated 4th April, 1991.

4. In the immediately succeeding financial year the shares of JISCO were further acquired in July, 1992 i.e. within few months of renunciation of rights to subscribe to PCDs. Thereafter the assessee purchased shares of JISCO at a fraction of market value and within same year sold the shares at a lower price. The transaction did not reflect the assessee's intention to hold shares and debentures of group companies on a long term basis.
5. The assessee had consciously held itself out as a company engaged in sale and purchase of shares and it was assessed on the income earned under Business Income and it had also claimed deduction of expenses form the income under the head Income from Business. These actions on the part of the assessee were contrary to and in complete contrast to its stated intention of holding the shares and debentures on long term basis.

HC further noted that the transaction of renunciation of rights in favour of JSL by the assessee and similar transaction by other group companies ensured that the right to subscribe remained in the group. The sale of shares of JSL had resulted in capital gains in the hands of assessee and in order to evade tax the assessee company had entered into transaction of renunciation of rights of PCDs of group companies in favour of another group company. HC held that the transaction of renunciation of right to subscribe PCDs was colourable device to avoid tax and was not a genuine transaction.

As regards the issue of set off of loss on renunciation of rights against business income Hon'ble High Court did not concur with the view of Hon'ble Bombay High Court in case of K.A.Patch (81 ITR 413) that for determining the cost of acquisition of rights entitlement for the purpose of computing capital gains the principles accepted by the Hon'ble Supreme Court in the case of Dhun Dadabhoy Kapadia would also be applicable in a case where the income from sale of shares is to be computed under the head Income from Business.

Hon'ble Delhi High Court has noted that in case of trader the principle of ascertaining notional cost attributable to the rights entitlement was neither necessary nor apposite. The profit and loss account prepared by the assessee was in accordance with Accounting Standards and would undisputedly reflect its true income. Thus there was no scope to provide for a deduction of notional business loss which was neither incurred by assessee nor recorded in his audited accounts. Thus HC held that it would be erroneous to impute notional cost after the assessee had drawn up accounts as per Companies Act, 1956.

Accordingly, HC held that the sale consideration received on sale of shares of JSL and sale of right entitlement of PCDs was business income and the assessee was not entitled to claim any notional loss on sale of right entitlement of PCD's

**Our Comments:**

The Introduction of section 56(2)(vii) w.e.f. 01-10-2009 is sought to plug loopholes such as these.

**Citation**: Abhinandan Investment Ltd , ITAT 130 of 2001, Delhi High Court

### Expenditure on Eye Treatment being personal in nature cannot be allowed as business expenditure

**Facts and Issue:** The assessee, a solicitor in his tax return for AY 1986-87, claimed deduction of expenditure incurred on a foreign tour in connection with a pre-operation investigation of his eyes by treating the same as business expenditure. The AO disallowed the same under section 37(1) of the Act. The CIT(A) upheld the AO's order by observing that if the assessee's contention is accepted then even expenditure incurred on food to preserve oneself shall be allowable expenditure under section 37(1) of the Act. The ITAT rejected the assessee's appeal by noting that eyes are an important organ for an effective living of every human being irrespective of the business, profession or vocation carried on by the person and therefore, expenditure on eye treatment cannot be allowed as business deduction.

**Observation:** The expense under section 37 of the Act is allowable only when same is made wholly and exclusively for the purpose of business/ profession and is neither capital nor personal in nature. The High Court rejected the argument of the assessee that in absence of investigation and treatment of eyes, it would be impossible to carry on the profession of solicitor and thus, expense was for the purposes of the profession. The High Court took note of the Delhi High Court's decision in the case of Shanti Bhushan [TS-240-HC-2011(DEL)] wherein it was held that eyes being necessary for effective living as a human being, the assessee's contention to claim deduction of such expenses could not be accepted.

**Decision:** As this expense on eye treatment was attributable to both personal and professional use, it cannot be allowed as a deduction as it was not incurred wholly and exclusively for the purpose of profession.

**Citation:** Dhimant Hiralal Thakar vs. The CIT [TS-613-HC-2015(BOM)]

For the purpose of section 72A of the Act, date of engagement in the business would be relevant. The date from which license for setting up power generation business, loans for construction of the building etc. were obtained, would be the date of engagement in the business

**Facts and issues:** The assessee was engaged in the business of manufacture of IML, sugar, co-generation of power and speed zone. By an amalgamation scheme, the amalgamating company was amalgamated with the assessee w. e. f. March 1, 2005. The amalgamating company was engaged in the business of manufacturing & trading of sugar and generation of power. It was in the business of manufacture of sugar since 1984. The amalgamating company started power generation business from the year 2000 and after establishing the unit, the unit commenced power generation from August 8, 2003.

For AY 2005-06, the assessee declared business income of Rs.24.64 crores and brought forward losses of the amalgamating company of Rs.21.33 crores were set off against such income.

During the assessment proceedings, the AO disallowed business loss and unabsorbed depreciation of a power generation unit amounting to Rs.3.48 crores on the ground that the amalgamating company could not be said to be engaged in power generation business for 3 years or more as required by section 72A.

The issue before the High Court was whether period of 3 years as prescribed under section 72A(2)(a)(i) of the Act had to be computed from the date of setting up of business and not from the date of commencement of actual generation of power.

***Contentions of the Income tax department***

Section 72A of the Act provides for carry forward or set off of accumulated loss and unabsorbed depreciation in case of amalgamation. Sub section (2) thereof provides that such carry forward or set off shall not be allowed in the hands of the amalgamated company, unless the amalgamating company has been "engaged in the business", in which the accumulated loss occurred/ depreciation remained unabsorbed, for three or more years.

The amalgamating company had commenced its power generation business only on August 8, 2003, which was within the period of 3 years prior to the date of amalgamation. Accordingly, the benefit of carrying forward of such losses of the amalgamating company could not be granted to the assessee.

***Contention of the assessee***

Sub-section (2) of section 72A of the Act provides that the accumulated loss of the amalgamating company and not an individual unit of the company has to be seen as a whole and not bifurcated into different business units.

***Observations of the High Court***

Date of commencement of business would be different from date of 'engagement in the business'. Commencement of business may be from the date when production has started, but to say that the taxpayer would be 'engaged in the business' only from the date it commences production, would not be correct. The taxpayer can be said to be engaged in a particular business from the day when it gets involved in the setting up of the business.

The license for setting up power generation business, loans for the same, construction of the building and purchase of machinery etc., had started from the year 2000 itself, which was duly reflected in the books of the amalgamating company.

**Decision:** Section 72A(2) of the Act uses the term 'engaged in business' which is different from 'commencement of business'. Accordingly, while 'commencement of business' may be from the date when production starts, but the assessee can be said to be engaged in a particular business "from the day when it gets involved in setting up of the business". As licence for setting up power generation business, loans for the same, construction of building, purchase of machinery etc., had started 5 years prior to amalgamation, section 72A(2) conditions were met. Also, the amalgamating company has to be viewed as a whole and not bifurcated into different business units.

**Decision: CIT vs. KBD Sugars & Distilleries Ltd. (TS-2015-HC-630)(Kar.)**

## International Tax & Transfer Pricing

### Relevance of RBI Press Note for computing ALP in case of trademark royalty upheld

**Facts:** The matter pertained to AY 2002-03. This was a departmental appeal.

The assessee was a wholly owned Indian subsidiary of Generale De Survillance (SGS) and engaged in India in providing quality certification and related services to various industries. SGS is a well-known Swiss Company which is a leading inspection, verification, testing and certification company.

For its business use, the respondent assessee used the trade mark of its parent company and it paid royalty for the same ranging between 2.5 % to 4% of the revenue generated.

For the purpose of transfer pricing, respondent assessee contended that 3% of the revenue generated should be considered as arm's length price ('ALP') for use of trademark provided by its parent company and in its support, placed reliance on the approval granted by Foreign Investment Promotion Board (FIPB) dated 25 September 2000 for the royalty arrangement.

However, the Transfer Pricing Officer (TPO) did not accept the same and placed reliance upon the Press Note No. 9 (2000 series) issued by the Ministry of Commerce and Industries, Government of India, which read as follows:

"III. Payment of royalty upto 2% for exports and 1% for domestic sales is allowed under automatic route on use of trademarks and brand name of the foreign collaborator without technology transfer."

Therefore, the TPO lowered the bench mark to less than 3% for purposes of computing the ALP. In terms of the above order of the TPO, the AO passed a final assessment order dated 24 March 2005.

In appeal, the CIT(A), byorder dated 20 January 2006 sustained the order passed by the AO. On further appeal, the ITAT, upon consideration of all the facts concluded that the royalty between the ranges of 5% to 8% if taken, could not be faulted as it too was covered by FIPB instructions. On this basis, the ITAT accepted the contention of the respondent that bench marking at 3% to arrive at ALP of payment made to parent company as royalty for use of trademark was reasonable. Aggrieved by this Order, the Revenue filed an appeal before the Mumbai High Court.

**HC Order:** Before the HC, the Assessee placed reliance on Clause (IV) of the Press Note No.9 (2000 series) issued by the Ministry of Commerce and Industries, Government of India, which said:

"IV. Payment of royalty upto 8% on exports and 5% on domestic sales by wholly owned subsidiaries to offshore parent companies is allowed under the automatic route without any restriction on the duration of royalty payments."

The High Court noted that the assessee paid royalty to its parent company for use of its trademark/brand name. Hence, the Court noted that the impugned case was covered by Clause IV and not Clause III of the aforesaid Press Note 9 (2000 series). Accordingly, it dismissed the revenue's appeal and confirmed the assessee's benchmarking of 3% as the ALP.

**Our Comments**: This case pertains to AY 2002-03 i.e. the second year of TP regime in India. It was a time when both the taxpayer and the Revenue officials were in their early phases of TP learning curves and gaining valuable experience. The TP provisions, at that time, were open to interpretation and did not have the benefit of judicial precedents as much as they do today.

This judgement upholds the relevance of RBI regulations in arriving at ALP and accepts the implication that FIPB approval implies arm's length. Trademark and Sales Royalty agreements are vetted and approved by the RBI and the royalty rates prescribed by RBI have sort of acted as a safe harbor when it comes to ALP computation.

In fact, recent ITAT judgements on the royalty matter such as the decisions in the Owens Corning [TS-328-ITAT-2014-Delhi], Air Liquide Engg. India P. Ltd. [TS-43-ITAT-2014-Hyderabad], Sona Okegawa [TS-773-ITAT-2011-Delhi], Hero Motocorp [TS-718-ITAT-2012-Delhi] have affirmed the RBI/FIPB approval as meeting ALP requirements. Having said this, in a recent ruling in the case of [A. W. Faber Castell (India) Pvt. Ltd. (TS-447-ITAT-2015[Mum-TP]), the Mumbai ITAT had, in the facts of that case, held that FIPB approval for Royalty payments cannot substitute ALP determination.

**Citation:** CIT, Mumbai vs. SGS India Pvt. Ltd. [ITA No. 1807 of 2013] reported in TS-569-HC-2015(BOM)

### Entire advertisement, marketing and promotion (AMP) expenses not allowable u/s 37; need to work-out value for creation of market intangibles for AEs; Delhi HC decision in Sony Ericson upheld; principles for application of bright-line test for AMP expenses enumerated

**Facts:** The matter pertained to AY 2010-11.

The assessee, an Indian Company, was a subsidiary of Discovery Channel (Mauritius) Pvt. Ltd. The assessee was engaged in the distribution of Discovery Channel, Discovery Travel and Living Channel and Animal Planet Channel in India region and also sale of advertisement inventory on the channels. The assessee reported six international transactions in its Transfer Pricing Study Report. On a reference made by the AO for determining the arm's length price ('ALP') of the international transactions, the TPO accepted the reported international transactions at ALP. He, however, observed that the assessee incurred AMP expenses to the tune of Rs. 29,60,08,795 which were not reported. It was found that there was a common pool of AMP expenses incurred both for the business of the assessee and the promotion of the brand of its AE.

For determining the ALP of the international transaction of AMP expenses, the TPO chose certain companies as comparables. By applying the bright line test, he worked out non-routine expenses incurred for developing intangibles in excess of bright line at Rs.22,85,49,990. Adding a mark-up of 14.48%, he worked out a transfer pricing adjustment of Rs.26,25,58,229. Aggrieved by this addition, the assessee approached the DRP without much luck. Hence, it preferred an appeal before the ITAT.

**Note: A bright-line test** is a clearly defined rule, composed of objective factors, which leaves little or no room for varying interpretation. In the context of AMP expenses, the bright line represents the point upto which AMP expenses are essential for sale of its products and beyond which, those expenses start benefiting the parent's / AE's brand or creating marketing intangibles. This test requires that the routine and non-routine expenses have to be segregated and the non-routine ones shall be regarded as a separate international transaction and benchmarked. The AMP expenditure is incurred for brand-building and predominantly benefits the foreign parent or associated enterprises (AEs). Hence, excessive expenses should be reimbursed with a mark-up based on the bright-line test. International jurisprudence has accepted AMP as a separate transfer pricing transaction to be benchmarked applying the bright-line test.

**Issue:** The issue raised in this appeal was against the transfer pricing adjustment due to difference in the ALP of the international transaction of incurring of AMP expenses relating to creation of marketing intangibles.

**ITAT's decision:** The ITAT referred to the decision of the Special Bench of the ITAT in case of LG Electronics India Pvt. Ltd. Vs. ACIT (2013) 152 TTJ (Del) 273 (SB) wherein the Special Bench of ITAT had, by majority, approved the bright-line test for working out the amount of non-routine expenses and held that ALP of AMP expenses should be determined on cost-plus method by treating AMP transaction as separate and distinct from other international transactions.

Thereafter, the ITAT noted the decision of the Delhi High Court in case of Sony Ericson Mobile Communications India Pvt. Ltd. Vs. CIT (2015) 374 ITR 118 (Del) and on the issue of the bright-line test, noted that the following points emanated therefrom:

- AMP expense was an international transaction
- The TPO had jurisdiction to determine the ALP of the international transaction of AMP expenses
- Inter-connected international transactions could be aggregated and section 92(3) did not prohibit the set-off
- AMP was a separate function. An external comparable should perform similar AMP functions.
- Bright-line test could be applied to work out non-routine AMP expenses for benchmarking
- ALP of AMP expenses should be determined preferably in a bundled manner with the distribution activity
- For determining the ALP of these transactions in a bundled manner, suitable comparables having undertaken similar activities of distribution of the products and also incurring of AMP expenses, should be chosen
- The choice of comparables could be restricted only to domestic companies using any foreign brand
- If no comparables having performed both the functions in a similar manner were available, then, suitable adjustment should be made to bring international transactions and comparable transactions at par
- If adjustment was not possible or comparable is not available, then, the TNMM on entity level should not be applied
- In the above eventuality, international transaction of AMP should be viewed in a de-bundled manner or separately
- In separately determining the ALP of AMP expenses, the TPO was free to choose any other suitable method including Cost plus method
- In so making a TP adjustment on account of AMP expenses, a proper set off/purchase price adjustment should be allowed from the other transaction of distribution of the products
- Selling expenses could be considered as part of AMP expenses.

Applying the above points in the backdrop of the facts of the instant case, the ITAT categorized the assessee as a distributor having regard to the functions it performed. It held that the ALP of distribution activity and AMP activity first had to be determined in a bundled manner by considering distribution and AMP functions performed by the assessee and also by the probable comparables. If comparables having performed both these functions were not available, then in such case, the ALP of AMP expenses had to be determined in a segregated manner. Applying this logic, it rejected the assessee's argument of applying TNMM for AMP expenses and that since the profit margin declared by assessee compared favorably with comparables, no adjustment was warranted on account of AMP expenses since the AMP expenses stood subsumed in the overall margin.

Noting that the TPO went by the quantum of AMP expenses and did not go into the AMP functions performed by the assessee as well the comparables which he had referred to, the ITAT remanded the matter back to the AO for reconsideration of the ALP of AMP expenses in this case, either in a combined or a separate manner.

**Our Comments**: This decision of the ITAT has reaffirmed the points clarified by the Delhi High Court in case of Sony Ericson (supra) with regard to application of the bright-line test for working out the ALP of AMP expenses. This decision provides clarity to this vexed issue and would be useful to decide existing cases on this subject.

**Citation:** Discovery Communications India vs. DCIT, New Delhi [ITA No.2931/Del/2015] reported at TS-713-ITAT-2015(DEL)

## Where the Indian company constituted Dependent Agent PE of the US television company in India, Income from advertisement earned by US Television Company held to be taxable in India

**Facts and issues:** The assessee, NGC Asia was a Delaware, USA incorporated entity. The assessee was a subsidiary of Fox Entertainment Group Inc. The assessee held 100% shares in NGC Mauritius, which in turn, held 99% shares in NGC India. All these companies were subsidiaries/ affiliate companies of News Corporation, USA. The assessee was the owner of two television channels viz., The National Geographical Channel and Fox International Channel. The assessee was engaged in the business of broadcasting of its channels in various Countries including India.

The assessee appointed NGC India as its distributor to distribute its television channels and also to procure advertisements for telecasting in the channels. The assessee generated two streams of revenues from India, viz.

(a) Fee for giving distribution rights for telecasting of its channels, and

(b) Advertisement revenues.

***Agreements between the assessee and NGC India***

Distribution Agreement

The assessee executed a Distribution Agreement with NGC India, giving NGC India the right to distribute the National Geographic Channel to media intermediaries' subscribers in India, Nepal, Bhutan, Bangladesh and Sri-Lanka. In consideration for the right to distribute the said channel in India, NGC India paid a fixed fee amounting to USD 32,00,000/- for the period April 01, 2006 to March 31, 2007 to the assessee.

Ad Sale Agreement

The assessee also sold advertising time on the National Geographic Channel for the period April 01, 2006 to March 31, 2007. The assessee signed an Advertising Sales Representation Agreement (Ad Sale Agreement) with NGC India on July 1, 2004 appointing NGC India as their exclusive independent representative in India to solicit television advertising for the Channel and to collect & remit advertisement charges in relation to such advertisements to the assessee. The assessee earned revenues in respect of advertisements placed by the Indian advertisers on the channels. The revenues were collected by NGC India and remitted net of all commissions & taxes to the assessee. The said agreement was terminated and thereafter, with effect from May 1, 2006, the assessee entered into another Ad Sale Agreement with NGC India, wherein the assessee sold the advertisement and sponsorship time on the channels to NGC India for a lump sum consideration of USD 22,80,000/-.

As per the old agreement, the assessee paid commission @ 15% to NGC India for the month of April, 2006 and retained 85% of the advertisement revenue for that month. As per the new agreement, the assessee received fixed sum of USD 22,80,000/- from NGC India for giving contract of procuring advertisements from May 2006 to March 2007.

***Taxability of the above receipts***

The assessee filed its return of income claiming both types of income, as not taxable in India. With regard to the various international transactions entered into by the assessee, a reference was made to the Transfer Pricing Officer (TPO) who accepted the Arm's length Price of the international transactions entered into by the assessee with its AE. The AO/DRP however held

that the advertisement revenues as well as distribution revenues were taxable in India. The Income tax authorities considered NGC India as the "Dependent Agent Permanent Establishment" of the assessee in India. The AO accordingly assessed 25.34% of the advertisement revenues as income of the assessee attributable to India, i.e. in the ratio of worldwide profits to worldwide revenue, in accordance with Rule 10B(ii) of the IT Rules. The AO further held that the revenue generated on
granting of Distribution rights was in the nature of "Royalty", taxable in India at 15% as per Article 12 of India USA Tax Treaty.

***Contention of the assessee***

The new agreement entered into between the assessee and NGC India was on "Principal to Principal" basis. Accordingly, NGC India could not be considered to be a dependent agent of the assessee in India. Where the assessee does not have a PE in India, business income from advertisement revenue would not be taxable in India. Further, the payment made by the assessee to NGC India was held to be at Arm's length as held by the TPO and therefore, no further income can be attributed to the assessee in India.

**Decision:**

***Whether "advertisement air time" falls under the category of "goods" capable of being transferred***

The "advertisement air time" was an item that can be identified and abstracted, since the telecasting time limit was predetermined. The right over the advertisement air time may also be capable of being possessed till the time of its expiry. Accordingly, after the expiry of that month, the said right would automatically lapse and hence the characteristic of "capable of being stored" would have limited application. One of the main characteristics of "goods" was that it should be capable of being "consumed" or "used". There should not be any doubt that the "advertisement air time" shall have value or capable of being used /consumed only if the concerned advertisement material was telecast by the assessee. If the assessee refuses to telecast the advertisements procured by NGC India, then the advertisement airtime purchased by it under the agreement shall not have any value. In case of "goods", it gets separated from its manufacturer and it can be used/consumed by anyone independent of or without any support from the manufacturer. Further, the “goods” are capable of universal use. However, the “advertisement air time”, in the instant case, was related to the television channels owned by the assessee only. The advertisement airtime sold by the assessee or NGC India shall not have any value with regard to other television channels, meaning thereby, the same could not be separated from the assessee. Accordingly, the “advertisement air time” fails to satisfy the test that it was capable of being used/consumed independently, i.e., independent of the assessee herein. Through the purchase of advertisement airtime, a person gets a right to get his advertisement material telecasted in the television channels owned by the assessee, the “advertisement air time” could not fall under the category of “goods”. It was only a right given to NGC India to procure advertisements. Though the “right to procure advertisements” for particular “airtime” may be capable of being transferred, but the same could not be consumed/used by the buyer of the right, without the assistance from the assessee by way of telecasting the same in the television channels.

***Principal-Agent relationship between the assessee and NGC India***

NGC India could not be considered to be selling any “goods”. In effect, it was only canvassing the advertisements for the assessee. Thus, NGC India provided only agency services to the assessee and in turn, the assessee was providing advertisement services or telecasting services to the clients. NGC India was only enabling the assessee to procure the advertisements for telecasting them and hence, NGC India could not be considered as selling advertisement airtime independent of the assessee. NGC India could not be considered to be “an independent principal/agent” in respect of dealing in advertisement airtime relating to the television channels owned by the assessee.

NGC India was only canvassing the advertisements for the assessee through the purchase and sale of advertisement airtime relating to the television channels owned by the assessee and the same makes NGC India an “agent” of the assessee, since the advertisement airtime, per se, does not have any value without the assessee agreeing to telecast the advertisement material.

Under the old agreement, the assessee has paid 15% of the revenue as commission to NGC India and under the new agreement, it has sold advertisement airtime for a fixed consideration. The assessee has only changed the method of giving compensation to NGC India or method of generating revenue from the broadcasting of advertisements. Under the old agreement, the compensation given to NGC India as well as the revenue generated by the assessee was agreed to be shared in a fixed proportions, whereas under the new agreement, it has been determined at the consolidated figure. The methodology adopted by the parties to share the revenue or to give compensation to NGC India for services rendered may not be the determining factor to decide about the nature of relationship between the parties.

It is well settled proposition that the substance shall prevail over the form and hence, even if the new agreement states that the relationship between the assessee and NGC India was that of "principal to principal" basis, the relationship between them actually exists on "principal to agent" basis only.

***PE in India in terms of India-USA Tax Treaty***

The certification of ALP by the TPO and the decision of the Supreme Court in the case of Morgan Stanely & Co. Inc., other High Courts in case of B4U International Holdings Ltd. & Set Satellite (Singapore) Pte Ltd. would be applicable only in respect of the payments made by a foreign company to its Indian AE in respect of services availed by it. If the foreign company receives any money from the Indian soil and if it was held to be having a PE, then the taxability of the same has to be examined in accordance with the provisions of the India-USA Tax Treaty as well as under the provisions of the Act.

The assessee was granted an opportunity to submit the computation of net income from advertisement. The matter was set aside to the file of AO with the direction that if the assessee fails to provide required details, 25.34% of the advertisement revenues (i.e. in the ratio of worldwide profits to worldwide revenue), as previously computed by the AO would be taxable in India.

***Distribution rights fee received by the assessee from NGC India***

As per the terms of the agreement, NGC India was allowed to distribute the channels during the contractual period and according to the terms laid down in the agreement. This shows that NGC India was not free to make use of the channels as per their wish, but strictly in accordance with the terms laid down by the assessee. Considering these facts, the assessee enjoyed the rights of owners, whereas NGC India paid compensation for the exploitation of the channels.

The AO has made general observations that the Article 12 of the India USA Tax Treaty shall be applicable without critically analyzing the provisions of the treaty. The AO has also referred to the provisions of Explanation 2 to section 9(1)(vi) of the Act for examining the definition of the term "royalty", yet he has not critically discussed about its applicability to the impugned payment. It was pertinent to note that the definition of the term "royalty" given in section 9(1)(vi) of the Act as well as in the India-USA treaty uses the expression **"process"**. The said expression has not been defined in the Tax Treaty, but the same has been defined in Explanation 6 to section 9(1)(vi) of the Act, as inserted by the Finance Act, 2012.

The question whether the payment received by the assessee for giving distribution rights shall fall in the category of "Royalty" needs to be examined afresh at the end of the AO.

**Citation:** NGC Network Asia LLC vs. JDIT(IT)(TS-714-ITAT -2015)(Mum.)

Payment in the nature of a penalty ordered by Court of competent jurisdiction will never attract tax liability and hence no liability to deduct tax u/s 195 of the Income-tax Act, 1961.

**Facts:**

Satyam Computer Services Limited ('the Applicant'), an Indian Company Incorporated under the Indian Companies Act, 1956, had its shares listed on the NSE and BSE in India. It also had American Depository Shares listed on the New York Stock Exchange.

After the infamous letter of the former Chairman of the Company and subsequent investigations by authorities, there was a complaint filed by the United States Securities and Exchange Commission ('SEC') against the Company in the US District Court for the District of Columbia.

The SEC prayed for imposing a civil monetary penalty pursuant to section 21(d) of the Securities Exchange Act and alleged violations of Sections 10(b), 13(a), 13(b)(2)(a) and 13(b)(2)(b) of the Securities Exchange Act and Rule of 10b-5, 12b-20, 13a-1 and 13a-16.

The Applicant filed its consent undertaking, without admitting or denying the allegations in the complaint, agreeing to an amount of $ 10 million as penalty. Based on the Consent and Undertaking, the US Court passed the final judgment against the applicant stating in its order that Satyam was liable for a penalty of $ 10 million pursuant to the provisions of Section 21(d) of the Exchange Act and that this penalty would have to be paid within 14 days from the entry of the final judgment to the court clerk. The Court also held that the amount ordered was to be treated as penalties paid to the government for all purposes including tax purposes.

The Company was liable to pay an amount of Rs. 44.375 Crores (INR equivalent of $ 10 million, converted at the rate of Rs. 44.375/USD) as penalty to the US Government.

The applicant applied to the AAR to confirm whether tax u/s 195 of the Income-tax Act, would be required to be deducted at source on the penalty amount being paid pursuant to the US Court Order.

**Questions Raised before the AAR:**

1. Whether penalty payable to the US Government, pursuant to the Final Judgment of the USA Court, is liable to tax deduction at source per provisions of the Income-tax Act, 1961?
2. If the Answer to above question is affirmative, at what rate shall Income tax be deducted?

**Ruling of the AAR**:

The AAR ruled that it was common knowledge that unless payment attracts tax under the Income-tax Act, 1961, no liability of tax deduction at source arose. A penalty ordered by a Court of competent jurisdiction in the United States of America could not attract any tax.

AAR held that penalty was not subject to tax since it could never attract any tax liability under the domestic law, as there is absolute clarity on this aspect.

The DR had also conceded that there was no necessity of deducting tax from the penalty amount and since the first question of the Applicant was answered in the negative the second question raised, stood nullified.

**Our Comments:**

The Authority for Advance Rulings reiterated what has been in common knowledge that a payment to a sovereign state would not be exigible to tax deduction at source. Even as per the section 196 of the Income-tax Act, 1961, provisions for the tax deduction at source would not apply to sums paid/payable to the Government and other categories in the section. In the instant case since, the Court of US held that the penalty amount was in the form of payment to the government of US, hence, this payment would partake the character of payment to a sovereign state. The applicant in this instance also had the option to apply to the AO under section 195(2) of the Income-tax Act, 1961, for the determination of taxability and the withholding of taxes on the sum payable to the US Court of Competent jurisdiction.

**Citation: Satyam Computer Services, Hyderabad (Applicant) (AAR No. 106 of 2011)**

The department's power to file appeal / cross objection is restricted only to cases where 'objection is to the direction of DRP' and not against voluntary action of AO himself.

**Facts and Issue:** The assessee was engaged in providing pre-sales and post-sales services, marketing and other technical services to the clients on behalf of its AE, Trend Taiwan in the specific areas at computer and network security. Trend Taiwan was in the business of selling Antivirus softwares to customers in India.. The assessee also imported certain services from its AE. For AY 2010-11, the assessee's aforesaid international transactions were benchmarked using cost plus method (CPM) as the most appropriate method to determine the arm's length price. In the process, 4 companies were selected as comparable.

The TPO rejected the application of CPM and adopted transactional net margin method (TNMM) as the most appropriate method, with operating profit/ total cost (OP/TC) as the Profit Level Indicator (PLI) for comparison. The TPO chose a fresh set of 9 comparable companies whose average PLI was computed at 23.25% as compared to assessee's PLI 10.26%. The TPO thus proposed a transfer pricing adjustment of Rs 1.80 Crores. The DRP allowed partial relief and a TP adjustment of Rs 1.70 crores was confirmed.

Before the Tribunal, the assessee contested the inclusion of 3 companies out of the 9 comparable companies selected in the final set, due to their functional dissimilarities. The department's contention was that if the 3 companies challenged by the assessee, having higher profit rate were to be excluded, the remaining 4 companies having low profit rate should also be eliminated.

**<u>Decision:</u>**

**On functional comparability of 3 companies included by the department**

The Tribunal found it necessary to examine the nature of work performed by the assessee before embarking on the comparability exercise. The Tribunal observed that the assessee was engaged in providing pre-sales and post-sales services to its AE which include understanding the requirements of the proposed customers, forwarding the same to its AE, communication with the customers and thereafter, providing technical support services to customers facing technical issues in handling the product/ demos. The Tribunal then compared it with the functions performed by the 3 comparable companies:

*<u>Aptico Ltd</u>*

The Tribunal noted that there was tiny resemblance of 'Market and social research' functions performed by Aptico Ltd. with the overall activities undertaken by the assessee. All other services were entirely different and therefore the services provided by this company were not functionally comparable with those provided by the assessee.

*<u>Global Procurement Consultants Limited</u>*

The Tribunal noted that this company was conducting Independent Procurement Review of multilaterally funded projects spread across the globe. It also undertook Procurement audits and was providing full time advice on procurement and contract related aspects to several agencies across the globe. These services were not comparable with the services provided by the assessee and therefore the Tribunal ordered its exclusion from the list of comparables.

*<u>TSR Darashaw Limited</u>*

The Tribunal noted that this company was a broking and investment banking house with its three segments, namely, Registrar and transfer agent activity; Records management activity (Records); and Payroll and trust fund activity (Payroll). Due to the huge functional disparity the services provided by this Company and the assessee, the Tribunal excluded this company from the list of comparables.

**Exclusion of low profit making companies**

The Tribunal held that the department cannot argue for exclusion of companies which were treated by the AO/TPO themselves as comparable, as it would mean that the AO is challenging the correctness of his own decision before the Tribunal, which is illogical. The AO was empowered to assail the correctness of such a decision in an appeal before Tribunal only when CIT(A)/DRP had decided some point in favour of assessee and AO was dissatisfied with such view.

The Tribunal highlighted the difference between the right to argue against the assessment order on the inclusion of incomparable companies with lower profit rates by the AO himself and the power of the tribunal to suo-motu examine the correctness of such an action of the AO.

In the case of ***DCIT vs. Quark Systems Pvt. Ltd.*** the special bench held inadvertent inclusion of any company as comparable in the final list, can be taken up for consideration by the Tribunal, if the assessee proves that the same was wrongly included. Distinguishing the situation in the case of **Quark Systems** *(supra)*, the Tribunal held the AO/TPO can under no circumstance be aggrieved with his own view taken in the assessment order, independent of any external influence of the DRP. The Tribunal further observed that after amendment vide Finance Act, 2012 to Section 253(2A)/(4), the department's power to file appeal / cross objection is restricted only to cases where 'objection is to the direction of DRP' and not against voluntary action of AO himself.

Accordingly, the Tribunal restored the matter to the AO for recalculating the ALP after exclusion of the 3 companies and refused to adjudicate on remaining 4 comparables contested by department.

**Citation: Trend Micro India Pvt. Ltd. vs. DCIT (ITA No. 1585/Del/2015) [Delhi Tribunal]**

### No distinction in facts/ nature of transactions pertaining to 'US' and 'non-US' entities brought on record by the TPO. Mark-up of 14.38% determined for US based AEs applied to remaining 4% transactions with non-USA based AEs

**Facts and Issue:** The assessee was engaged in the business of providing IT Enabled Services (ITeS) to its AEs. 96% of total business of the assessee was with US based entities, whereas only 4% transactions were done with non-US based AEs. The assessee had shown a margin of 12.26%.

The TPO treated ITeS as one business, without making any distinction between US & non-US based AEs and applied mark-up of 21.58%. The said transfer pricing adjustment, resulted into transfer pricing adjustment of Rs. 39.30 crores, was confirmed by the DRP.

The assessee was in appeal before the Tribunal against the DRP's order confirming addition of Rs. 39.30 crores. In the interim, one of the assessee's AE, JP Morgan Chase & Co. USA had initiated Mutual Agreement Procedure (MAP) proceedings under Article 27 of the India-USA Tax Treaty. Before the hearing of the appeal by the Tribunal, the assessee received a letter from the TPO that MAP proceedings had been concluded with JP Morgan Chase & Co. USA and the assessee had accepted the MAP conclusion at 14.38% mark-up. The transaction with JP Morgan Chase & Co. USA constituted 96% of the total transactions.

The assessee accordingly filed revised grounds of appeal before the Tribunal challenging the reduced amount of addition for a sum of Rs. 1,65,07,806, which constituted additions on business with non USA based AEs

The assessee before the Tribunal argued that mark-up of 14.38% which was accepted in MAP should be applied to balance 4% of transactions on the ground that the TPO had not made any distinction between transactions with US and non-US based AEs. The assessee before the Tribunal placed the letter dated 9 April 2015 from the Foreign Tax and Tax Research Division, CBDT New Delhi, wherein margin of the assessee in respect of US related transactions were determined at 14.38%. In the said letter, apportionment between US and non-US ALP and TP adjustment was margined out by the APA on the basis of US and non-US revenue. It was noted from the perusal of the annual accounts of the assessee, the aggregate turnover of the assessee was shown, without distinction between the US and non-US transaction.

The Income tax authorities contended that there is no concept of determination of ALP under the MAP. The rules and regulations of transfer pricing as prescribed under section 92C of the Act are not applicable under MAP. Therefore, no ALP was determined under MAP and therefore, the assessee cannot claim to take any benefit of the mark-up reached under MAP i.e. @ of 14.38% to non-US based AEs.

**Decision:** The Tribunal noted that under the MAP proceedings, margin for transaction with US based AE was concluded at 14.38% as against 21.58% determined by TPO. The Tribunal observed that no distinction was made between 'US' and 'non-US' transactions in the assessee's annual report as observed by the APA or in the order passed by the TPO. The Tribunal also noted that no distinction in facts or nature of transactions pertaining to 'US' and 'non-US' entities has been brought out on record by the TPO. Accordingly, mark-up of 14.38% determined for US based AEs should be applied to remaining 4% transactions with non-USA based AEs as well.

**Citation:** J.P. Morgan Services P. Ltd. vs. DCIT (ITA No. 8987/Mum/2010) (Mumbai Tribunal)

## Freight income earned by Danish company from operation of ships in international traffic not taxable in India, as per Article 9 of the India-Denmark Tax Treaty

**Facts and issues:** The Indian Company, for AY 2009-10 filed Vessel Voyage Returns (VVR) under section 172(3) in respect of ships managed by LR2 Management K/S, Denmark ('LR2). LR2 was foreign commercial agent for the principal freight beneficiary, Torm A/s. LR2 operates entirely from outside India, without any presence in India.

***Proceedings before the AO and the CIT(A)***

During the course of assessment proceedings, LR2 submitted that the obligation to file VVRs was of Torm A/s. Accordingly, LR2 corrected VVRs to take on record that actual freight beneficiary was Torm A/s and LR2 was only the commercial manager for number of vessels which were owned/ chartered by Torm A/s for its global operations

The AO passed the order under section 172(4) of the Act, without forwarding the draft assessment order to the non-resident assessee, as required by section 144C of the Act. The AO further noted that there was nothing on record to show that the effective management of Torm A/s was in Denmark. The AO also noted that 36.4% of the shares of Torm A/s were held outside Denmark. The AO accordingly denied the tax treaty benefit of the India-Denmark Tax Treaty (Tax Treaty) to Torm A/s in India stating that it is only when there is evidence of income being actually taxed in the other contracting state i.e. Denmark in this case, that tax treaty benefit can be granted.

The CIT(A) held that VVRs filed by LR2 could not be subjected to any revision, or even correction. Since there is no evidence in support of LR2 being a tax resident of Denmark, it cannot be accepted that income belonged to Torm A/s. The CIT(A) further held that since LR2 was not the beneficial owner of the freight received from India, it cannot avail the Tax Treaty benefits. The CIT (A) also observed that no evidences have been produced by LR2 to prove that remittances of freight charges have been offered to tax in Denmark.

***Issues before the Tribunal***

The two issues before the Tribunal were:

- Whether the requirement of serving a draft order is only in respect of an assessment order under section 144C of the Act and whether the order passed under section 172(4) can be treated as an assessment order?
- Whether the AO was right in denying the benefit of the Tax Treaty?

***Eligibility of Tax Treaty benefit***

*Observation of the Tribunal*

- The Principal freight beneficiary in this case i.e. the company which carried on the business of operations of ships in international traffic was a Danish tax resident by the name Torm A/s. There was a categorical finding by the CIT(A) to the effect that LR2 was not a beneficial owner of freight remitted from India and it is for this reason, LR2 cannot avail the treaty benefits.

- The business of operation of ships in international traffic was carried out by Torm A/s and the relevance of LR2 was only as a foreign commercial manager acting for Torm A/s. The freight receipts in the hands of LR2 were not in its own right, but in a representative capacity for Torm A/s. All the business risks continue to be borne by Torm A/s. The taxability is of profits and not receipts, and profits are rewards after risks. When all risks continue to be borne by Torm A/s the profits are to be taxed in the hands of Torm A/s as well as the treaty entitlement needs to be examined of Torm A/s and not LR2.
- Article 4(1) of the India- Denmark Tax Treaty defines the term 'resident' to mean 'any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature', though it does also specifically exclude 'any person who is liable to tax in that State in respect only of income from sources in that State or capital situated therein'. The true test for residence status thus is that the person should be a taxable unit, in principle on global income basis, rather than limited source basis, and this tax liability should be by virtue of domicile, residence, place of management or 'any other criterion of similar nature'. In essence, these tests refer to being 'liable to tax' on the basis of a locality related attachment which leads to residence type taxation. As long as this test is satisfied, the assessee is entitled to be termed as resident for the purpose of India- Denmark Tax Treaty.
- Torm A/s is a listed company on NASDAQ Copenhagen. Out of its seven directors, five directors, including its chairman and including its executive director, were Danish nationals. Torm A/s filed certificates issued by the Danish Customs & Tax Administration certifying that 'Torm A/s, Tuborg Havnevej 18, DK 2900 Hellerup' has submitted tax returns for the above mentioned income years.
- As evident from the Directors' report of Torm A/s, it has incurred a loss before tax of USD 579 million in 2012. This report also states that Torm A/s incurred an operating loss of USD 253 million which was stated to be on account of adverse market conditions. When Torm A/s was incurring losses, in respect of its global operations, there cannot be an occasion to pay tax on the income. <u>In these circumstances, if the freight receipts from India had not actually suffered income tax in Denmark, it is not because of the profits from these receipts were not taxable in Denmark.</u> So far as Article 4(1) of the Tax Treaty was concerned, all that was required of a Danish company, to be entitled to tax treaty benefit in India, was that its profits,

on global basis, should be liable to tax in Denmark, irrespective of whether or not Torm A/s indeed earns any profits taxable in Denmark or whether or not such profits are actually subjected to tax in Demark.

**Decision:**

***Requirement of serving the draft order***

Section 144C of the Act categorically states that the AO is required to 'forward a draft of the proposed assessment order to the eligible assessee and thus give to assessee, an option of approaching the Dispute Resolution Panel (DRP) before the final assessment order is passed. Unless, the impugned order passed under section 172(4) is not treated as an 'assessment order', the requirement of section 144C of serving draft order does not come into play. An order computing the taxable income is essentially an assessment order and therefore, any order passed under section 172(4) is also an assessment order. According, the AO ought to have forwarded the draft order to the assessee in order to enable it to file its objection before the DRP.

***Taxability of Freight income earned by Torm A/s***

Torm A/s has a place of effective management and control outside India in Denmark. It also qualifies as 'resident' of Denmark as per the India- Denmark Tax Treaty. Accordingly, freight income earned by Torm A/s. would not be taxable in India.

**Citation:** LR2 Management K/S vs. ITO (ITA No. 755/RT/2014) (Rajkot Tribunal)

## Tribunal ruling on applicability of Article 8 of the India-UAE Tax Treaty on shipping income from India and invoking of Article 29 dealing with Limitation of Benefit (LoB) clause

**Facts and issues:** The assessee, a UAE tax resident was engaged in shipping business. The assessee filed its tax return for AY 2009-10 claiming 100% tax treaty benefit on profits from operation of ships situated in India. The AO rejected the claim of tax treaty protection submitting that (1) no taxes were actually paid in UAE and (2) the assessee was registered in UAE only to obtain tax treaty benefits. The AO referred to LOB clause enumerated in Article 29 of the India - UAE Tax Treaty which provides that an entity, which is a resident of contracting state shall not be entitled to the tax treaty benefits if the main purpose, or one of the main purposes of the creation of such an entity was to obtain benefits of tax treaty which would otherwise not be available. The AO also referred to the assessee's documents and requisitioned the information regarding shareholders, AGM etc. and concluded that merely because it got registration & license for doing the business in UAE, it could not be said to have a place of effective control and management in UAE. The AO on that basis concluded that the agent/freight beneficiary was not entitled to claim the tax treaty benefit and was therefore taxable in India.

The CIT(A) granted tax treaty benefits to the assessee and held that the AO was not correct in his logic that the tax treaty benefit would be denied on the ground that the assessee's AGM was held outside UAE, Directors of the assessee were not UAE resident (Citizens), shareholders of the assessee were not resident of UAE. The CIT(A) further held that the true test for determining the location of control and management is where the Board Meetings were held. The management of the assessee was in the hands of its Board of Directors who are responsible for the operations and growth of the assessee. The entire decision making though reviewed by the shareholders was done by the Board of Directors in Board Meetings, which were held in UAE. The CIT(A) thus held that the profits arising out of operation of ships were not taxable in India in view of Article 8 read with Article 4 of India-UAE Tax Treaty.

***Contention of the Income tax department***

There was no evidence to suggest that the assessee actually paid any taxes in UAE. Further, LOB clause under Article 29 would be attracted, as the assessee could not rebut the facts bought on record by the AO.

**Observations of the ITAT**

***On non-payment of tax in UAE***

According to India-UAE protocol, the definition of tax resident in UAE was amended to do away with the requirement of actual liability to pay tax. Thus, tax treaty benefits could not be declined on the ground that UAE tax-resident has actually not paid any tax in UAE.

***On invoking Article 29 - LoB clause***

As regards the stand of the AO that the directors of the assessee were not UAE nationals, this is wholly irrelevant as the directors are residents of the UAE. Nationality of the directors, *dehors* their place of residence and business activity, is not decisive of the fact as to whether or not the company is managed and controlled in the UAE. The directors of the assessee were residents of UAE and the Board, as also shareholders' meetings had taken place in the UAE. There were no defects pointed out in copies of the minutes of the meetings. As evident from the annual accounts and the list of employees, it is clear that the assessee was not merely a paper company, but had actually carried out material business operations from the UAE.

Only when creation of an entity is part of manoeuvring, wholly or mainly, to obtain the benefits of the India UAE Tax Treaty which "would not be otherwise available", the benefits of India UAE Tax Treaty could be denied under Article 29.

**Decision:** The AO could not decline the treaty protection to the assessee with respect to India sourced income, on the ground that the UAE tax resident had not paid tax in UAE in respect of his income in UAE. Income earned by the assessee from shipping business would not be taxable in India as per Article 8 of the India-UAE Tax Treaty.

**Citation:** ITO(IT) vs. MUR Shipping DMC Co, UAE

### Foreign tax credit relief available to section 10A claimants

**Facts:** The matter pertained to AYs 2001-02 to 2004-05.

The assessee was engaged in the business of export of computer software including services for onsite development of software through its permanent establishment in many countries such as USA, UK, Canada, Japan and Germany. The assessee computed the profits attributable to the PEs, paid the applicable income-taxes on such profits and filed the tax returns as required by the domestic laws in the respective countries. The clients in some countries withheld tax at-source from the consideration payable to the assessee which was regarded as the final tax in such countries. However, the assessee being an Indian company and hence a tax resident in India in terms of section 6 of the Act and was therefore, liable to tax in India on the worldwide income including the profits attributable to its PEs in foreign countries and also the incomes which are subjected to withholding tax in foreign countries.

The assessee claimed it was entitled to relief of such foreign tax paid in the foreign jurisdiction. The entitlement to relief of foreign tax was governed by the relevant DTAAs with the foreign countries. The AO, on the other hand, disallowed the assessee's claim of foreign tax credit on the ground that the entire earnings in respect of claim under section 10A had been included in computing the total income. A finding was recorded that when the assessee was not liable to pay income-tax in view of the exemption u/s 10A and hence, the assessee was not entitled to tax relief in respect of taxes paid in the foreign countries.

The matter was taken to the CIT(A) who ruled in favor of the assessee. The ITAT remanded the matter back to the CIT(A) for consideration with an observation that in view of exemption u/s 10A, assessee was not entitled to foreign tax credit in respect of taxes paid in the contracting foreign countries. Aggrieved by the ITAT Order, the assessee filed an appeal before the Karnataka High Court.

**Arguments and counter-arguments before the High Court:**

The assessee argued that a reading of section 90(1)(a)(i) of the Act made it clear that if the income is subjected to tax, both in India and the foreign country, the foreign income-taxes paid attributable to such income is allowed as credit in India.

It was further contended that if for any reason, the foreign tax relief was not given u/s 90 or 91, then the said amount of tax paid in the foreign country was liable for deduction u/s 37 r/w 40(a)(ii) of the Act. Therefore, the assessee contended that seen from any angle, the assessee was entitled to the benefit of credit of tax paid in the foreign country.

The Revenue, on the other hand, contended that section 10A appeared under Chapter III which refers to "incomes which do not form part of total income". Therefore, it does not partake of the nature of total income chargeable to tax as per the provisions of section 4 of the Act. The credit is being claimed under the provisions of section 90, which is applicable for the grant of relief in respect of income on which taxes have been paid both as income-tax under this Act and income-tax in the foreign country. The issue of credit u/s 90 clearly did not arise. A perusal of the DTAA between India and USA/Canada showed that the relief claim was admissible only for the taxes paid under the Act and Federal taxes paid in the USA/Canada. At best, the claim for relief could be considered on the portion of section 10A claim which has been rejected.

**High Court's decision:** The Division bench of the Karnataka High Court opined that the idea behind foreign tax credit was that the same income should not suffer taxation twice. When an income suffered taxation in both source and resident jurisdiction, tax paid in the first jurisdiction needs to be allowed as tax credit in the other jurisdiction.

Relying on section 90(a)(ii) of the Act, the High Court ruled that this section was meant for granting relief in respect of income chargeable under the Act and under corresponding law in force in the foreign country, to promote mutual economic relations, trade and investment. This section applied to a case where the income was chargeable under this Act as well as under the corresponding law in force in the other country. Though the income-tax was chargeable under the Act, it was open for the Parliament to grant exemptions under the Act from the payment of tax of any specified period which was the case in the present situation.

After referring to section 4 (charging section), section 2(45) which defines total income and section 5 (scope of total income), the High Court concluded that these sections were 'subject to the provisions of the Act' i.e. including section 90 of the Act. Upon a reading of section 10A of the Act, the High Court held that though the relief u/s 10A was by way of exemption although termed as deduction, yet the position remained that the income of that undertaking was chargeable to income-tax u/s 4 of the Act and was included in computing total income u/s 5 but no tax was charged because of the exemption given u/s 10A for a period of 10 years. Merely because the exemption had been granted in respect of the taxability of the said source of income, it could not be postulated that the assessee was not liable to tax. Accordingly, the High Court allowed the claim of foreign tax credit of the assessee in respect of section 10A income u/s 90(1)(a)(ii) of the Act.

After examining the provisions of Article 25(2a) of the India-USA DTAA, the High Court also concluded that this article did not talk of any income-tax being paid in India as a condition precedent to claiming the said benefit.

**Citation:** Wipro Ltd. vs. DCIT, Bangalore [ITA Nos. 879/2008, 880/2008, 334/2009 and 108/2009]

### Services rendered by highly qualified personnel would tantamount to FTS under the Act

**Facts:** The matter pertained to AY 2008-09.

The assessee was an Indian company engaged in the business of ownership and operation of supermarket chain in India. The assessee entered into an agreement dated 6 June 2007 with M/s Dairy Farm Company Ltd., ('DFCL') which was a company based in Hong Kong and engaged in the identical business activity with that of the assessee. Under the said agreement, DFCL agreed to assign its employees to the assessee and consequently 5 employees/expatriates were deputed by DFCL to the assessee.

It was also agreed between the parties that DFCL would pay salary to the assigned personnel and the assessee would reimburse such amount to DFCL. Accordingly, salary to assigned personnel were paid by DFCL which was subjected to TDS u/s 192 of the Act. The assessee reimbursed the same to DFCL towards the salary paid to the assigned personnel without deduction of tax at-source.

The AO initiated proceedings u/s 201 of the Act for not withholding tax at source in respect of reimbursement made to DFCL. An order u/s 201(1) and 201(1A) was passed, whereby it was held that remittance made by the assessee constituted fee for technical services ('FTS') u/s 9(1)(vii) of the Act. Therefore, the same was chargeable to tax on gross basis.

The assessee challenged the action of the AO before the CIT(A). The CIT(A) did not accept the contention of the assessee and after examination of the terms and conditions of the secondment agreement, arrived at the conclusion that the seconded employees did not have an master servant relationship with the assessee. They had provided managerial and consultancy services to the assessee within the meaning of explanation 2 to sec. 9(1)(vii) of the Act. The CIT(A) upheld the decision of the AO.

It is against this order the assessee filed an appeal before the Bangalore ITAT.

**Contentions and counter-arguments:**

Before the ITAT, the assessee contended that:

- The remittance in question was not FTS but merely reimbursement of salaries of the seconded employees. The assessee relied upon the decision of the Spl. Bench in the case of Mahindra and Mahindra Ltd. 314 ITR (AT) (SB) 263) as well as the decision of the Bangalore ITAT in the case of IDS software Solution Software India Pvt. Ltd., 122 TTJ 410.
- When the assessee has already discharged its liability by deducting tax at-source u/s 192 applicable on salary, then the payment in question could not be held as FTS.
- As an alternate plea, the AR submitted that even if the payment were treated as FTS, the secondees would constitute a service Permanent Establishment (PE) and, therefore, only the net expenditure would be chargeable to tax as per the provision of sec. 44D of the Act. In such a case, there would be no tax liability because the net amount would be Nil after deducting the expenditure which was in the shape of salary of these secondees.

The DR, on the other hand, argued that:

- As per the terms of the secondment agreement, the assessee did not have any control over deputed personnel.
- Further these employees were still on the payroll of DFCL and, therefore, there was no relation of master and employees between the assessee and these secondees. DFCL was the actual employer & hence the services rendered by these employees were actually rendered on behalf of DFCL.
- Thus, the remittance was not towards reimbursement of salary but for the services rendered by the expatriates on behalf of DFCL.
- The AO as well as CIT(A) after examination of the qualification of the secondees had come to the conclusion that they had been involved in management and consultancy services and these services were provided as per the agreement and, therefore, the remittance made by the assessee was actually FTS and not reimbursement of salary.
- He relied upon the judgment of Hon’ble Delhi High Court in the case of Centrica India Pvt. Ltd. vs. CIT (364 ITR 336) wherein it had been held by the Hon’ble High Court that

the secondees were imparting technical expertise to all regular employees of the assessee and hence was exigible as FTS. The SLP against the said judgment of Hon'ble High Court had been dismissed by Hon'ble Supreme Court reported in 227 Taxman 368.

- Further, nomenclature used in the agreement relating to the payment as reimbursement cannot be a determinative factor. This is because the Agreement stipulated that DFCL would "only depute manpower" as required by the assessee under this Agreement and not be 'rendering any service & that DFCL shall not be responsible for or assume any risk for the performance by the secondees while on assignment to the assessee.

**ITAT's decision:**

The ITAT noted that the secondment agreement was between the assessee and DFCL and the secondees assigned to the assessee were not party to the agreement. Further, the secondees were assigned by DFCL and there was no separate contract of employment between the assessee and the secondees. The secondees were under the legal obligation as well as employment of DFCL and assigned to the assessee only for a short period of time. In the absence of any contract between the assessee and the secondees, the parties could not enforce any right or obligation against each other. The secondees could claim their salary only from the parent company i.e. DFCL and not from the assessee. In view of the above, the ITAT concluded that there was no employer-employee relationship between the assessee and the secondees.

In view of the managerial nature of the services provided by the secondees, the remittance to DFCL was in the nature of FTS under the Act.

As regards the alternate plea put forth by the AR, the ITAT observed that this plea had been taken by the assessee for the first time before the ITAT and there was no DTAA between India and Hong Kong therefore, this concept of service PE required a proper examination of all the relevant facts as well as provisions on the point whether it constituted a service PE in India. Accordingly, the issue was remitted to the record of the AO for adjudication of the plea raised by the assessee that the secondment of the employees constituted a services PE and accordingly provisions of sec. 44DA would be applicable.

**Our Comments**: This judgement reaffirms the principles laid down by the Delhi High Court in the case of Centrica India Pvt. Ltd. vs. CIT (supra) as to under what circumstances, the services rendered by the secondees would be taxable as FTS in the hands of the parent employer. The principles would have to be referred to while structuring international secondment structures.

**Citation:** Food World Supermarkets Ltd. vs. DDIT, Bangalore [ITA 1356 & 1357/Bang/2013] reported in TS-629-ITAT-2015(Bang)

## Partnership firm registered in UK can avail the benefit of India-UK Tax Treaty, even though the firm is not recognized as separate taxable entity as per the domestic tax laws of UK

**Facts and issues:** The assessee, an Indian company engaged services of a solicitor firm based in UK, for its proposed ADR offering. It paid fees to the solicitor firm and deducted withholding tax thereon at applicable rate of tax. The assessee, thereafter filed tax return in India, as a representative of the solicitor firm declaring the total income as Nil, claiming refund of entire withholding tax. It was claimed that fees received by the solicitor firm was not taxable in India, as per India-UK Tax Treaty.

The AO noticed that a partnership firm is not considered as separate taxable unit as per the domestic tax laws of UK. Any income earned by the partnership firm in UK is taxed in the hands of individual partners. The AO accordingly, denied the benefit of India UK Tax Treaty to the solicitor firm and held that the fee received by it would be taxable as 'fee for technical services' as per section 9(1)(vii) of the Act.

The CIT(A) allowed the benefit of India-UK Tax Treaty to the solicitor firm. The CIT(A) held that the fees received by the solicitor firm would fall under Article 15 of the India-UK Tax Treaty dealing with 'Independent personal services'. As the period of stay of the lawyers, who visited India was less than 90 days, the CIT(A) held that the solicitor firm does not have fixed base in India and accordingly, fees received was not taxable in India.

**Decision:** The Kolkata High Court in P & O Nedlloyd Ltd. & Ors. vs. ADIT (2014-TII-70-HC-KOL-INTL) has held that the benefit of India-UK Tax Treaty is available to a partnership firm registered in UK, even though the firm is not recognized as taxable entity as per the tax laws of

UK. The Kolkata High Court in the said decision took note of section 2(31)(iv) and section 2(31) of the Act as well as provision of the Indian Partnership Act, 1932 and came to the conclusion that once a partnership is a firm as per the Act, it becomes a person under section 2(31)(iv) of the Act, thereby eligible for the Tax Treaty benefit as per Article 3(2) of the India-UK Tax Treaty. Accordingly, it was held that a solicitor firm was entitled to avail the benefit of the India-UK Tax Treaty and therefore, fees received by it would not be taxable in India, as per Article 15 of the India-UK Tax Treaty.

**Citation: DDIT(IT) vs Zee Telefilms Ltd. [2015-TII-164-ITAT-MUM-INTL]**

## Procurement services rendered by Chinese company to an Indian company taxable as fees for technical services (FTS) as per India-China Double Taxation Avoidance Agreement (Tax Treaty)

**Facts and Issue:** The assessee, a company incorporated in China was a wholly owned subsidiary of M/s Usha International Limited (UIL), an Indian company. The assessee was set up to carry on business of import and export as well as provide services relating to business of household electrical appliances & equipment, household goods & accessories etc. to the Indian company. The assessee, as per the Service Agreement was required to perform the following services for the Indian company:

- New suppliers development,
- New product development,
- Market search,
- Co-ordinating with UIL for resolution of pricing terms,
- Safety/ performance/ endurance test,
- Review of quality systems,
- Quality system – monitoring of vendors,
- Inspection, interaction with vendors and sharing information with UIL etc.

In terms of the Service Agreement, the assessee was eligible for service fee at cost plus 10 per cent mark up. While making the payment of service fee to the assessee, UIL withheld tax under section 195 of the Act at the rate of 10 per cent, treating the payment as FTS in terms of Article 12 of the Tax Treaty.

The issues before the AAR were:

- Whether the services provided by the assessee in connection with procurement of goods by UIL were taxable in India?
- If the same were taxable in India, then whether the same were chargeable to the extent of full amount or only to the extent of mark –up received on it?
- The service fee received is taxable in India as FTS at the rate of 10% of the gross amount.

**Contentions of the assessee**

***Income not taxable in India as per the Act as well as Article 7 of the Tax Treaty***

Income earned by the assessee has neither accrued, nor arisen in India and cannot be deemed to have accrued or arisen in India. Accordingly, the said income earned would not be taxable in India as per the Act. The assessee was carrying on business activities wholly in China and therefore, in absence of a PE in India, the income earned by the assessee would not be taxable in India as per the Tax Treaty.

***Income earned not taxable in India in terms of Article 12 of the Tax Treaty***

The payment received by the assessee is not FTS under Article 12(4) of the Tax Treaty since no services are rendered in India. Further, the services rendered are not in the nature of managerial, technical or consultancy services. These services are in connection with procurement of goods as per instructions and requirement of UIL and can only be categorized as Business Income.

***Contentions of the Income tax department***

The assessee was acting as a consultant to UIL and providing consultancy services in a specialized field i.e. the Chinese Market, by identifying and evaluating the products & ideas available for buying by UIL from that market. Accordingly the services rendered were under the purview of 'consultancy services'. The assessee also provided managerial services to UIL in its procurement work by carrying out interaction with vendors; doing monitoring of the vendors and helping it in resolution of the pricing issues.

As per the Tax Treaty, the services were taxable in the contracting state where they were provided. In the absence of specific definition in the Act, the **place of provision of a service shall be the location of the recipient of service i.e. India.** Accordingly, no matter where the services were performed, these will be considered as provided in India, as the recipient of the services is located in India. Since the services performed by the applicant in China were received by UIL located in India, the services were provided in India.

Considering that **the applicant had provided technical, consultancy and managerial services to UIL in India**, any fee received in lieu thereof will fall under the definition of "fees for technical services" within the meaning of section 9(1)(vii) of Income Tax Act and Article 12 of the Tax Treaty.

**Decision:**

***Income not taxable in India as per the Act as well as Article 7 of the Tax Treaty***

The AAR held that the services provided by the assessee were highly specialized and technical, and hence would fall squarely within the ambit of 'consultancy services' and therefore should be taxable as FTS under the Tax Treaty.

***Income earned not taxable in India in terms of Article 12 of the Tax Treaty***

The AAR observed that unless the services are actually performed in India, the same cannot be taxable in India. According to AAR the expression 'provision of services' should be construed as rendering of services. There seems to be some grey area in the use of the expression 'provision of services' and 'utilization of services'. There are three types of situations envisaged:

(a) Provision
(b) Rendering
(c) Utilization

The scope of the expression 'provision for services' is much wider in scope than the expression provision for rendering of services and will cover the services even when these are not rendered in the other contracting state, as long as these services are used in the other contracting state.

The AAR observed that the expression 'provision of services' is not defined anywhere in the Tax Treaty. There is a distinction between India-China Tax Treaty and India-Pakistan Tax Treaty. The Pakistan-China Tax Treaty refers to 'provision of rendering of any managerial, technical or consultancy services, whereas India-China Tax Treaty refers to 'provision of services of managerial, technical or consultancy nature. The distinction between these two DTAAs clearly points out that the scope of provision of services as in India-China Treaty is much wider than scope of provision of rendering of services' as in Pakistan-China Treaty. It was thus held that income earned by the assessee from an Indian company would be taxable in India irrespective of the fact that the entire services are provided in China.

***Determination of amount for taxability***

The AAR relied on its earlier decision in the case of *Danfoss Industries Private Limted (AAR No. 606 of 2002)* and *Timken India Limited (AAR No. 617 of 2003)* wherein it was held that the amount paid might be income or income hidden or otherwise embedded therein. The scheme of TDS under the Act applied not only to amount paid which would wholly bear income character but also to gross sums, the whole of which might not be income or profit of the recipient. The AAR thus held that the service fee received by the assessee was taxable in India as fees for technical services at the rate of 10% of the gross amount.

**Our Comments:**

The AAR in this decision rightly observed that the assessee not only identified products but also conducted market research based on which advice (in the form of a report) was offered to UIL thus services rendered were specialized and technical in nature requiring skill, acumen and knowledge. The services were therefore considered to be FTS and not commercial services. Accordingly, the AAR rejected the argument of the assessee that the service fee would not be taxable in India, in absence of PE of the assessee in India.

Once the service fee received by the assessee is classified as FTS, the same is taxable on gross basis. The argument of the assessee to withhold tax only on mark-up would have been relevant only where the said services were taxable under business profits.

**Citation: Guangzhou Usha International Ltd. (AAR No. 1508 of 2013) [AAR]**

## Determination of ALP based on TP study conducted by CA was held to be in good faith and with due diligence. Penalty under section 271(1)(c) was deleted as the condition specified in Explanation 7 were not met

**Facts and issues:**

The assessee was engaged in the business of providing investment advisory services. During the TP assessment proceedings for AY 2009-10, the TPO made an adjustment of Rs. 4.03 crores which was confirmed by the DRP. Simultaneously, penalty proceedings were initiated under section 271(1)(c) of the Act for filing inaccurate particulars of income. During the penalty proceedings, the assessee stated that although it had accepted the variation proposed in the order, it was not in agreement with the same as the ALP taken by the TPO was based on the final comparable companies which were not in similar line of business as that of the assessee. It was further contended that the only reason for accepting the order of the AO was to avoid protracted litigation as the company was in the process of voluntary winding up. The AO, however, was of the view that Explanation-1 to section 271(1)(c) of the Act was squarely applicable for furnishing inaccurate particulars of income and levied the penalty

**Observation of the ITAT**

The assessee did not contest the assessment order as it was under liquidation and was winding up its affairs. The determination of reasonable arm's length price is a matter of estimate. Merely because it is possible to arrive at two different estimates of arm's length price, it cannot be held that the lower of the two estimates is based on inaccurate particulars, while higher one is accurate.

**Decision**:

Explanation 7 to Sec 271(1)(c) needed to be considered in respect of TP additions wherein it was provided that no penalty could be levied where pricing was done in good faith and with due diligence. In the present case, transfer pricing study was conducted by an independent expert CA. In such a situation, it cannot be said that the assessee has not determined the arm's length price in accordance with the scheme of section 92C in good faith and with due diligence. The conditions precedent for invoking Explanation-7 to section 271(1)(c) did not exist on the facts of this case and therefore, penalty was deleted.

Accordingly, ITAT set aside CIT(A)'s order and directed AO to delete Sec 271(1)(c) penalty.

**Citation: Babcock and Brown India Pvt Ltd [TS-564-ITAT-2015 (Mum)**

## Tribunal

### Provisions of section 115JB (MAT) not applicable to banking company (excluded u/s 211(2) of the Companies Act, 1956); amendment vide Finance Act, 2012 prospective

**Facts & Question:** The matter pertained to AY 2002-03.

The assessee was a nationalized bank.

The only issue before the ITAT in this appeal was as follows:-

Whether the provisions of Section 115JB of the Act could be made applicable to a bank when their profit and loss account was not prepared in accordance with Part II & Schedule VI to Companies Act, 1956?

This issue had already been decided by the ITAT in ITA No. 1768/Kol/2009 vide order dated 19.3.2013 in favor of the assessee. The Revenue had challenged this issue before the Hon'ble Calcutta High Court which, vide order dated 13.1.2014, restored the matter to the ITAT only on the issue of the applicability of Minimum Alternate Tax u/s 115JB of the Act to banking companies.

It so happened that the ITAT had relied upon the judgment of a coordinate bench in the case of State Bank of Hyderabad vs DCIT (33 taxmann.com 312) wherein it was held that provisions of section 115JB were applicable and that the amendment was prospective in nature. However, in conclusion, the ITAT held that MAT provisions were not applicable to the assessee. Disturbed by this contradiction, the High Court remanded the matter back for the ITAT's consideration.

**Contentions and counter-arguments:**

Before the ITAT, the assessee contended that:

a. Assessee was not a company under the Companies Act, 1956. Only for income-tax assessment purposes, all banking, electricity and insurance companies are given the status of a company.
b. Section 115JB of the Act overrode all other provisions of the Act as it started with a non-obstante clause. Hence, it was an independent code by itself. In this section, the term 'company' should be construed as company as defined under Companies Act, 1956 only. The Section 115JB of the Act clearly stated that the accounts are to be prepared in accordance with Part II of Schedule VI of Companies Act, 1956.
c. Computation provision stated that 'Net profit as per Profit and Loss Account should be prepared as per Part II of Schedule VI of Companies Act, 1956.
d. Sec 211 of Companies Act, 1956 was not applicable to assessee herein, whereas it was very much applicable to companies defined under Companies Act, 1956.
e. Assessee prepared its accounts as per section 29 and Schedule III prescribed under Banking Regulation Act.
f. When the computation provision could not be applied in a particular case, it was indicative of the fact that the charging section also would not apply.
g. The prudential norms of RBI were to be followed mandatorily by assessee as per Banking Regulation Act with regard to recognition of income, classification of assets and provisioning requirements to be made thereon which was not contemplated in the provisions of the Companies Act, 1956.
h. Section 36(1)(viia) of the Act provided for deduction towards provision made for doubtful debts allowed in respect of banks which was not available for companies registered under the Companies Act, 1956. Hence, it had to be understood that the banking company as defined in

Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970 was structurally different from a company defined under Companies Act, 1956.

i. Under Banking Regulation Act, the bad debts had to be routed only through the provision account unlike in Companies Act, 1956. Hence it would not appear in profit and loss account. Even provision was made for standard assets under Banking Regulation Act by following Prudential Norms prescribed by Reserve Bank of India. Hence, there was material difference in the manner in which accounting entries are passed for the purpose of preparation of accounts under Banking Regulation Act and Companies Act, 1956 and corresponding income determination under the Act thereon.

j. Amendment in section 115JB came into effect only from 1.4.2013 vide Expln 3 inserted by Finance Act 2012. At the time of Finance Bill 2012 stage, amendment was proposed only in section 115JB(2). Expln 3 was not proposed at that time. But when the Act was enacted, Expln 3 was inserted. Expln 3 states that assessee being a company to which section 211(2) of Companies Act applies. Admittedly, the accounts of bank are not prepared as per section 211(2) of Companies Act, 1956.

k. Amendment was brought only from 1.4.2013 and hence was not retrospective. More amendments were brought in Finance Act 2012 with retrospective effect. But this amendment was specifically made effective only from 1.4.2013 having prospective effect. Hence, the legislature in its wisdom had intention only to prospectively tax the banking companies under MAT.

l. Company under Companies Act is defined. It did not include company assessed as company for tax purposes. Banking company also is defined under Companies Act.

m. The expression ‘for the removal of doubts, it is hereby clarified’ used in Explanation 3 to section 115JB should not be construed as clarificatory in nature and thereby giving retrospective effect. Reliance in this regard was placed on the decision of the Hon’ble Apex Court in the case of Vatika Township case reported in 367 ITR 466 (SC).

n. The levy of MAT on banking companies was a substantive levy on the assessee and hence could only be prospective.

Per contra, the DR argued that:

i. Section 11 of the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970 states that “For the purposes of the Income-tax Act, 1961, every corresponding new bank shall be deemed to be an Indian Company and a company in which the public are substantially interested.”
ii. Section 115JB(2) of the Act refers to Companies Act only for the limited purpose of computation of book profits. Hence it need not be a company under the Companies Act for the purpose of charging provision.
iii. Accordingly, Banking Companies also would automatically fall under the provisions of section 115JB of the Act.
iv. Merely because section 115JB(2) of the Act refers to Companies Act, it did not mean that the definition from therein has to be borrowed.
v. Explanation 3 to section 115JB stated that it was applicable for AY commencing on or before 1st April 2012 and hence has to be construed as retrospective in operation.

**ITAT’s decision:**

The ITAT observed that it was necessary for it to ascertain whether the assessee could legally be considered as a ‘company’ for the purpose of applying the proviso to section 211(2) of the Companies Act, 1956. After examining the definitions under the Banking Regulation Act, 1949 and the Companies Act, 1956, the ITAT came to the conclusion that even though the assessee was assessed in the status of a ‘company’ for tax purposes, yet it was not a ‘company’ within the meaning assigned to that expression by section 3 of the Companies Act, 1956. Accordingly, the ITAT held that since the provisions of section 211(2) of the Companies Act, 1956 were not applicable to the assessee, therefore, the provisions of section 115JB of the Act did not apply too for the impugned AY.

**Our Comments**:

This judgement reaffirms the position which is fairly well-settled by now viz. MAT provisions are applicable to insurance, banking & electricity companies w.e.f AY 2013-14 prospectively.

However, in the judgement, with humble regards, we feel that the ITAT has misdirected itself to reach a conclusion that unless an assessee comes within the ambit of section 211 of the

Companies Act, 1956, it was not covered by Explanation 3 to section 115JB of the Act and as a corollary, section115JB was not applicable to it. In fact, to our understanding, it is just the converse. Were it not so, then the entire edifice of applying MAT provisions to non-section 211 companies would fail. The intent of Explanation 3 to section 115JB of the Act was to make MAT provisions applicable to those companies to which section 211 of the Companies Act, 1956 did not apply as a result of the proviso thereto.

While in our view, with due regards, the ITAT has reached the correct conclusions, the rationale for reaching such conclusions desire some relook.

**Citation:** UCO Bank vs. DCIT, Kolkata [ITA 1768/Kol/2009] reported in TS-687-ITAT-2015(Kol)

## Where the directors had rendered services and in recognition were paid commission, the same could not be questioned merely on the basis of a surmises that the same was done to avoid payment of dividend distribution tax

**Facts and issues:** The assessee was engaged in the business of execution of contract work of lift irrigation scheme. It paid commission amounting to Rs. 1 crores to 3 out of 6 of its directors, who had substantial shareholding. The commission was sanctioned in a resolution passed by the Board and was paid for the extra services rendered by directors, which resulted in substantial increase in turnover and profits. For AY 2010-11, the assessee claimed the said expenditure under section 36(i)(ii) of the Act.

The AO allowed the deduction on account of remuneration as well as commission paid. The CIT(A), however enhanced the income and disallowed the same. The CIT(A) observed that dividend was paid to the directors in the garb of commission to avoid dividend distribution tax. The CIT(A) observed that only Rs.1,90,000 was proposed as dividend out of profit of Rs.93.48 lakh available for appropriation after payment of commission of Rs.1 crore.

***Contention of the assessee***

The commission was not paid in shareholding pattern, but was paid on account of services rendered by directors to assessee. Commission paid was justifiable as the assessee could achieve the turnover and profit only because of the extra efforts of the directors. Further, section 40(b) of the Act which applies to a partnership concern allows payment of the remuneration upto 60% of the profits to the partners, while in assessee's case remuneration paid to the directors was less than 60%. Merely because the assessee was a private company, deduction could not be disallowed on mere surmises.

***Contention of the Income tax authorities***

In the absence of documents to prove that extra services were rendered by directors, no commission could be allowed as deduction under section 36(i)(ii) of the Act

**Observations of the ITAT**

Section 36(1)(ii) of the Act provides that bonus or commission paid would be allowed as deduction. Section 40A(2) of the Act imposes restriction on allowability of deduction on the basis of unreasonableness of expenses. The assessee paid commission to 3 directors and not all directors. Taking note of the qualifications of the directors and nature of sub-contracts executed by the assessee which were in specialized field, such contracts could not be carried out without the efforts of concerned directors.

In case the entity was a partnership concern, 60% of the profits of business could have been allowed as remuneration to the partners of the said entity.

Remuneration paid to the same directors was allowed by the AO and not disturbed by the CIT(A) which in turn established that the directors were working directors. Where the directors had rendered services and in recognition thereof, there was a proposal to pay commission to the said directors, then the same could not be questioned merely on the basis of surmises that the same was to avoid payment of dividend distribution tax.

The assessee was entitled to claim deduction of Rs.1 crore under section 36(1)(ii) of the Act. ITAT relied on the decisions of various High Courts, wherein it was held that that where the commission had been paid to the directors and the taxes had also been paid by the said directors on income, then no disallowance was warranted in the hands of the assessee company.

**Decision:** The assessee had furnished the details of directors’ remuneration and commission paid to the directors and the total of the same did not exceed 60% of the profits. Merely because the assessee was a private limited company and had agreed to pay the commission to the directors by passing Resolution in this regard before the close of year, the same would not be disallowed in the hands of assessee on mere surmises.

**Citation:** Arihantam Infraprojects Pvt. Ltd. vs. JCIT (TS-685-ITAT-2015)(Pune)

Stay be granted to an assessee if on balance of convenience, prima facie case in favor of the assessee and financial distress proven. Stay Petitions should not be rejected in an objective manner and facts of each case to be appreciated subjectively.

**Facts of the case**:

The assessee was engaged in the business of development of revenue assurance, fraud management and related solutions for the telecom sector. The assessee had appealed before the ITAT against the order of the DCIT made as per the directions issued by the DRP. It had filed a stay petition before the ITAT requesting stay of the entire demand of Rs. 12,16,10,656, which was reduced to Rs. 5,04,90,837 (including interest of Rs. 1,43,65,851 levied u/s 234B of the Income-tax Act, 1961) consequent to various rectification applications filed before the revenue.

The ITAT granted stay on the rectified demand till the expiry of 6 months or the disposal of the appeal whichever was earlier.

The appeal was pending disposal before the Tribunal and the date of hearing of the impending appeal was December 28, 2015. The period of 6 months term had expired September 30, 2015. The assessee applied for the extension of the stay granted earlier, on the grounds, that the impugned order on account of transfer pricing adjustment of Rs. 22,65,49,250 was bad in law and violative of principles of natural justice and that the assessee, prima face, had a strong case on merits and most issues were covered by the decisions of the ITAT itself.

**Arguments:**

The AR intimated the ITAT that the assessee applicant had already paid 30% of the demand raised. It was submitted that the assessee was suffering from substantial losses since AY 2008-09 which position continued till FY 2014-15. It had an impaired financial position and cash flows and its day-to-day cash and working capital requirements were funded by substantial bank borrowing since assessee's internal accruals were not enough to meet the requirements. Owing to such financial position the assessee was not in a position to deposit such huge tax demand on account of the impugned additions.

The assessee also produced evidences before the ITAT to substantiate that its debts were far exceeding the equity.

The DR opposed the grant of stay of the entire demand and vehemently argued that the assessee pay before the disposal of the appeal.

**<u>ITAT Decision:</u>**

The ITAT referred to the decision of the Hon'ble Supreme Court in the case of ***Ravi Gupta Vs CST, Delhi (2009) Civil Appeal No. 1965 of 2009*** wherein the Apex Court had held that Petitions for stay should not be disposed of in a routine matter without considering the consequences flowing from such orders requiring an assessee to deposit the demand in full or in part. Facts have to be considered on a case-to-case basis. Where denial of interim relief lead to public mischief or grave irreparable private injury or shakes a citizen's faith in the public administration, then interim relief could be granted.

ITAT noted that the Assessee had made out a prima facie case by the gravity of its despaired financial condition. The balance of convenience was in the favor of the assessee and hence, the extension ought to be granted to the assessee. ITAT also noted that since the case was posted for hearing on December 28, 2015, the stay was granted till the disposal of the appeal provided either of parties to this appeal did not take adjournment and the hearing took place without delay.

**Citation: Subex Limited Vs. Deputy Commissioner of Income-Tax, Circle 12(3) – [S.P. No 122/Bang/2015 in IT(TP) No. 223/Bang/2014]**

Fact that expenditure under different expenditure heads had been incurred was indicative of the setting-up of business of the assessee.

**<u>Facts:</u>**

The assessee company was in the business of trading and merchandising of goods and services. The assessee e-filed its return of Income declaring a loss of Rs. 87,26,445. The return was selected for scrutiny assessment.

The assessing officer, on a perusal of the Annual Accounts, found that the assessee had not commenced its business and thus, the expenditure claimed was not allowable to the assessee. The Assessee contended before the Assessing Officer that the expenditure is allowable on the ground that the expenditure was incurred wholly for the purpose of business, was not personal in nature and was not capital expenditure and thus, eligible for deduction u/s 37(1) of the Income-tax Act, 1961.

The Assessing Officer disallowed the claim of the assessee and disallowed the entire claim of expenditure. The Assessing Officer reasoned that the expenses are allowable only when the business has commenced.

Aggrieved with the order of the Assessing officer, the assessee appealed before the CIT(A). However, the CIT(A) dismissed the appeal of the assessee. The assessee then approached the ITAT against the sole issue of disallowance of expenditure u/s 37(1) of the Income-tax Act, 1961.

**Arguments:**

The AR furnished the details of Salary, employees, job descriptions and tax deducted at source on such emoluments and details of other revenue expenditures. AR argued that setting up of business is distinguishable from the commencement of business and that the expenditure is allowable once the business was set-up. The AR relied on the decision of the Hon'ble Delhi High Court in the case of **Omniglobe Information Tech India Private Limited Vs CIT**. wherein it was held that a business is said to be set-up at the moment when the employees are recruited for the purpose of business and therefore any expenditure incurred by the assesse after setting up of the business was allowable u/s 37(1) of the Income-tax Act, 1961.

The DR relied on the findings of the lower authorities. The DR also contended that the decisions relied upon by the assessee were not applicable as they related to service industries.

**ITAT Ruling:**

The ITAT began its decision by referring to the proviso to Section 3, which defined previous year in relation to a newly set-up business or profession and not with the date of commencement. ITAT also referred to Section 28, which charged the profit and gains from business or profession carried out at any time during the previous year, under the head 'Income from Business or Profession'.

ITAT noted the fact that the assessee had recruited employees for its business and the fact that the line of business which the assessee carried on, required expertise, skills, proficiency in understanding the jewels and jewelry, without such recruitment it would not have been practicable to commence the business.

ITAT referred to the decision in Omniglobe Information Tech India Private Limited (Supra.) wherein the Delhi High Court observed that there was a distinction between the setting-up and commencement of business. In this case it was held that the moment the assessee had acquired infrastructure facilities and training was imparted to its personnel, it could be said that the assessee's business was set-up. The subsequent rendering of service to third parties could be at a later date.

Decision of the very same High Court in the case of CIT Vs Hughes Escorts Communication Limited was also referred to wherein it was held that the moment assessee purchased VSAT equipment, it should be said that business had been set-up. Decision in the case of Whirlpool of India was also referred to where a similar view was taken.

Thus, after elaborate discussion and deliberations, the ITAT held that the fact that recruitment of employees took place and expenditure under different heads was incurred was indicative that the business was set-up and hence the order of the CIT(A) was set aside and the assessing officer was directed to allow the claim of expenditure.

While closing the judgment the ITAT decreed that the objection of the DR on the judgments relied by the AR were not tenable as the ITAT had considered the broader principle.

**Our Comments:**

In the instant case distinction has been made between set-up and commencement of business. There is a thin dividing line between set-up and commencement of business which are peculiar to the facts of every case. The test laid down by various Appellate authorities in their decisions was that the business would commence when the activity, which is first in point of time, must necessarily precede other activities is started; as business connotes continuous course of activity and all activities which go up to make the business need not be started simultaneously. It is not necessary that the business should commence for claiming the expenditure and that income should necessarily be generated.

**Citation: Reliance Gems and Jewels Limited Vs. The DCIT – 3(3), [TS-658-ITAT-2015 (Mum.)]**

### Erroneous system restricting e-TDS return revision upto 4 characters i.e. 2 alpha and 2 numeric was held to be not in accordance with the law

**Facts and Issue:** The assessee was a public sector undertaking and approximately 69% of the shares were held by GOI. During FY 2013-14, the assessee deducted TDS @2% on payment to one of the contractors namely GETCO Ltd. The assessee duly deposited the TDS and filed the quarterly e-TDS return in Form 26Q. Form 26Q required the deductor to furnish the details of the deductee including PAN as well as amount of sum credited/paid and TDS deducted. Inadvertently, the assessee mentioned wrong PAN of the deductee due to which Centralized Processing Cell–TDS (CPC-TDS) treated wrong PAN as no PAN and accordingly created demand for FY 2013-14 by imposing a burden of differential TDS @ 18% as per the provisions of section 206AA of the Act. The Income tax department treated the assessee as assessee in default under section 201(1)/(1A) of the Act.

The assessee tried to rectify the above mistake of wrong quoting of PAN by filing the correction statement, but the same was rejected by CPC-TDS on the ground that the system only allowed the change of 4 characters subject to maximum of two numerical characters and two alpha characters. There were more than 4 changes in the wrong PAN quoted by the deductor and, therefore, correction statement was not accepted.

The ITAT took note of the Notification No 3/2013 which came up with centralized processing of statement of TDS scheme which dealt with various aspects of online filing and processing of e-TDS returns. The scheme TDS clearly gave an option to the deductor to correct the quarterly return(s) filed by it and this correction had not been restricted to any particular alpha-numeric correction. The correction, as per the scheme could be made by way of deleting the entry, adding of the deductee, change in details mentioned about the deductee including his PAN, adding of TDS challans etc, and that the deductor can rectify any kind of mistake which has been inadvertently made by it at the time of filing original e-TDS return and also this correction statement can be filed multiple times.

**Decision:** Refusal of the CPC-TDS to accept change in PAN details beyond 4 alpha-numeric characters filed by the deductee in its correction statement was not correct and justifiable. The deductee should be given further opportunity of filing the correction statement with the correct PAN details.

There was no intention on the part of the deductor or deductee to furnish wrong PAN details. The system was erroneous to the extent, it restricts the deductor to revise its e-TDS return which in this case was correction of PAN details, subject to change of two alpha and two numeric characters. Accordingly correction statement filed by the assessee needs to be accepted after ascertaining the correctness of the PAN furnished by the deductor.

**Citation:** Oil & Natural Gas Corporation Ltd. vs. DCIT,CPC-TDS[TS-673-ITAT-2015(Ahd)]

## Mere transfer of fixed assets without transfer of other assets and liabilities does not amount to Slump Sale

**Facts:** The matter pertained to AY 2000-01.

The assessee company carried on the business of growing and manufacture of tea and owned 2 tea gardens by the names – Tongani Tea Estate and Nagrijuli Tea Estate. By an Agreement dated 14 September 1999, the assessee sold the Nagrijuli Tea Estate to Russel Tea Ltd. for a consideration of Rs. 18 crores. According to the AO, the assesse company had sold its entire tea estate known as Nagrijuli Tea Estate as a going concern basis and also on 'as is where is' basis and hence, assessed the transaction as a slump sale u/s 50B of the Act. The assessee, on the other hand, contended on the basis of the agreement and the intent that this was an itemized sale of assets.

The CIT(A) held in favor of the assessee on grounds which were relied upon by the ITAT (as seen in the ITAT's decision below). Aggrieved by this order, the Revenue preferred an appeal before the Kolkata ITAT.

**Issue:** The question before the ITAT was on facts, whether this transaction was an itemized sale of assets or whether it would be categorized as slump sale?

**ITAT's decision:** The ITAT considered the arguments of the Revenue and the assessee. Accordingly, it made the following observations:

a. From a perusal of the Agreement, it appeared that the intention of the parties was to transfer the fixed assets situated and lying at Nagrijuli Tea Estate for a consideration.
b. The parties made their intention clear by apportioning sale consideration between different categories of the fixed assets. The values for individual fixed assets were arrived at by an expert (Chartered Surveyor and valuer) in his report titled "A Report on the Assessment & Apportionment of Fixed assets of Nagrijuli Tea Estate".
c. The purchaser and seller passed accounting entries for purchase / sale of assets in their respective books as per the values estimated by the valuer. The tax computations were also made by the parties with reference to values apportioned amongst different fixed assets.

d. No intangible assets such as licences, brand names, quotas etc., associated with the business were transferred.
e. Current assets except stock of stores and spares and liabilities of Nagrijuli Tea Estate were not subjected to transfer though they were integral to the Tea Estate under transfer.
f. An important factor noticed by the CIT(A) and also the ITAT was that the liabilities incurred for the Tea Estate under sale, upto the date of the transfer were to be borne by the assessee (i.e. seller) only. The ITAT observed that in a slump sale, all assets and liabilities pertaining to the undertaking were to be transferred.

The ITAT noted that section 50B of the Act is a code by itself and contains complete computational mechanism for assessment of capital gain on transfer of an undertaking in a slump sale. In the present case, as all assets and liabilities of the undertaking were not transferred, 'net worth' could not have been computed in the manner specifically prescribed by Explanation 1 to section 50B of the Act. The Hon'ble Supreme Court had held in the case of B. C. Srinivasa Shetty vs. CIT (128 ITR 294) that if the computation provisions of the Act fail and capital gain cannot be computed in the manner statutorily provided in law, then there cannot be assessment of income under the head 'capital gains'.

On the basis of the above, the ITAT concluded that this was a case of split sale and not exigible as slump sale as claimed by the Revenue.

**Our Comments**: This judgement adds to the various judgements available on this subject which deal with slump sale vs. itemized sale. In an itemized sale scenario, one is able to set-off the gains against the unabsorbed business losses; whereas in a slump sale, the rate of long-term capital gains works out lower than business profits. Structuring the sale transaction after considering the principles enunciated by these judgements bring clarity to the desired tax outgo, which incidentally forms a significant part of the cost-benefit analysis of such transactions.

**Citation:** DCIT, Kolkata vs. Tongani Tea Co. Ltd. [ITA 1233/Kol/2014]

## Payment to credit-company under risk sharing arrangement cannot be treated "commission" triggering TDS obligations under section 194H

**Facts and issues:** The assessee was engaged in the business of selling tractors and had setup a unit at Pune. TDS verification was carried out by the TDS officers to verify TDS compliance of the assessee for AYs 2010-11 to 2012-13. The assessee had incurred an expenditure of Rs.3,28,29,048/- allocated under the head “Authority to Guarantee”. The assessee had entered into an agreement with a credit-company for providing credit facilities to its customers. The assessee explained that their customers mainly comprise of farmers who did not have resources and liquidity to purchase tractors and other agricultural equipment. As per the agreement, certain portion of losses if any, incurred by the credit company on account of non-payment of loan by the borrowing farmers would be borne by the assessee. The assessee had to bear only stipulated percentage of amount which was not recoverable from the ultimate customers. Thus, the expenses in essence was towards providing credit to its customers by the finance company on recourse basis to the assessee upto a certain agreed percentage. In consideration of this commitment by the assessee to share stipulated percentage of losses, credit-company agreed to provide credit assistance to the retail customers of the assessee. The assessee emphasized that sharing of loss does not represent payment of any commission to the finance company as alleged by the AO. The entire arrangement entered into by the assessee was in order to provide credit facilities to the farmers.

The AO, rejected the contentions of the assessee that the agreement was entered to take care of certain percentage on loss which would occur to the finance company in case the customers did not repay the loan advanced. The AO observed that the expenditure was part of its sale promotion activity. The services for sale promotion were given by the financial institutions by giving loans to the customers. The services rendered by the financial institutions obviously helped in increasing the sale or else the assessee would not have incurred such high expenditure. For these services, the assessee incurred “Authority to Guarantee charges”. This is nothing but payment similar to commission/brokerage. The AO regarded the said payments as commission under section 194H of the Act and invoked section 201(1)/ 201(1A) r.w.s. 194H, imposed penalty and interest for the alleged default in not deducting TDS.

**Decision:** The definition of expression “commission or brokerage” as appearing in section 194H of the Act States that, (a) payment should be received by a person for services rendered, and (b) such person should be acting on behalf of the other person to whom the services have been rendered in respect of buying and selling of goods. <u>In the present case, there was no component of service rendered by the credit-company to the assessee against recovery of portion of losses, if</u>

any. Accordingly, the assessee's case was a simple business proposition whereby an arrangement was entered into by the assessee to assist its customers to enable them to obtain finance to buy their products and simultaneously assure the credit-company for recovery of losses, if any due to default in repayment by the customers. The requirement of an agent and principal relationship was found absent in the assessee's case since no nexus was found between the amount of sales made by the assessee and the expenditure towards 'authority to guarantee charges'. Accordingly, it was held that section 194H was not applicable to the assessee and sections 201(1) and 201(1A) would not get triggered.

**Citation:** John Deere India Pvt. Ltd. vs CIT(A) (TS-648-ITAT-2015(PUN)

## Assessee eligible for higher rate of depreciation on commercial vehicles despite not being used in hiring business

**Facts and issue**: Assessee was engaged in the business of engineering and fabrication. Assessment order u/s 143(3) for AY 2010-11 was passed by the AO. Thereafter, in response to notice u/s 263 pertaining to claim for depreciation at higher rate on vehicle acquired during the year, assessee submitted that the vehicle acquired by the assessee was new commercial vehicle as defined in IT Rules and therefore eligible for higher rate of depreciation. Further the assessee also pointed out that it was nowhere mentioned in the IT Rules that the vehicle should be used in the business of running them on hire for claiming higher rate of depreciation. However Principal CIT was not satisfied with the explanation and held that the AO had not verified the claim of depreciation on commercial vehicles @ 50% amounting to Rs 6.48 Lakhs. Accordingly, PCIT passed order u/s 263 directing the AO to verify the claim for depreciation.

**Decision**: Assessee submitted that during the assessment proceedings it had submitted the detailed depreciation schedule along with supporting bills. Thus the depreciation claim of the assessee was verified by the AO during the assessment proceedings. Tribunal noted that as per item no 3(via) of the Appendix under Rule 5 new commercial vehicle which is acquired on or after 1st January 2009 but before 1st April 2009 and is put to use before 1st April 2009 for the purpose of business or profession was eligible for depreciation @ 50%. Further, period of 1st

April 2009 stood extended to 1st October by virtue of subsequent amendment. Thus, the IT Rules provide that new commercial vehicles are eligible for depreciation @ 50%. The IT Rules nowhere prescribe that they should be used in a business of running them on hire. The provision of higher rate of depreciation was an incentive provision. PCIT cannot restrict the same by bringing a new condition that they have to be put to use in the business of running them on hire when the IT Rules do not prescribe so. Accordingly the order of PCIT u/s 263 was set aside.

**Citation**: SEC Industries Pvt. Ltd, Hyderabad Tribunal, ITA No 814/Hyd/ 2015

### Selling products continuously to the parties amounts to commercial production for the purpose of section 80IC

**Facts and issue**: Assessee was engaged in the business of manufacturing of compact florescent lamps (CF lamps), halogen lamps, metal halide lamps. During AY 2004-05, the assessee had started a new unit in the export processing zone at Dehradun.

AO noted that the special provisions in respect of certain undertakings in certain special category States as laid down u/s 80IC were applicable to the unit at Deharadun. AO also noted that the assessee company had purchased and consumed materials of Rs 3.98 crores and claimed various expenditure towards salary & wages, repairs etc. and had sold goods worth Rs 3.13 crores from the said Unit. AO also noted that as per section 80IC (8) initial assessment year means the assessment year relevant to the previous year in which the undertaking of the enterprise begins to manufacture or produce articles or things or commences operation or completes substantial expansion.

The assessee contended that the unit was under trial run and it had not commenced commercial production during the year. Further, the assessee also contended that it had incurred huge wastage due to trial run and the expenditure was shown as pre-operative expenditure in AY 2004-05. However the AO rejected the contention of the assessee and held that the unit had commenced production in AY 2004-05 and accordingly held it as the initial assessment year for purposes of section 80IC of the Act. The AO also held that it would have no impact on the taxable income in the year under consideration but would have effect on the remaining years for which the unit would be eligible for deduction u/s 80IC of the Act.

**Decision**: Assessee submitted that there was manufacturing only in 3 months but it could not be termed as commercial production because it amounted to trial production. Assessee also pointed that it had incurred losses on account of huge wastage of material due to such trial run in AY 2004-05. Tribunal noted that assessee from the beginning of the unit was taking purchase order from various customers and had also fulfilled the same by supplying goods to various parties from time to time in routine course. The Tribunal also noted that the assessee had been supplying goods to various customers continuously and had raised more than 60 invoices from time to time during the period December 2003 to March 2004. Further, no instances of defect or complaint made by the customers at any point of time was pointed out. Tribunal noted that selling of the products to particular parties continuously also showed that it was commercial production and not trial production. Tribunal also held that huge wastage will also not be a criteria for determining non-applicability of 80IC. Accordingly Tribunal held that the Deharadun Unit had commenced commercial production from December 2003 and AY 2004-05 would be the first initial assessment year for the purposes of section 80IC of the Act.

**Citation**: Phonix Lamps India Limited, ITA No. 390/Del/2009, Delhi Tribunal

## Treatment of finance lease as per AS 19 in the accounts is irrelevant while determining allowability of lease rental payments under Income Tax Act.

**Facts and issue**: Assessee had acquired vehicles worth Rs 27.88 Lakhs on financial lease terms. In accordance with Accounting Standard 19 Leases issued by ICAI the assets acquired were capitalized in the books. However, at the time of filing of return assessee claimed deduction towards payment of lease rentals u/s 37 in respect of these vehicles. AO disallowed the claim of lease payments on the ground that the payments made by assessee were under a finance lease and hence the same were required to be capitalized. Further no depreciation on the vehicle was also allowed on such assets.

**Decision**: The Tribunal noted that AS 19 on accounting for leases issued by ICAI is only applicable for accounting the lease transaction in the books of account. It is a settled law that treatment in the books of account is not determinative of the liability towards income tax for the purpose of IT Act. The liability under the Act is governed by the provisions of the IT Act and is not dependent on the treatment followed in the books of account. CBDT vide circular no 2 of 2001 had opined that AS 19 issued by ICAI creating distinction between finance lease and operating lease will have no implication under the provisions of the Act. Tribunal also noted that Hon'ble SC had held that the lessor is the owner of the leased property in case of finance lease and therefore entitled to depreciation. Rajasthan High Court in case of Rajshree Roadways ( 129 Tax man 663) had upheld the assesssee's claim for allowability of lease rentals paid as lessee of the truck, as a revenue expenditure even though the lease was categorized as finance lease. Accordingly, the Tribunal allowed the claim of the assessee in respect of lease payments.

**Citation**: Minda Corporation Limited , ITA No. 1962 of 2012 , Delhi Tribunal

An assessee having leasehold rights for a long period of time cannot be held as the owner of the property for computing capital gain by adopting market value as per the provisions of 50C.

**Facts and issues:** The assessee, an individual filed his return of income for AY 2009-10 declaring total income of Rs. 28,24,185. The AO noticed that the assessee had sold leasehold land alongwith building thereon during the relevant previous year for a sale consideration of Rs. 1 crore. The AO therefore, called upon the assessee to furnish the details relating to the property sold. After verifying the details furnished, the AO found that in the computation of capital gain, the assessee had worked out short term capital gain of Rs. 14,47,029, on sale of factory premise and lease hold land. The AO, further noted that for computing the short term capital gain, the assessee had taken sale consideration of Rs. 1 crore whereas the market value of the property was Rs. 2,35,07,298. The AO, therefore, proposed to compute capital gain by invoking the provisions of section 50C of the Act.

The assessee submitted that provisions of section 50C of the Act will not be applicable as the land transferred was by way of a deed of assignment. The assessee was not the owner of the land. The leasehold land was assigned along with factory shed having constructed area of 2,205 sq. ft. The assessee bifurcated the sale consideration of Rs. 1 crore between the building and land by apportioning an amount of Rs.22,05,000, towards building by taking the cost of construction at Rs. 1,000 per sq.ft. The balance amount of Rs. 77,95,000, was apportioned towards assignment of leasehold land.

***AO's contention***

The assessee was allowed the plot of land on lease basis for a period of 60 years on fixed ground rent and on deposit of certain amounts. No sale consideration was paid by the assessee for getting allotted the plot. The assessee had not shown the land in block of assets in the balance sheet. The assesse had only shown factory premise at Rs. 3,50,464 on which the depreciation had been allowed. Further, the lease for 60 years was a very long period and the lease was also not revocable for all practical purpose.

The AO, accordingly held that income arising from the sale of such capital asset had to be treated as short term capital gain. Thus, in essence, the assessee had become owner of the land. The AO proceeded to compute the short term capital gain on sale of factory premises at Rs. 18,29,120 and long term capital gain on sale of plot at Rs. 2,13,02,298.

The CIT(A) deleted the addition made by the AO by holding that section 50C of the Act cannot be applied in respect of leasehold rights. The assesse was not the owner of the land and was only having leasehold rights. Accordingly such transfer would not attract section 50C of the Act.

***Observation of the ITAT***

The AO has computed long term capital gain on assignment of lease hold rights of the plot by taking the market value as per section 50C only for the reason that the lease hold rights are for 60 years, and, for all practical purpose, the assessee should be held to be the owner of the property. As could be seen from the terms of the allotment letter, the lease hold rights conferred on the assessee were on certain terms and conditions attached thereto. Therefore, it cannot be said that the assessee has absolute rights of an owner.

**Decision**: As the assessee was having only lease hold rights for a period of 60 years, he cannot be considered to be the owner of the property so as to compute capital gain by adopting the market value as per the provisions of section 50C of the Act.

**Citation: ACIT vs Nadir Nazarali Dhanani [2015-TIOL-2109-ITAT-Mum]**

## Consideration received from JV partner for not sharing expertise or skills was held to be non-taxable as it was in the nature of capital receipt

**Facts and issues:** The assessee, an individual, was a promoter and managing director of IOPL established for manufacturing two wheelers in India. In June 2004, Suzuki Japan became a major shareholder in IOPL. In February 2005, the name of the IOPL was changed to Suzuki India.

The assessee and Suzuki Japan continued to be joint venture partners of Suzuki India. The assessee was retained as the managing director of Suzuki India by virtue of his being the Indian Joint venture partner. In March 2010, the assessee decided to terminate his relationship as joint venture partner in Suzuki India and stepped down as managing director. Suzuki India and the assessee, thereafter entered into agreement where Suzuki India paid Rs 1.32 crores to the assessee in consideration of him not providing the benefit of his knowledge of regulatory matters, negotiating skills and strategic planning expertize to any other person in India in the two wheeler segment for a period of two years from date of agreement.

The assessee while filing return for AY 2010-11 claimed the said sum of Rs. 1.32 crores from Suzuki India as capital receipt, not subject to income tax under section 17(3) or section 28(va) or any other section of the Act. The AO refused to allow exemption and held that the sum of Rs 1.32 crores received from Suzuki India was chargeable to tax under section 17(3) as “profits in lieu of salary”. The AO rejected the assessee’s claim that the sum was neither chargeable under section 17(3), nor under section 28(va).

***Submissions of the assessee***

The assessee was not the employee of Suzuki India as otherwise there would have been a Service agreement between Suzuki India and the assessee, laying down the terms of employment, including the salary, perquisite and benefits to be paid/provided etc. Accordingly, the amount received from Suzuki India could not be taxed as ‘profits in lieu of salary’. The assessee was appointed as managing director by virtue of his being Indian Joint venture partner. He stepped down as managing director of Suzuki India as soon as he was no longer the Joint venture partner. No TDS was deducted under section 192 from the amount payable to him, but the Suzuki India deducted tax “out of abundant caution” to “avoid any future disputes” with the tax authorities.

Clause (va) of sec 28 would not apply in present case as the provision was introduced to tax the receipts in the nature of non-compete fees and exclusivity rights. The payment made in present case was not made by Suzuki India for not competing with it, but for prohibiting the assessee from providing the benefit of his knowledge, skill and expertise to others. Such a payment could not be related to business in any manner.

***Contentions of the revenue***

The assessee was an employee of Suzuki India. Mere fact that he did not receive any salary or perquisites from Suzuki India would not justify the conclusion that he was not an employee.

***Observation of the ITAT***

The assessee was joint venture partner in Suzuki India and was not an employee. Various duties assigned to assessee as a managing director, clearly implied that he was not subject to the direct control or supervision of Suzuki India, but was managing all affairs of Suzuki India, evolving business strategies and advising Suzuki India only as a joint venture partner in Suzuki India.

**Decision:** The assessee was not an employee of Suzuki India and so the sum received by him from Suzuki India cannot be taxed as “profits in lieu of salary” under section 17(3) of the Act. The amendment made by the Finance Act, 2002 was intended to bring only non-compete fee within the ambit of taxation. The payment made to the assessee for not providing the benefit of his knowledge of regulatory matters, negotiating skills and strategic planning expertise to any other person in India in the two wheeler segment) could not be considered as non-compete fee as it was paid not for competing with Suzuki India, but for not providing the benefit of his knowledge, expertise, skills etc. to any other person in the two wheeler segment.

Clause (va) of section 28 of the Act taxes a sum received for a restrictive covenant in relation to a business and not a profession. Accordingly, sum received by the assessee would not fall within the ambit of section 28(va).

**Citation: Satya Kant Khosla [TS-664-ITAT-2015-DEL]**

## CBDT Notification/ Circular

### CBDT directs department not to file appeal on issue of disallowance of contribution of funds for the welfare funds made after due date prescribed in the respective Act but before due date of filing of income tax return

Section 43B of the Act provided that payments towards employers contribution to funds for welfare of employees are admissible only on payment basis. The Assessing Officers have been consistently disallowing such expenditure if payment towards contribution was made beyond the due date prescribed under the respective Act. Hon'ble Supreme Court in case of Alom Extrusions Ltd (185 Taxman 416) (2009) held that the deletion of the second proviso to section 43B by the Finance Act 2003, was curative in nature and therefore retrospectively applicable from 1st April 1998. Accordingly, it was held that the deduction is available if the employer assessee deposits the contribution to the welfare funds on or before the due date of filing of return of income.

CBDT vide this circular noted that with the above decision of the Supreme Court the issue is well settled and the assessee employer would be eligible for deduction once payment is made before due date of filing of the return as prescribed under section 139(1). CBDT accepting the settled position on account of decision of Supreme Court has now directed that no appeals be filed on this ground and appeals already filed on this ground may be withdrawn or not pressed upon.

This is a welcome step and would help in reducing the time and cost on unnecessary litigation.

Citation: CBDT circular no 22 of 2015

### Amendment in the Rules regarding mandatory quoting of PAN for specified transactions

Rule 114B of the Rules specifies the list of transactions in relation to which quoting of PAN is mandatory. The aim of making quoting of PAN mandatory for specified transactions is to collect information of certain types of transactions from third parties in a non-intrusive manner, where the transaction value exceeds specified limit. Persons who do not hold PAN are required to fill a Form 60 and furnish any one of the specified documents to establish their identity.

One of the recommendations of the Special Investigation Team (SIT) on Black Money was that quoting of PAN should be made mandatory for all sales and purchases of goods & services where the payment exceeds Rs.1 lakh. Accepting this recommendation, the Finance Minister made an announcement to this effect in his Budget speech. The CBDT has received numerous representations from various quarters regarding the burden of compliance this proposal would entail. Considering the representations, Rule 114B has been amended whereby quoting of PAN will be required for transactions exceeding Rs.2 lakh regardless of the mode of payment.

The CBDT has also enhanced the monetary limits of certain transactions which require quoting of PAN. The monetary limits have been raised to Rs. 10 lakh from Rs. 5 lakh for sale or purchase of immovable property, to Rs.50,000 from Rs. 25,000 in the case of hotel or restaurant bills paid at any one time, and to Rs. 1 lakh from Rs. 50,000 for purchase or sale of shares of an unlisted company.

The changes to the Rules will take effect from 1 January 2016.Key changes to Rule 114B of the Rules are as under:

| **Sr. No** | **Nature of Transaction** | **Existing requirement** | **New requirement** |
|---|---|---|---|
| 1. | Immovable property | Sale/ purchase valued at Rs.5 lakh or more | • Sale/ purchase exceeding Rs.10 lakh;<br>• Properties valued by Stamp Valuation authority at amount exceeding Rs.10 lakh will also need PAN. |
| 2 | Motor vehicle (other than two wheeler) | All sales/purchases | No change |
| 3. | Time deposit | Time deposit exceeding Rs.50,000/- with a banking company | • Deposits with Co-op banks, Post Office, Nidhi, NBFC companies will also need PAN;<br>• Deposits aggregating to more than Rs.5 lakh during the year will also |

| | | | |
|---|---|---|---|
| | | | need PAN |
| 4. | Deposit with Post Office Savings Bank | Exceeding Rs.50,000/- | Discontinued |
| 5. | Sale or purchase of securities | Contract for sale/purchase of a value exceeding Rs.1 lakh | No change |
| 6. | Opening an account (other than time deposit) with a banking company. | All new accounts. | • Basic Savings Bank Deposit Account excluded (no PAN requirement for opening these accounts);<br>• Co-operative banks also to comply |
| 7. | Installation of telephone/ cell phone connections | All instances | Discontinued |
| 8. | Hotel/restaurant bill(s) | Exceeding Rs.25,000/- at any one time (by any mode of payment) | Cash payment exceeding Rs.50,000/-. |
| 9. | Cash purchase of bank drafts/ pay orders/ banker's cheques | Amount aggregating to Rs.50,000/- or more during any one day | Exceeding Rs.50,000/- on any one day. |
| 10. | Cash deposit with banking company | Cash aggregating to Rs.50,000/- or more during any one day | Cash deposit exceeding Rs.50,000/- in a day. |
| 11. | Foreign travel | Cash payment in connection with foreign travel of an amount exceeding Rs.25,000/- at any one time (including fare, payment to travel agent, purchase of forex) | Cash payment in connection with foreign travel or purchase of foreign currency of an amount exceeding Rs.50,000/- at any one time (including fare, payment to travel agent) |

| | | | |
|---|---|---|---|
| 12. | Credit card | Application to banking company/ any other company/institution for credit card | No change.<br>Co-operative banks also to comply. |
| 13. | Mutual fund units | Payment of Rs.50,000/- or more for purchase | Payment exceeding Rs.50,000/- for purchase. |

**Source:** Press Release dated 15 December 2015

### Clarification regarding defective notices issued to FII/FPIs

The Centralized Processing Centre, Bengaluru had issued notices to Foreign Institutional Investors/Foreign Portfolio Investors (FIIs/FPIs) under section 139(9) of the Act where Balance Sheet and P&L account were not filled while e-filing the tax return. FIIs/ FPIs had taken a tax position that in absence of any business in India, they would not be required to fill the details of Balance Sheet and P&L account in the tax return e-filed with the Income tax department.

The CBDT vide the Press Release clarified that such tax returns will not be treated as defective, where the FIIs/FPIs) are registered with SEBI, ii) do not have PE/ Place of Business in India and iii) have provided basic information required under section 139(9)(f) of the Act, if there is business income.

All such cases, where the SEBI registration number has been provided by the FIIs/FPIs in the tax return for AY 2015-16,in view of the Press Release, the CPC Bengaluru would not treat the said tax return as defective. For previous AYs where the above information is not available in the tax return, FII/FPI has been directed to provide such details in their online response on the e-filing portal of the Income-tax Department. Once the details are submitted the tax return filed would not be considered as defective under section 139(9) of the Act.

**Source:** Press Release dated 10 December 2015

## Furnishing of information in respect of payments made to the non-resident

Section 195 of the Act empowers the CBDT to capture information in respect of payments made to non-residents in Form 15CA and 15CB, whether the remittance is chargeable to tax or not. Rule 37BB prescribes the detailed procedure to be followed in order to comply with section 195 of the Act. In view of frequent amendment in Rule 37BB, there was no clarity on requirement of compliance with Rule 37BB in respect of certain remittances including payment towards import of goods from foreign country.

Rule 37 BB of the Rules has been amended to strike a balance between reducing the burden of compliance and collection of information under section 195 of the Act. The significant changes under the amended Rules are:

- No Form 15CA and 15CB will be required to be furnished by an individual for remittance which do not require RBI approval under its Liberalized Remittance Scheme (LRS)
- The list of payments of specified nature mentioned in Rule 37 BB which do not require submission of Forms 15CA and 15CB has been expanded from 28 to 33 including payments for imports.
- A CA certificate in Form No. 15CB will be required to be furnished only in respect of such payments made to non-residents which are chargeable to tax and the amount of payment during the year exceeds Rs. 5 lakh.

The amended Rules would be applicable from 1 April 2016.

**Source:** Press Release dated 17 December 2015

## New facility of pre-filling TDS data while submitting online rectification

The CBDT has simplified the process of online rectification of incorrect TDS details filed in the Income Tax Return. The Taxpayers were required to fill in complete details of the entire TDS schedule while applying for rectification on the e-filing portal of the Income Tax Department. Errors due to incomplete TDS details in rectification applications were leading to delays in processing of such applications thereby causing hardship to the Taxpayers.

To avoid this inconvenience, a new facility has been provided for pre-filling of TDS schedule while submitting online rectification request on the e-filing portal, to facilitate easy correction or up-dating of TDS details. This is expected to considerably ease the burden of compliance on the taxpayers seeking rectification due to TDS mismatch.

**Source:** Press Release dated 10 December 2015

## Stringent Authentication mechanism through Corporate Head Quarter Server for filing of Correction statements & download of TDS certificates, consolidated files etc. by Banks/ Corporates

The CBDT under Explanation to sub-rule 5 of Rule 31A of the Rules has delegated powers to the Principal Director General of Income Tax to lays down the authentication mechanism for filing of e-TDS return, correction statements as well as download of TDS certificates, consolidated files etc. for Banks and Corporates deductors. There were various cases of challan mismatch, wrong feeding of information in the cases of the Bank/ Corporate deductor giving rise to huge outstanding demand created in their case with no clarification on rectification procedure to be followed to resolve and rectify the demand.

***Need for Authentication Process***

The CPC-TDS had initiated "Corporate Connect" with intent to pursue TDS compliance related issues of all branches of Bank/ Corporate deductor with their corporate headquarter.

During this exercise, the Banks were finding it hard to resolve the TDS defaults in case of closed branches and branches merged with other banks. The Banks were not able to retrieve old records for FYs 2007-08, 2009-10 etc. in order to file correction statements to resolve the outstanding defaults. Further, the Banks also found challenging to procure digital signatures for each branch for filing online correction on TRACES portal.

The genesis of the modified access process lies in strategy to address the above challenges of retrieval of old data without use of digital signature. The modified access process will bring in discipline to the correction process as only the authorized bank official would be able to work on TRACES system. The concept of involving headquarter as a "Corporate Connect" drive will help in bringing in better TDS compliance as the Headquarter of the Bank will have complete picture of the TDS compliance of each branch.

***Mechanism involved***

This mechanism is based on the concept of routing the access requests of various TAN branches of a particular entity through its corporate Headquarter' server. The deductor branch will pass-on the login credentials to the relevant bank/corporate Headquarter server, who would in turn validate the login credentials and IP address of the user's system. After necessary validations, Headquarter server will send digitally signed string, in form of encrypted information, to TRACES server. TRACES server will authenticate the defined particulars access to the concerned TAN account.

***Benefits of the above mechanism to the Banks***

The above initiative is likely to provide the following benefit to the Banks/ Corporate

a. Secured access of sensitive third party data: Only authorized representative of banks/corporates will be able to access TRACES portal as the login would be through corporate server only.
b. Corporate headquarter can keep track of the access requests of the branches and this will help in enforcing discipline among the branches.
c. No need to procure separate digital signature for each bank/corporate branch to access TRACES portal on account of routing of request through corporate server.

**Our comments:** This is a welcome step by the TRACES for the Banks/ large Corporate is to resolve their pending rectification with Traces. Such initiatives are likely to resolve long pending dispute on outstanding demand raised by the Traces on the Banks/ large Corporate due to technical errors generated due to reasons like challan mismatch, wrong feeding of information etc.

**Source:** Notification No. 3/2015 dated 1 December 2015

## Draft Amendments to Indian Transfer Pricing Rules by CBDT

In India, TP adjustment on account of comparability analysis is one of the major reasons for Transfer pricing litigation. CBDT therefore proposed changes to the Indian Transfer pricing Rules. A draft scheme for amendments was issued on 21 May 2015 for obtaining public comments. The Scheme introduced the range concept and use of multiple year data, which were expected to provide the required flexibility and reduce hassles in compliance to some extent. The CBDT has finalised the rules vide Notification No. 83/ 2015 dated 19 October 2015 which would be applicable to international transactions and specified domestic transactions that are entered into by the assessees on or after 1 April 2014.

The highlights of the Final Rules under which the range concept and multiple year data are to be used for determination of (ALP) are as under:

**I. The 'Range Concept' -**

The range concept can be used for all the methods except for the Profit Split Method ('PSM') and the Other Method. Accordingly, while determining the ALP by using PSM or the Other Method, the arithmetic mean concept will have to be used;

The range concept can be applied only if 6 or more comparables are available. If the number of comparables is less than 6, the arithmetic mean concept will be applicable;

The arm's length range will constitute of the values falling between the 35th and the 65th percentile of the comparable entries that are arranged in ascending order. If the price at which the transaction has taken place falls outside the arm's length range, the median value of the comparables shall be considered to be the ALP;

Following formula is to be used to identify the range:
35th percentile = Total number of comparable entries * (35/100)
65th percentile = Total number of comparable entries * (65/100)

If the value derived from this formula is not a whole number, then the comparable entry appearing on the next higher data place is to be considered.

The median is to be considered as the middle value of the comparables arranged in ascending order. However, if there are even number of comparables, then the median shall be computed by taking the average of the two middle value of the comparable entries arranged in ascending order.

In cases where arithmetic mean concept is used, and if the variation between the ALP and the actual value of the transaction is less than three percent (or the percentage that may be notified) of the actual value of the transaction, then value of the transaction will be considered to be at arm's length.

**Our comments -**

The final rules specify to use data points lying within the 35th to 65th percentile of the data set of series as the arm's length range as compared to 40th and 60th percentile proposed in the draft rules. These rules are not completely in sync with globally accepted norms and practices, where data points falling within the 25th and 75th percentile for the determination arm's length range are used. However, CBDT has not broadened the range as compared to what was proposed.

In the draft rules, there was ambiguity for calculating percentiles and median. While the final rules provide clear guidance along with apt illustrations for calculating percentiles and median.

The number of comparables has been reduced to 6 as compared to 9 in the draft rules. With reduction in the number of comparables, the scope of comparability based on the range concept would be larger.

The range concept would be applicable even in the case where CUP method has been selected as the most appropriate method to determine the arm's length price. Whether that would benefit the assessee would depend on the statistical dispersion of the prices selected in the dataset.

The final rules do not envisage a scenario where the assessee has selected 6 or more comparable entities, applied the range concept and at the time of transfer pricing audit, the TPO rejects one or more entities resulting in comparable entities falling below the threshold of minimum 6 comparables. There is no clarity even in the reverse scenario where the assessee has selected less than 6 comparable entities (thereby applying the arithmetic mean concept) and at the time of transfer pricing audit, the TP officer includes one or more entities resulting in 6 or more comparable entities. In such a scenario, the method of computation itself will change thereby leading to uncertainty.

## II. Use of Multiple Year Data

The Final Rules, in connection with the use of multiple year data, can be split into two parts, (i) at the time of compliance and
(ii) at the time transfer pricing assessment.

### i. At the time of compliance

Multiple year data will be considered for computation of ALP irrespective of the fact whether the Range Concept is applicable or not;

Multiple-year data can only be used if the most appropriate method selected for benchmarking purposes is either Transactional Net Margin Method (‘TNMM’), Resale Price Method (‘RPM’) or Cost Plus Method (‘CPM’);

Multiple-year data entails use of data for the year under consideration (‘current year’) and data for upto two preceding financial years;

Data for the current year is compulsorily to be considered. If the data for the current year is available but not comparable on account of either qualitative or quantitate reasons, the comparable cannot be considered;

If data for the current year is available and comparable, data for previous two years can be used only if such data passes all the qualitative / quantitative filters applied for benchmarking purposes in either or both the previous years.

**<u>ii. At the time of transfer pricing assessment</u>**

At the time of transfer pricing assessment, data for the current year, if available, must be used;

If such updated data for the current year cannot be used since it fails the qualitative / quantitative filters, then such a comparable cannot be used for benchmarking purposes irrespective of the fact that the data for previous years is comparable;

A fresh comparable not appearing in the benchmarking set at the time of compliance can be used at the time of assessment.

The Final Rules have been announced just in time before the deadline of the transfer pricing compliance.

**Our comments :**

The Final Rules have provided clarity for using multiple year data. However, the leeway to include a fresh comparable at the time of assessment is bound to create increased litigation. Further, this is not in line with Rule 10D(4) of the Rules which stipulates that the prescribed information and documents should be contemporaneous and should exist latest by the due date of filing the return.

The Final Rules do not mention using multiple year data for calculating margin of the assessee vis-à-vis the comparable companies for the purpose of determining the ALP. A situation might arise wherein the margins of the comparable companies would have got affected in the preceding years due to an exceptional economic, political or seasonal situation. Such an impact would be visible in the average margin of the comparable companies derived on the basis of use of multiple year data. However, the assessee's margin would not reflect such economic, political or seasonal situation as it would be calculated basis the current year data.

Before this notification came into force the assessee had an option to use the data relating to two years prior to the current year of comparable uncontrolled transaction which could have an influence on the determination of transfer prices in relation to the actual transaction to be undertaken. Now, such an option will not be available to the assessee. Therefore the assessee cannot use earlier two year data of uncontrolled transactions for fixing the transfer price for compliance purpose.

## The CBDT revises its earlier guidance for selection of Transfer Pricing cases for scrutiny. Recording of AO satisfaction necessary before making reference to TPO

The CBDT on 16 October 2015 issued Instruction No. 15/2015, replacing its earlier Instruction No. 3 dated 20 May 2003, that provided guidance to the AO and the TPO regarding administration of TP assessments. The guidelines issued would be applicable predominantly for international transactions and provide that not more than 50 cases should be assigned to the TPOs being, Additional/ Joint CIT. The guidelines specify that cases for TP assessments should not be selected for scrutiny merely based on the value of international transactions reported by the taxpayers in the Accountants Report i.e. Form 3CEB. The AO should make risk assessment of the matter before making reference to the TPO based on factual information in Form 3CEB filed by the taxpayer. The AO on review of Form 3CEB should arrive at a prima facie belief whether or not reference to the TPO is necessary based on the following parameters:

- The AO notices that the taxpayer has entered into the international transactions but no details are filed in the Form 3CEB.
- The AO notices that the taxpayer has failed to disclose one or more international transaction(s) in the Form 3CEB.
- There are qualifying remarks declared by the taxpayer in the Form 3CEB stating that such transaction(s) are not international transaction(s) or that it does not have impact on the taxpayer's income.

In all the above situations, an opportunity of being heard should be given to the taxpayer by the AO before recording his satisfaction. In cases where no objection is raised by the taxpayer to the applicability of Chapter X (Section 92-92F) of the Act, prima facie view of the AO would be sufficient before making a reference to the TPO. Where the taxpayer objects the applicability of Chapter X of the Act, the taxpayers' objection should be considered and specifically dealt with by the AO in the interest of natural justice.

The AO should seek approval from the Principal Commissioner or Commissioner, before making a reference to the TPO to determine the ALP of international transaction(s). Taking into consideration all the relevant facts and data available with him, the TPO shall determine the ALP and pass a speaking order after seeking the necessary approvals. It has been emphasized that the TPO shall document adequate reasons and supporting analysis to support the determination of ALP, in light of the fact that the same shall be subject to judicial scrutiny.

The TPO shall also be responsible for conducting the compliance audit of Advance Pricing Agreements (APA) and performing a scrutiny for the cases referred to him by the AO with respect to taxpayers opting to get governed by Safe Harbor Rules.

In case of Specified Domestic Transactions (SDTs), similar guidelines are under consideration with the CBDT. It has been emphasized that the CIT(TP) shall ensure the expeditious resolution of cases referred by the AO to the TPO in their respective jurisdictions and accurate records of the same will be maintained in a specified format. It is endeavored by the CBDT to use this database for determination of the ALP in identical/ substantially identical cases.

**Source: CBDT Instruction No. 15/2015 dated 16 October 2015**