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PARTNERS BEYOND BOUNDARIES

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In this edition of our thought leadership publication, we have tracked the progress of some significant cases decided by the appellate forums across the country.

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Transfer Pricing

Case law 1: India Debt Management Private Limited Vs. Deputy Commissioner of Income Tax (IT(TP)A No. 7518/M/2014)

Loan transactions – interest rate must be based on economic and market factors affecting the currency and data available for debt issuances of the currency in which loan has to be repaid rather than foreign currency or external data.

Facts of the case:

The assessee, India Debt Management Pvt. Ltd., is a company incorporated in India as a Non-Banking Finance Company ('NBFC'). The assessee is a subsidiary of Mauritius Debt Management Ltd. The assessee is primarily engaged in the business of identifying investment opportunities in financially distressed companies, which otherwise have an inherently viable business proposition. The assessee raised debts from group companies and Associated Enterprises ('AE's') by issuing Compulsory Convertible Debentures ('CCD's'). For the purpose of benchmarking, the following procedures were undertaken:

1. The assessee analysed the external market data in order to find external Comparable Uncontrolled Price ('CUP');
2. The assessee also carried out corroborative search process using Bombay Stock Exchange ('BSE') data on INR denominated debt issuances;
3. The assessee assimilated interest rates quotes from various public sector banks for loans taken from lenders in the Indian market.

The Transfer Pricing Officer ('TPO') rejected the entire methodology adopted by the assessee since the assessee did not mention who the tested party was. On the aspect of benchmarking, the TPO observed that if assessee was treated as the tested party, then interest benchmarking should have been done by using the LIBOR rate. The TPO stated that the prevailing interest rate for foreign currency loan, extended in India for companies with similar credit rating as that of the AE on a standalone basis, had to be taken into account, and made an adjustment of INR 48.53 crores.

The assessee filed its objections before the Dispute Resolution Panel ('DRP') wherein the DRP upheld the TP adjustment made by TPO. Aggrieved, the assessee appealed at the Hon'ble Mumbai Tribunal ('ITAT').

Decision of the Hon'ble ITAT:

- Referring to the OECD guidelines, the ITAT held that identification of the tested party is far more imperative while applying Cost Plus Method ('CPM'), Resale Price Method ('RPM') or Transactional Net Margin Method ('TNMM') and not while applying CUP;
- The base rate on which the interest rate depends is directly related to the currency or denomination of issuance and, therefore, it should be taken into account according to the market conditions prevalent in the country of the said currency;
- Relying on the decision rendered by the Hon'ble Delhi High Court in CIT Vs. Cotton Naturals P. Ltd (55 taxman 523), it held that arm's length interest rate should be computed based on market determined interest rate applicable to the currency in which the loan has to be repaid.

Thus, arm's length interest rate should be based on the currency in which CCDs have been issued and the currency in which interest is being paid and not on any foreign currency lending rate.

Case law 2: JCB India Limited Vs. Deputy Commissioner of Income Tax (ITA No. 1075/Del/2016)

TPO is only required to determine the Arms' Length Price ('ALP') of a transaction, irrespective of any benefit accrued to the assessee; TNMM at the entity level could be applied only if transactions are closely linked.

Facts of the case

The assessee is a wholly owned subsidiary and is primarily a manufacturer of earthmoving and construction equipment.

The assessee entered into international transactions with its AE with respect to payment of royalty and benchmarked the same using TNMM. The TPO rejected the method applied by the assessee and applied the CUP method. The TPO also considered the value of the royalty at NIL by observing that no specific benefit was accrued to the assessee.

The assessee filed its objections before the DRP which partially upheld the TP adjustment made by the TPO. Aggrieved, the assessee appealed before the Hon'ble Delhi Tribunal.

Issues before the Hon'ble Delhi Tribunal and decision thereon:

Whether the TPO was correct in considering the value of royalty as NIL on account that there was no benefit accrued to the assessee?

- As per the *ratio decidendi* in CIT Vs. Cushman & Wakefield India (P.) Ltd. (2014) 367 ITR 730 (Del), the TPO was required to simply determine the ALP of the international transaction of 'payment of royalty' unconcerned with the fact, if any benefit accrued to the assessee and thereafter, it was for the Assessing Officer ('AO') to decide the deductibility of this amount u/s 37(1) of the Act;
- The action taken by TPO was in contradiction to the ratio laid down by the aforementioned legal precedent.

Whether TNMM could be applied at an entity level which, *inter alia*, included payment of royalty?

- Relying on the judgement of the Hon'ble Punjab and Haryana High Court in case of Knorr-Bremse India P. Ltd. vs. ACIT (380 ITR 307) (P&H), the court had held that in order to combine two or more transactions, it is essential that they be inextricably linked to each other either by way of a package deal or that a number of differently priced transactions will be accepted on the understanding that the assessee will accept all of them together.

Thus, applying TNMM on an entity level, cannot be upheld because the international transaction of `payment of royalty' is independent of other transactions and the ALP has to be determined without considering accrual of benefit to the assessee.

KNAV Comments:

In order to determine whether transactions could be benchmarked at an entity level or not, the following factors have to be considered:

1. ***Inter-connected international transactions can be aggregated; section 92(3) does not prohibit the set-off;***
2. ***An external comparable must perform similar functions;***
3. ***ALP of expenses should be determined preferably in a bundled manner;***
4. ***For determining the ALP of transactions in a bundled manner, suitable comparables having undertaken similar activities should be chosen;***
5. ***If no comparables having performed the functions in a similar manner are available, then, suitable adjustment should be made to bring international transactions and comparable transactions at par;***
6. ***If adjustment is not possible or comparable is not available, then, the TNMM on entity level should not be applied;***
7. ***In the above eventuality, international transaction should be viewed in a de-bundled manner or separately.***

Case law 3: Merck Limited Vs Commissioner of Income Tax (I.T.A. No. 1946/Mum/2014)

Various factors to be considered while computing ALP.

Facts of the case:

The assessee is a pharmaceutical Company and is a subsidiary of a German Company. The assessee imports an Active Pharmaceutical Ingredient ('API') used in manufacturing of Finished Dosage Form ('FDF') of medicine from its associate enterprise in Switzerland. The assessee had claimed these imports to be at the ALP on the basis of the TNMM. Disregarding the TNMM, the AO contended for the CUP method and made adjustments on various other factors. To this, objections were filed before DRP, where DRP upheld the decision of AO.

Aggrieved by the decision,an appeal was filed before the ITAT.

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Decision by the Hon'ble Tribunal on the various points:

1. **Revenue encouraged for application of CUP method as the most appropriate method for determining ALP in the case of generic APIs.**

   The assessee readily accepted the CUP method on the fact that the issue is covered against the assessee by a coordinate bench of this Tribunal in the case of Serdia Pharmaceuticals India Pvt Ltd Vs ACIT [(2011) 44 SOT 391 (Mum) and the matter is currently pending before the Hon'ble Bombay High Court. Thus no interference was required at this point.

2. **Quality superiority should be considered for determining ALP.**

   The Hon'ble ITAT considered the assessee's contention regarding the superiority of the quality of the assessee's product as it is manufactured in a German plant, where quality control requirements are much more stringent than in India. As it is difficult to quantify this adjustment, the Hon'ble ITAT granted 10% quality adjustment.

   Therefore, the ALP ought to be computed in the light of CUP inputs, with 10% adjustment for the quality difference, as the product is manufactured by a globally reputed company and an industry pioneer, in its own facilities in Germany.

3. **Only the domestic prices of the product should be taken into account and not the export price while computing ALP.**

   It was held that not only are the markets different, but so are the pricing considerations, which are influenced by many other factors in the case of export prices. The pricing considerations in the context of exports are not essentially the same as in the case of domestic pricing. Thus, it is appropriate to compare it with the price at which the product is available in the domestic market.

4. **Just because these services were too general, or just because the assessee did not need the services from the outside agencies, it cannot be the reason enough to hold that the services were not rendered at all.**

   Even though the assessee may not have received all the services under the agreement the assesse had a right to receive all these services, as and when required. The fees for technical services was rendered for the rights accruing to the assessee for the bundled services under the contract and not for each service on *a la carte* basis. The revenue had erred in treating ALP of the technical know-how fees as NIL and concluding that no separate payment is warranted for such services.

5. **Share buyback expense cannot be disallowed by the revenue.**

   Since the payment was made by the assessee in order to give the shareholders an exit opportunity through the buyback of shares, the payment is considered a normal business activity incurred wholly and exclusively for the purpose of business, in order to maintain a cordial relationship with the shareholders and to safeguard their interests. Thus, holding in consideration the decision of CIT Vs Selan Exploration Technology Ltd [(2010) 188 Taxmann 1 (Del)] rendered by the Hon'ble Delhi High Court, the issue is covered in favour of the assesse.

Applicability of section 50C

Case law 1: Shri Farid Gulmohamed Vs. Income Tax Officer (ITA No. 5136/Mum/2014)

Capital assets that are in the form of land or building or both are covered within the scope of section 50C of the Act, and not all capital assets.

Facts of the case:

The assessee had assigned the leasehold right in a property to the lessee for a consideration of INR 90,00,000/- net of tax; the gross amount of sale consideration being determined at INR 1,35,00,000/-. In the course of the assessment proceedings the AO noticed that the value of the said land was adopted at INR 3,41,51,500/- by the registering authority for stamp duty purpose. The AO, instead of taking into consideration the transfer of the leasehold rights in the said land at INR 1,35,00,000/-, invoked the provisions of section 50C of the Act, and took the value of consideration for transfer of the land at INR 3,41,59,500/-, as adopted by the registering authority for stamp duty purposes, and computed the capital gains arising from the said transaction accordingly.

The same was upheld by the Commissioner of Income tax Appeals ('CIT(A)'). Aggrieved by the decision of the CIT(A), the assessee appealed before the ITAT that the AO has wrongly invoked section 50C of the Act as it only covers

capital assets in the form of land or building or both and not the rights on the land and building.

Decision of the Hon'ble Tribunal

The Hon'ble Tribunal held that this issue has been examined by various benches of the Tribunal, wherein it has been consistently held that the provisions of section 50C of the Act cannot be invoked in transactions involving transfer of leasehold rights in either land or building.

- Further, reliance was also placed on the decision rendered by the Hon'ble Mumbai Tribunal in the case of Atul G. Puranik Vs. ITO (132 ITD 499) wherein it has been held that as per section 54D of the Act there is a clear distinction between a capital asset being `land or building or both' and any `right in land or building or both' and therefore section 50C of the Act cannot be made applicable to lease rights in a land.
- Therefore, the Hon'ble Tribunal favouring the assessee, directed the AO to compute the capital gains by adopting the value of the property at INR 1,35,00,000/- as offered by the assessee.

Thus, the provisions of section 50C of the Act, being a deeming provision, the deeming fiction created therein cannot extend to any other asset other than those provided for specifically, and are either applied to land or building or both.

Speculative business; section 14A

Case law 1: J. G. A Shah Share Brokers P. Ltd Vs. DCIT CIR 4(3) (ITA no. 4053/Mum/2013)

Aggregation of share trading transactions and derivative transactions should be done before applying Explanation to section 73 of the Act which deems the transactions to be speculative transactions.If earning of exempt income is incidental to main business activity, then expenditure incurred for earning taxable income for said business activity cannot be proportionately disallowed u/s 14A.

Facts of the case

The assessee company was engaged in the business of stock broking, borrowing moneys, depository participants and investment in shares and securities. The assessee traded in equity shares as well as future options in their respective markets.

The AO held that the transactions done by the assessee would be split in two parts. The part considered speculative and the other part which was not covered u/s 43(5) shall be hit by *Explanation* to section 73 of the Act which states that any loss computed in respect to a speculation business shall only be set off against profits and gains of another speculative business. The *Explanation* to section 73 deems certain transactions to be speculative in nature. The assessee claimed that he had carried out arbitrage/jobbing activities and fairly submitted that the transactions should be held either entirely speculative or entirely non-speculative.

The AO quashed the assessee's claim and accordingly did not allow the loss from the speculative business to be set off against the profits from the non-speculative business. Further, with regard to earning of dividend income the AO disallowed certain expenses u/s 14A by applying Rule 8D. To this, the assessee claimed that a similar issue had previously come up in appeal in his own case and that the Hon'ble Tribunal had decided in his favour.

The assessee appealed before the CIT(A) who dismissed the submissions of the assessee and upheld the decision of the AO.

Aggrieved by the decision of CIT(A), the assessee filed an appeal before the Tribunal.

Decision of the Hon'ble Tribunal:

Whether the transactions can be split and accordingly assessed under different sections?

Placing reliance on various relevant judgements, the Hon'ble Tribunal held that aggregation of share trading transactions and derivative transactions should be done before applying *Explanation* to section 73 of the Act. Where the assessee is a dealer in shares and the entire business consists of sale-purchase of shares, then, it should be treated as composite business. Since both the parties agreed that the provisions of *Explanation* to section 73 are applicable, the Hon'ble Tribunal directed that the entire business shall be treated as speculative and the AO shall grant the benefit of set off and carry forward of losses accordingly.

When dividend income is incidental to business activity, whether expenditure claimed for said business activity be proportionately disallowed u/s 14A of the Act?

The Hon'ble Tribunal held that the expenditure which is claimed by the assessee is incurred wholly and exclusively for earning taxable

income arising from the business activity of the assessee in arbitrage trading. Therefore, in the absence of any actual expenditure incurred in relation to earning of dividend income, no expenditure can be apportioned u/s 14A by applying Rule 8D for the purpose of earning exempt income. This decision holds good as long as the shares are held by the assessee in the course of its business activity and not as an investment.

Thus, in the case of an assessee who is a share broker dealing in shares and derivatives, entire transactions carried out by the said assessee come within the umbrella of speculation transactions, and therefore, there is no bar in setting off the losses arising out of derivatives from the income arising out of buying and selling shares.

With regard to earning of dividend income incidental to business activity, expenditure claimed for the business activity cannot be proportionately disallowed if no expenditure is actually incurred for the earning of the dividend income.

Deemed Dividend

Case law 1: Shri Uday K. Pradhan Vs Income Tax Officer (ITA No. 4669/Mum/2014)

Redemption of preference shares cannot be considered as reduction of authorized share capital and therefore the same cannot be treated as deemed dividend under section 2(22)(d) of the Act.

Facts of the case:

The assessee was a partner in the firm which was converted into a company. As per the books of the erstwhile firm, the assessee had a certain credit balance as on 31.03.2001 and in lieu of the said credit balance the assessee had received some equity shares and had redeemable preference shares at par. On scrutinizing, the AO considered the redemption of preference shares as reduction of authorised share capital and invoked the provisions of section 2(22)(d) of the Act to tax the same as deemed dividend. On appealing before the CIT(A), it upheld the decision of AO contending that it was a colourable device for distribution of accumulated profits, without any payment by the assessee against the redemption of shares. On further appeal, the Hon'ble ITAT restored the matter to CIT(A) for fresh consideration and adjudication after offering the assessee adequate opportunity of being heard.

In the second round also, the CIT(A) contended in favour of revenue. Aggrieved, the assessee appealed before the Hon'ble Tribunal:

Decision of Hon'ble Tribunal:

The assessee had received the redeemable preference shares in lieu of the credit capital balance in the erstwhile firm. Thus, the assessee was allotted the aforesaid redeemable preference for valuable consideration.

Therefore, it was evident that there was no distribution of accumulated profits by the company to its shareholders by redemption of preference shares at par.

- Section 80(3) of the Companies Act, 1956 states that the redemption of preference shares cannot be considered as reduction of authorized share capital.

Therefore, the provisions of section 2(22)(d) of the Act would not apply in the case of the assesse, as redemption of preference shares does not tantamount to reduction of authorized share capital.

Revision of order u/s 263

Case law 1: Neo Sports Broadcast Pvt. Ltd Vs. CIT(TDS) (ITA No. 4010 & 4011/Mum/2014)

Revision of order u/s 263 cannot be done if two or more views are possible on the issue.

Facts of the case:

The assessee (A ltd.) is engaged in the business of broadcasting. A ltd. is a step-down subsidiary of B ltd., a subsidiary of C ltd, the main company of the group. The group is engaged in the business of acquiring telecast rights of BCCI's Cricket matches organized in India (apart from IPL), and broadcasting the same through two of the assessees sports channels. C ltd. has acquired telecast rights from BCCI, for which it provides a Bank Guarantee to BCCI. To secure this, C Ltd pays Bank Guarantee Commission (BGC) to the bank. As per an agreement, 80% of the BGC was reimbursed to C ltd. by the assessee. No tax was deducted on the said reimbursement.

The AO, after taking into consideration the provisions of section 194H and 194C of the Act, came to the conclusion that the assessee was liable for TDS on the reimbursement of BGC u/s.194C of the Act. However, the CIT held that since the payment of BCG was in the nature of interest, therefore, the assessee was liable for TDS @10% u/s.194A of the Act and further declared that the order of the AO was erroneous as well as prejudicial to the interest of revenue.

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Aggrieved by the order of the CIT u/s 263, the assessee appealed before the ITAT:

Decision of the Hon'ble Tribunal:

Revision of order u/s 263

As regards applicability of TDS provisions, not two but three views exist on the impugned issue - (i) TDS u/s 194H - which was discussed by AO in the assessment order; (ii) TDS u/s 194C - which was discussed and upheld by AO in the assessment order; and (iii) TDS u/s.194A – which was held by the CIT.

Revision of order u/s 263 cannot be done if two or more views are possible on the issue.

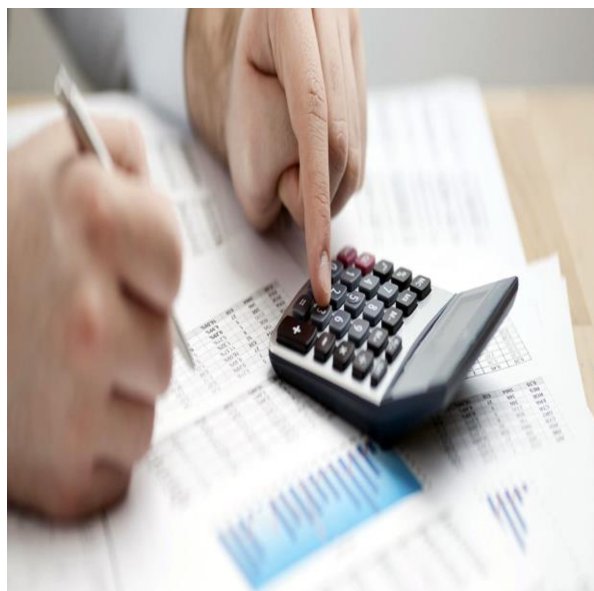
Reliance was placed on the following decisions:

- Hon'ble Supreme Court in the case of CIT v. Max India Limited (295 ITR 282) (SC) held that the phrase 'prejudicial to the interests of the revenue' has to be read in conjunction with an erroneous order passed by the AO. Every loss of revenue as a consequence of an order of the AO cannot be treated as prejudicial to the interests of the revenue. Where the AO has taken one of the two views possible, the one with which the CIT does not agree, it cannot be treated as an erroneous order prejudicial to the interests of the revenue unless the view taken by the AO is unsustainable in law.
- In the case of Grasim Industries Ltd. vs. CIT (321 ITR 92), it has been held that in order to exercise power u/s 263 it has to be shown unmistakably that the order of the AO is unsustainable.

Applicability of section 194A

Section 194(A) is applicable only to "income by way of interest". The Central Board of Direct Taxes ("CBDT") Circular No. 202 dt. 5/7/1976 provides that the definition of interest u/s 2(28A) covers interest payable in any manner with respect to loans, debts, deposits, claims and other similar rights or obligations and this definition will be applicable for all purposes of the Act. In the instant case, there is no money borrowed or debt incurred. The payment made by the assessee to C ltd. is in the nature of reimbursement of expenses incurred by C ltd. Therefore, provisions of sec. 2(28A) and sec. 194A do not apply.
The Hon'ble Tribunal held that there is no merit in the order passed by the CIT u/s.263. Even on merit, the BGC does not come under the purview of interest so as to make assessee liable for TDS u/s.194A. Therefore, both appeals of the assessee are allowed.

Thus, in case of a debatable issue on which more than one plausible view is reasonably possible, and if the AO takes one plausible view, it cannot be said that the assessment is erroneous or prejudicial to interest of the revenue and, accordingly, the CIT cannot exercise power u/s 263 of the Act.



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