KNAV
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 and a few important notification issued by the CBDT.

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Transfer pricing

Case Law 1: GE Money Financial Services Pvt. Ltd Vs. Deputy Commissioner of Income Tax *(ITA No. 440/Del/2014)*

The transfer pricing officer ('TPO') shall determine the arms' length price ('ALP') based on the factum of the receipt of service and not on the basis of the benefit availed from such services.

Facts of the case:

The assessee entered into international transaction for availing consulting, internet technology and administrative services from it's associated enterprise *('AE')* in USA and Asia. The assessee applied transactional net margin method *('TNMM')* as the most appropriate method and chose the foreign AE as a tested party, based on which the ALP was determined.

During the transfer pricing *('TP')* proceedings, the TPO held that that the assessee should have taken itself as a tested party instead of the foreign AE and comparable uncontrolled price *('CUP')* method should have been applied as the most appropriate method for determining the ALP. Further, the TPO held that the services availed by the assessee were either of no benefit to the assessee or were either duplicate in nature. Thus, the ALP of such transaction was determined at NIL. Objections were raised before the dispute resolution panel *('DRP')*, wherein the DRP upheld the order of TPO.

Decision of the Hon'ble Delhi Tribunal:

On appealing before the Hon'ble Delhi Tribunal, it was held that:

- The services rendered by the assessee were not duplicate in nature. Further, the need for services cannot be ascertained by the TPO, so long as the services are actually received. Once the factum of receipt of services is proved, the TPO cannot correlate it with the benefit actually derived.
- For determining the tested party, irrespective of the fact that the foreign AE has entered into least complex transactions, no other material was evident to substantiate the same, as the data chosen by the assessee does not conform to the comparability of the services received by the assessee and that data was not reliable and accurate for comparison. The contention of the assessee fails and thus the foreign AE shall not be considered as the tested party.
- For determining the ALP and the most appropriate method for determining the ALP, the matter was remanded back to the TPO whereby the TPO was directed to consider the assessee as the tested party and based on the available data, the TPO shall determine the same.

Thus, once the factum of receipt of services has been proved, the TPO cannot correlate it with the benefit actually derived.

Case Law 2: Dell International Services India Private Limited Vs. Joint Commissioner of Income Tax *(IT(TP)A No. 308/Bang/2015)*

The transaction of allowing the credit period to the AE on realisation of sale proceeds has to be considered along with the main international transaction in respect of sale to AE and thus, no separate adjustment in respect of account receivables can be made.

Facts of the case:

The assessee is a 100% subsidiary of an entity in USA and is primarily engaged in providing software development services to its US parent company. The TPO accepted the transaction of providing software development services at an arms' length. However, the TPO made an adjustment regarding interest on outstanding receivable as against NIL shown by the assessee by adopting prime lending rate as ALP.

The assessee filed its objections before the DRP wherein the DRP dismissed the objections filed by the assessee. Aggrieved, the assessee appealed before the Hon'ble Bangalore Tribunal.

Decision of the Hon'ble Bangalore Tribunal:

- Referring to the judgement given by Hon'ble Mumbai Tribunal in case of Goldstar Jewellery Ltd (ITA No.6570/Mum/2012) and Hon'ble Delhi Tribunal decision in case of Kusum Healthcare

Pvt. Ltd. *(ITA No.6814/Del/2014),* the Hon'ble Bangalore Tribunal opined that allowing the credit period over and above normal credit period prevailing in the industry is certainly relevant and part of the main international transaction of sale or purchase between the assessee and the AE.
- Thus, it cannot be treated as an independent international transaction *dehors* the main international transaction between the parties.

Thus, if the international transaction is found to be at arms' length then, there is no question of any separate adjustment on account of allowing the credit period on the receivable from AE.

KNAV Comments

Adjustments on account of grant of excess credit period to AE's is faced by entities across all industries. There are a horde of decisions on this issue which uphold the abovementioned view as well as state the otherwise. Some of the decisions which support the view are:

• CIT Vs. Indo American Jewellery Ltd [2014] 44 taxmann.com 310 (Bombay);
• Yash Jewellery (P.) Ltd Vs. DCIT [2016] 66 taxmann.com 216 (Mumbai - Trib.); &
• ACIT Vs. Information Systems Resource Centre (P.) Ltd. [2015] 59 taxmann.com 147 (Mumbai - Trib.)

Some of the decisions which state the otherwise include:

• Logix Micro Systems Ltd. Vs. ACIT [2010] 42 SOT 525 (Bang); &
• CIT Vs. Patni Computer Systems Ltd. [2013] 33 taxmann.com 3 (Bombay).

Case Law 3: Kirloskar Toyota Textile Machinery Private Limited Vs. Deputy Commissioner of Income Tax *(IT(TP)A No. 485/Bang/2015)*

Profit level indicator ('PLI') of gross profit over sales can be used to benchmark the international transaction of purchase of auto-components from AE.

Facts of the case:

The assessee is engaged in manufacture and sale of textile machinery, manufacture and sale of auto transmission components and is also engaged in distribution of material handling equipment. The TPO proposed an adjustment in case of transaction of purchase of components from its AE by stating that the appropriate PLI should have been operating profit to operating cost. The assessee contended that the appropriate PLI should be gross profit over sales since, due to underutilization of capacity, the comparability of operating profit to operating cost did not give proper analysis.

The assessee filed its objections before the DRP wherein the DRP accepted certain objections and issued directions to the assessing officer *('AO')* accordingly. However, the AO did not give effect to the entire adjustment as directed by the DRP. Aggrieved, the assessee appealed before the Hon'ble Bangalore Tribunal.

Decision of the Hon'ble Bangalore Tribunal:

- The PLI of gross profit over sales can eliminate the difference in claim of depreciation due to age of machinery, rate at which it was claimed and method of claims like straight line or written down value.
- Since the details of capacity utilization of the comparable companies and rate of depreciation could not be analyzed, it would be better if gross profit analysis was undertaken taking sales less cost of raw material as basis *(excluding cost including depreciation, interest etc.).*

Thus, PLI of gross profit over sales can be used to benchmark the international transaction of auto components of AE so as to understand whether the import of material from AE had affected the profitability of the assessee.

Case Law 4: Nikon India Private Limited Vs. Deputy Commissioner of Income Tax *(ITA No. 6314/Del/2015)*

The TPO has jurisdiction to determine the ALP of unreported international transaction which comes to his notice during the course of proceedings before him. Additionally, Central Board of Direct Taxes ('CBDT') Instruction no. 3/2016 is prospective in nature.

Summary of the case:

a. Jurisdiction of the TPO to determine ALP of unreported international transaction which was noticed by him during the course of proceeding:

The assessee stated that AO must have first provided an opportunity of being heard to the assessee before recording a satisfaction in respect of the transaction of advertising, marketing and promotion *('AMP')* expenses. In order to substantiate the same, reliance was placed on Instruction no. 03/2016.

The Hon'ble Delhi Tribunal stated that assessee's case did not fall within the Instructions ambit as it is not the AO who formulated his view on AMP expenses as an international transaction and then required determination of its ALP by the TPO. The

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Instruction requires reference by the AO to the TPO and since the AO did not make any reference to the TPO for determination of ALP of the unreported international transaction of AMP expenses, it was held that the Instruction would have no application. Thus, the jurisdiction of TPO in respect of same was upheld.

b. Instruction no. 3/2016 – whether prospective or retrospective?

The assessee submitted that though the instruction is dated March 2016, it is curative and hence should be treated as retrospective in nature. On the other hand, the department submitted that the Instruction was procedural in nature and therefore could not be given retrospective effect. In other words, it was contended that no Instruction issued by the CBDT laying down a particular procedure to be followed by the authorities, can ever be retrospective in nature.

The Hon'ble Delhi Tribunal stated that, if the Instruction is construed as retrospective enjoining upon the AO to record satisfaction, it would render several earlier assessment orders containing transfer pricing additions, null and void. Since this procedure has been put in place by the CBDT with effect from March 10, 2016, it has to be treated as prospective, which means that the same will follow *qua* the matters under consideration on March 10, 2016 and onwards.

Case law 5: Indorama Synthetics Vs. Additional Commissioner of Income Tax *[2016]* 71 taxmann.com 349 *(Delhi)*

Where the assessee objects to the applicability of TP provisions contained in Chapter X of the Income Tax Act, 1961 ('the Act') to the facts of the case, a hearing should be given by the AO to the assessee to consider the said objection before making a reference to the TPO u/s 92CA the Act'.

Facts of the case:

Indorama Synthetics (India) Limited *('petitioner')* entered into transactions of import of raw materials during the FY 2009-10 *(i.e. AY 2010-11)* from Indorama Petrochem Limited *('IPL'),* a company incorporated in Thailand. During the assessment proceedings relating to AY 2010-11, the AO required the petitioner to explain why the TP provisions of the Act should not be made applicable. The petitioner pointed out to the AO that IPL was not an AE of the assessee as defined in Section 92A of the Act. No further correspondence took place between the AO and the petitioner. Vide a letter dated March 31, 2013 the AO informed the petitioner that its case had been referred to TPO for determination of ALP in relation to the international transactions undertaken by the petitioner with AEs during AY 2010-11.

The issue: Whether it was incumbent on the AO to have given the petitioner an opportunity of being heard before making a reference to the TPO u/s 92CA*(1)* of the Act?

Decision of the Hon'ble Delhi High Court:

- Section 92CA reveals that there are certain jurisdictional perquisites for the making of a reference by the AO to the TPO. At the outset, the AO has to be satisfied that the assessee has entered into an international transaction or a specified domestic transaction. Whereas in the present case, the assessee raises a threshold objection that it has not entered into any international transaction within the meaning of section 92B of the Act, it is imperative for the AO to deal with such an objection. If the AO decides to nevertheless make a reference, he has to record the reasons, even prima facie, why he considers it necessary and expedient to make such a reference to the TPO.
- While Section 92CA *(1)* does not itself talk about a hearing having to be given to the assessee upon the latter raising an objection as to the jurisdiction of the AO to make a reference, such requirement appears to be implicit in the very nature of the procedure that is expected to be followed by the AO.
- Reliance was placed on the decision rendered by the Hon'ble Bombay High Court in the case of Vodafone India Services (P) Limited Vs. Union of India *[2014]* 361 ITR 531 *(Bom)* wherein it was concluded that grant of personal hearing before referring the matter to the TPO has to be read into section 92CA*(1)* in cases where the very jurisdiction to tax under Chapter X is challenged by the assessee.
- The same has been clarified explicitly in Instruction no. 3 of 2016 dated 10th March 2016 issued by the CBDT.

Thus, in a situation wherein the assessee raises an objection as to the very jurisdiction of the AO to make a reference u/s 92CA, then it will be incumbent on the AO to deal with such objection on merits.

KNAV comments:

In order to make a reference u/s 92CA of the Act, the AO has to be satisfied that there is an existence of an international transaction. Once the reference u/s 92CA is made, the TPO is bound to determine the ALP of the international transaction under consideration. In a case wherein the assessee makes an objection regarding tl same, the objection has to be considered at the very threshold by the AO. Wherein the assessee's objectio is not dealt with at the threshold, the entire elaborate exercise of determining the ALP may turn out to be entirely academic.

International tax

Case Law 1: Steria (India) Ltd Vs. Commissioner of Income Tax-VI *[2016]* 72 taxmann.com 1 *(Delhi)*

Protocols of double taxation avoidance agreement ('DTAA') forms part of DTAA and have equal binding force to that of the principal text of DTAA.

Summary of the case:

When an application was filed before the authority for advance rulings *('AAR')* to determine the tax liability payable for the management service provided by France entity to the Indian entity, the AAR, disregarding the existence of the Clause 7 of the Protocol of India-France DTAA held that Protocol could not be treated as forming part of the DTAA itself.

On filing a writ petition, against the AAR ruling, the Hon'ble Delhi High Court held as under:

- Reliance has been rightly placed by the Indian entity on the Klaus Vogel commentary on 'double taxation conventions', wherein it was contended that protocols would form part of the treaty and their binding force is equal to that of principal text of treaty.
- Protocol automatically becomes applicable and does not require separate notification incorporating the beneficial provisions.
- Clause 7 of the protocol of India-France DTAA states that if any convention, agreement or protocol is signed between India and a third state which is a member of the Organization for Economic Co-operation and Development *('OECD')*, then India shall limit its taxation at source on dividends, interest, royalties, fees for technical services *('FTS')* or payments for the use of equipment to a rate lower or a scope more restricted than the rate of scope provided in India-France DTAA.
- As India-UK DTAA excludes managerial services from the definition of FTS, managerial service is outside the ambit of FTS.
- Thus, it is not necessary to examine further as to whether any services envisaged are made available by the France entity.

Protocol having equal binding force to that of the principal text of DTAA, managerial service rendered by France entity shall not be taxable in India.

Recent important notifications issued by the Central Board of Direct Taxes *('CBDT')*

1. Notification No. 70/2016: income declaration scheme *(second amendment)* rules, 2016

The Central Board of Direct Tax introduced further rules to update the income declaration scheme rules, 2016. Form 3 pertaining to 'intimation of payment under sub-section *(1)* of section 187 of the Finance Act, 2016' in respect of the income declaration scheme, 2016 has also been substituted and prescribed in the notification.

A link for the same is provided herewith:
http://www.incometaxindia.gov.in/communications/notification/notification702016.pdf

2. Notification No. 68/2016: effective date of amendment of protocol of India-Mauritius DTAA

The protocol amending the agreement between the Government of the Republic of India and the Government of Mauritius, was set out and signed on 10th May 2016, whereas the said protocol entered into force on 19th July, 2016, being the date later of the notifications of the completion of the procedure as required by the law. Therefore, the CBDT notified that all the provisions of the said protocol shall be given effect in accordance with Article 9 of the said protocol.

A link for the same is provided herewith:
http://www.incometaxindia.gov.in/communications/notification/notification682016.pdf

3. Notification No. 67/2016: seeking PAN details of trustees and others in case of registration of trusts

CBDT has amended Form 10A required for registration of charitable or religious trust or institution under clause *(aa)* of sub-section *(1)* of section 12A of the Act whereby the details of author*(s)*/founder*(s)* and trustee*(s)*/manager*(s)* shall be required along with PAN.

A link for the same is provided herewith:
http://www.incometaxindia.gov.in/communications/notification/notification672016.pdf

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