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 notifications and press releases issued by the Central Board of Direct Taxes.

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Transfer pricing

Case law 1: M/s. Marico Ltd. Vs. Assistant commissioner of income tax *(ITA No. 8713/Mum/2011)*

Transfer pricing officer ('TPO') shouldn't benchmark the royalty from one associated enterprise ('AE') against royalty received from other AE if there are geographical differences as well as difference in products and brands.

Facts of the case:

The assessee is engaged in the business of manufacturing and marketing of fast moving consumer goods *('FMCG').* A reference was made to the TPO for determining arm's length price *('ALP')* of the international transactions reported in Form 3CEB.

An appeal was filed before the commissioner of income tax *(Appeal) ('CIT(A)')* for deleting the transfer pricing *('TP')* adjustments *(mentioned below)*. The CIT(A) disposed off the case partly in favour of the assessee.

Aggrieved by the decision, appeal was filed before the Hon'ble Tribunal on the following grounds:

A. Adjustment towards royalty charged

Assessee being the owner of trade mark had entered into an agreement with its AE in Bangladesh and UAE for selling its goods, for which the assessee would pay royalty as consideration. However, the rate of royalty differed for both the AE i.e. 0.5% - 1% for Bangladesh and 2.5 % for UAE. To this, the TPO made adjustment disregarding the transactional net marginal method *('TNMM')* as most appropriate method for determining the ALP and benchmarked the transaction using comparable uncontrolled price *('CUP')* method at 2.5%.

The Hon'ble Tribunal held as under:

The agreement was entered into by the assessee with Bangladesh was in respect to 'Parachute' whereas that with UAE was in respect trade mark of 'Parachute' as well as 'GGN'. Further, due to the difference in geographical location, brand, products, there were issues relating to the use of controlled transaction for the purpose of comparability. Accordingly, the TP adjustments proposed by the TPO were deleted.

B. Interest charged on loan

During the assessment year *('AY')* 2006-07, a loan was granted by the assessee to its AE in the USA at London Interbank offered rate *('LIBOR')* + 150 basis points. However, during the relevant year, the assessee had granted loan to its another AE in UAE at 9.5% in order to finance the AE for purchasing shares of certain company. The TPO stated that the assessee ought to have charged interest at least at the rate of 9.5% i.e. rate charged to its another AE and accordingly, adjustments were made by the TPO.

The Hon'ble Tribunal held as under:

If the loan is taken and given in foreign currency, LIBOR would be the safest tool to determine the ALP. Following the principle laid down in,

- CIT Vs Tata Autocomp Systems Ltd. *(56 taxmann.com 206)*; and
- Siva Industries & Holdings Ltd. Vs ACIT *(46 SOT 112)*,

the Hon'ble Tribunal held that the LIBOR has been accepted in case of foreign currency loan. Thus, the Hon'ble Tribunal rejected TPO's adjustment as the rate of interest was higher than LIBOR.

C. Guarantee fees charged

The assessee had provided corporate guarantee *('CG')* to Citibank (India) so that Bangladesh entity could avail the credit facility in Bangladesh, and to ICICI Bank Bahrain so that UAE entity could avail the credit facility from ICICI Bank UAE @ 0.8% of the guarantee fees. The TPO observed that providing CG was not a normal business activity of the assessee. In case the AE makes any default, the assessee would be exposed to a higher risk. Thus, adjustments were made to determine the appropriate rate.

The Hon'ble Tribunal held as under:

There is no difference between the bank or a corporate entity as far as guarantee commission is concerned. In case of default by the borrower, the CG is exposed to the same risk of a bank.

Judgements *(cont…)*

Further, relying on the following judicial pronouncements

• Siro Clinpharm Private Limited Vs ACIT *(ITA No.2618 and 2876/2014)*;
• Bharti Airtel Limited Vs ACIT *(43 taxmann.com 150)*;
• Micro ink Limited Vs ACIT *(63 taxmann. com 353)*; and
• Redington India Ltd. Vs JCIT *(49 taxmann.com 146),*

the Hon'ble Tribunal held that guarantee commission is not considered as an international transaction and thus, the decision was given in favour of the assessee.

Case Law 2: Seven N Consulting (P.) Ltd. Vs. Income tax officer *(ITA No. 6192/Del/2015)*

For computing the ALP of the international transaction, of the software support service, additional evidence in the form of segmented audited accounts are to be admitted.

Facts of the case:

The assessee derived its income by providing software consulting and support services, to its 100% subsidiary in Denmark. The case was referred to the TPO to determine the ALP of the international transaction entered by the assessee. However, the TPO made adjustment taking into account the comparables as provided by the assessee and his own comparables, as well as by applying TNMM method instead of assessee's cost plus method *('CPM')*. The TPO contended that the assessee has not provided segmental profit and loss account of the services provided to the AEs and non AEs and in such a scenario, the application of CPM is extremely difficult as the gross profit margin is required to be charged on the direct and indirect costs identified.

During the course of hearing, the assessee had requested the TPO to consider the non-audited segmental P&L account in relation to transaction with AEs and Non AEs to ascertain the revenue of the associated costs for arriving at segmental profit and loss. However, as the segmental profit and loss statement was non-audited, it was not accepted by the TPO.

Aggrieved by the decision, the assessee filed the objections before the dispute resolution panel *('DRP')*, wherein the DRP affirmed the additions prosposed by the TPO.

Decision of Hon'ble Tribunal:

The Hon'ble Tribunal held that as the additional evidences furnished by the assessee are relevant and go to the root of the matter, they need to be admitted. Thus, the matter was remanded back to the TPO so as to adjudicate afresh in accordance with law, after providing due and reasonable opportunity of being heard to the assessee.

Thus, the additional evidence which go to the root of the matter are considered as relevant and ought to be admitted.

Case Law 3: Trilogy E-Business Software India (P.) Ltd Vs. Deputy commissioner of income tax *(ITA No. 33 & 115/Bang/2013)*

TPO ought to have given risk adjustments to margins of comparables for bringing them on par with assessee.

Facts of the case:

The assessee had provided software development services to its AEs. To benchmark its international transactions regarding software development services, the assessee had selected 21 comparable companies. The TPO did not accept the international transactions to be at arm's length and accordingly rejected 15 companies selected by the assessee and accepted 6 companies from the set of comparables selected by the assessee. Further, he added 14 more comparable companies in the final set of comparables. Accordingly, TP adjustments were made by the TPO.

On appeal before CIT*(A)*, the CIT*(A)* rejected 9 comparable companies from the set of comparables selected by the TPO and directed the TPO/AO to retain 12 comparable companies.

Decision by the Hon'ble Tribunal:

The Tribunal laid down following principles while selecting or rejecting the comparables for determining the ALP

• Company engaged in development of products and which owned its own intangibles is incomparable to a software development service provider;
• It is the duty of the TPO to have necessarily furnished information gathered under section 133*(6)* of the Act to the assessee and to take its submissions thereon into consideration before deciding to include a comparable in list of comparables;

Judgements *(cont...)*

• Fluctuating margins in the results of a company over years cannot be reason enough to establish differences in functional profile or any clinching factual reason, warranting exclusion of such company from list of comparables;
• A company rendering high-end technical services and which earned revenue from sale of licences is incomparable to assessee; and
• A company should be excluded from set of comparables for reason that its related party transactions *('RPT')* are in excess of 15 per cent.

Case Law 4: Pole to Win India Private Limited Vs. Deputy Commissioner of Income Tax [*(2016)* 70 taxmann.com 318 *(Bang)*]

Nature of companies that cannot be taken as a comparable for the purpose of benchmarking the transaction relating IT enabled services clarified.

Summary of the case:

The assessee was subsidiary company of Vinciti Networks Inc. USA. During the relevant year, assessee rendered IT enabled services *('ITES')* to its AE. To benchmark its international transactions, the assessee selected 17 companies of which certain comparables were rejected by TPO and a few others were added. Objections raised by the assessee were dismissed by the DRP.

Aggrieved, the assessee preferred appeal with the Hon'ble Bangalore Tribunal wherein the following principles were laid down:

- the software development segment cannot be compared with ITES segment and hence such company cannot be compared with the assessee's ITES segment;

- company engaged in providing data analysis and process solutions and recognized as expert in market financial services, retail and manufacturing cannot be considered as comparable with the low end service provider;

- companies having more than 15 per cent RPT were rejected;

- company deriving revenue from the software product and having huge intangible assets apart from the brand value and a leader in the market was rejected; and

- company having significant investment in business acquisition as well as engaged in the innovation activities of various fields including technology innovation cannot be said to be a comparable of company involved in low-end services.

International tax

Case Law 1: Baan Global B V Vs. Additional director of income tax *(ITA No. 7048/Mum/2010)*

Supply of off-the-shelf software to an Indian customer not taxable as royalty under India - Netherlands double taxation avoidance agreement ('DTAA').

Facts of the case:

The assessee was engaged in the business of development and sale of computer software. The computer software is sold 'off-the-shelf' which is mainly used by the Indian customer. The assessee had entered into distribution agreement with its Indian subsidiary for supply of its software to Indian customer on which it has to receive a fixed percentage sum as per agreement. The customers are not permitted to make copies and sell the software. Except for the limited right to access the copyrighted software for its own business purpose, the customer does not acquire any right to exploit the copyright in the software.

The assessing officer *('AO')*, considering it as transfer of copyright, treated the same to be royalty income and thus, chargeable to tax in India. On an appeal by the assessee, the CIT*(A)* held the same to be business income and since the assessee did not have a permanent establishment ('PE') in India, the same was considered to not be taxable in India. Aggrieved, the AO preferred an appeal with the Hon'ble Mumbai Tribunal.

Decision of the Hon'ble Mumbai Tribunal:

• the computer software does not fall under most of the phrases *(that constitute royalty)* under Article 12 of the DTAA barring "use of process" or "use of or right to use of copyrights"; and
• what is available for customer's use is software product as such and not the process embedded in it. Several processes may be involved in making computer software but what the customer uses is the software product as such and not the process, which are involved into it.

Thus, none of the conditions mentioned in section 14 of the Copyright Act were applicable.

Thus, the consideration is received for pure sale of off-the-shelf software and hence, cannot be considered as a royalty within the meaning of Article 12 of the India – Netherlands DTAA.

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Judgements *(cont...)*

Domestic taxation

Section 26*(va)(b)*

Case Law 1: M/s. Orient Blackswan Private Limited Vs. Asstt. commissioner of income tax circle 16*(3) (ITA No. 252/Hyd/2012)*

A capital receipt can be taxable in the hands of the assessee when it is shown that it comes within the purview of section 26(va)(b).

Facts of the case:

The assessee is an India based publication house, holding trademark in the name of "ORIENT LONGMAN" which was registered since 1980. Owing to disputes regarding the use of trademark, assessee entered into a settlement agreement with a Pearson Group, UK for not using the trademark 'Longman' while carrying on the business in the field of printing and publishing. The assessee was previously named and styled as Orient Longman Pvt. Ltd. The assessee was required to change the name of the entity excluding the word 'Longman' as per a Tomlin Order *('court order')*. Accordingly, the name of this assessee was changed to Orient Blackswan Pvt. Ltd. Pursuant to this, assessee received compensation *(as per the compromise order passed by UK court)* for losing the right to use the word "Longman" which was a part of its trademark. During the course of assessment procedures for AY 2008-09, the AO held that the amount received for losing right to use the trademark should be taxable as business profits in terms of section 28*(va)(b).*

On appeal, the CIT*(A)* confirmed the order of the AO. Aggrieved, assessee filed an appeal before the Hon'ble Hyderabad Tribunal.

Section 28*(va)(b)*: Section 28*(va)(b)* provides for taxability of payments received for not sharing trademark as business income. This clause provides for taxation of certain capital receipts which are not taxable as capital gain.

Decision of the Hon'ble Tribunal:

The Hon'ble Tribunal placed reliance on the case of Commissioner of income tax Vs. Best & Co. *(60 ITR 11) (SC)* and Commissioner of Income tax Vs. Guffic Chem. *(332 ITR 602) (SC)* wherein it was held that a capital receipt is not taxable in the hands of assessee. Bearing in mind the principle stated by the Hon'ble Supreme Court, it can be derived for this case that the capital receipt is not taxable in the hands of the assessee unless it is shown that the capital receipt falls within the purview of section 28*(va)(b)* of the Act.

Is the compensation a capital receipt?

The Hon'ble Tribunal observed that the agreement was towards settling various disputes on the use of name 'Longman' and did not relate to any transfer of trade mark etc. Further, since the settlement agreement was not entered in the ordinary course of business, the Hon'ble Tribunal held that compensation received under a negative covenant for impairment of right to use the word 'LONGMAN' is in the nature of capital receipt.

Applicability of section 28*(va)(b)* of the Act:

The Hon'ble Tribunal noted that section 28*(va)(b)* only deals with payment received for not sharing of trade mark etc. It held that the extended meaning of taxable income as envisaged u/s 28*(va)(b)* is controlled by the words 'not sharing'. The Hon'ble Tribunal held that the word 'sharing' appearing u/s 28*(va)(b)* postulates there must be someone to use the trade mark, but in the present case, the sharing or otherwise was not possible when trade mark itself ceases to exist.

The Hon'ble Tribunal thus allowed the assessee's appeal.

Amongst other intangibles, section 28*(va)(b)* deals with payment received for not sharing trade mark. This would presuppose that the assessee should own the trade mark and for a given consideration, has agreed not to share it with any other person. Hence, emphasis has to be placed on the term 'not sharing of'.

Perquisite value

Case Law 1: Vikas Chimakurty Vs. Deputy commissioner of income tax [*(2016)* 70 taxmann.com 96 *(Mum)*]

The perquisite value of the residential accommodation provided by the employer shall be on actual basis and not on notional basis.

Facts of the case:

The assessee, an employee of Kotak Investment Advisors Ltd., having income from salary and other sources filed return declaring total income of Rs. 19,066,894. The case was taken up for scrutiny and the assessment was concluded by AO after making additions on the grounds that the notional interest on deposit of Rs. 2,000,000 given by his employer to the landlord for accommodation provided by the employer to the assessee is to be considered as perquisite.

The assessee appealed before CIT*(A)* wherein the order of the AO was upheld. Aggrieved by the order of CIT*(A)*, assessee preferred appeal with the Hon'ble Mumbai Tribunal.

Decision of the Hon'ble Mumbai Tribunal:

The Hon'ble Mumbai Tribunal while giving relief to assessee held as under:

• Perquisite value of residential accommodation provided by employer to assessee employee shall be actual amount of lease rent paid or payable by employer;
• The Hon'ble Mumbai Tribunal relying on the judgement of Hon'ble Bombay High Court in case of CIT Vs. Shankar Krishnan *(349 ITR 685)* held that the contention of the authorities that notional interest on the deposit of Rs. 2,000,000 paid by the employer to the landlord for securing accommodation, while computing the perquisite value of the residential accommodation is to be included in the assessee's income, is not sustainable in view of the express words used in Rule 3 of the Income tax Rules, 1962 *('the Rules')*.

Thus, notional interest on deposit made by employer to landlord for providing accommodation to employee cannot be included in employee's income.

Recent important notifications and press releases issued by the central board of direct taxes *('CBDT')*

1. Notification No. 43/2016 dated June 02, 2016 – amendment of Rule 8D

The computation mechanism in Rule 8D for calculation of expenditure to be disallowed by the AO in relation to earning of exempt income has been amended by the CBDT vide this notification. The amendment has done away sub-clause *(ii)* in Rule 8D*(2)* which dealt with computation of expenditure towards interest *(not directly attributable to any particular income/receipt)* as per the prescribed formula. It also increases the rate to be applied on annual average value of investments from 0.5% to 1%.

A link for the same is provided herewith:
http://www.incometaxindia.gov.in/communications/notification/notification432016.pdf

2. Notification No. 49/2016 dated June 22, 2016 – amendment of GAAR provisions.

The CBDT amended rule 10U of the Rules vide this notification to provide as under:

a. The GAAR provisions shall not be applicable to any income accruing or arising to, or deemed to accrue or arise to, or received or deemed to be received by, any person from transfer of investment made before April 01, 2017 (earlier, the date was August 30, 2010); and

b. The GAAR provisions shall be applicable to any arrangement, irrespective of the date on which it has been entered into, in respect of the tax benefit obtained from an arrangement on or after April 01, 2017 (earlier, the grandfathering date had been set to be April 01, 2015).

A link for the same is provided herewith:
http://www.incometaxindia.gov.in/communications/notification/notification49_2016.pdf

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The notification has amended rule 10U of the Rules to grandfather the existing arrangements/investments made/to be made before April 1, 2017 from the applicability of GAAR provisions. The amendment is a result of various representations made by various stakeholders to the CBDT which stated that GAAR provisions should not be made applicable to existing structures. The prospective applicability of GAAR provisions w.e.f April 01, 2017 is a favorable move which shall provide certainty and help boost the investor confidence.

3. Notification No. 53/2016 dated June 24, 2016 – rule 37BC

The CBDT has notified a new rule 37BC specifying the conditions to be fulfilled by non-resident deductees to obtain relaxation from higher withholding tax rate under section 206AA of the Act in the absence of permanent account number *('PAN')* in India. The deductee shall have to furnish the details and documents specified in the new rule in order to obtain the said relaxation. To capture and report the details specified in the notification, corresponding changes have also been made in the quarterly withholding tax return *(i.e. Form 27Q)* applicable for reporting withholding tax on payments made to non-resident deductees.

A link for the same is provided herewith:
http://www.incometaxindia.gov.in/communications/notification/notification532016.pdf

Notifications and press releases *(cont…)*

4. Notification No. 54/2016 dated June 27, 2016 - foreign tax credit *('FTC')* rules

The CBDT has notified 'foreign tax credit' rules *('the FTC rules')* allowing residents to claim credit for taxes, surcharge and cess paid overseas. The FTC rules, which come into effect from April 1, 2017, allow taxpayers to claim credit of foreign tax paid.

The FTC rules provide a detailed procedure to claim the FTC. A few important points of the FTC rules are mentioned hereunder:

- FTC will be available against tax, surcharge and cess payable under the Act, including minimum alternate tax *('MAT')* but not in respect of interest, fee or penalty;
- The mechanism to compute the FTC which can be claimed is specified in a detailed manner;
- Taxpayers claiming FTC are required to furnish certain documents which have been listed in the FTC rules; and
- Disputed foreign tax would be allowed as credit for the year in which the income is taxed in India, subject to certain conditions.

A link for the same is provided herewith:
http://www.incometaxindia.gov.in/communications/notification/notification542016.pdf

5. Press release dated July 06, 2016 – deferment of applicability of income computation and disclosure standards *('ICDS')*

The CBDT deferred the applicability of ICDS to Financial Year *('FY')* 2016-17 *(AY 2017-18)* from FY 2015-16 *(AY 2016-17)* vide press release dated July 06, 2016 considering the fact that some of the tax payers might have filed their return of income and obtained tax audit report without incorporating the compliance with the ICDS and related disclosures in the absence of the revised tax audit report.

A link for the same is provided herewith:
http://www.incometaxindia.gov.in/Lists/Press%20Releases/Attachments/490/Press-Release-Applicability-of-Income-Computation-06-07-2016.pdf

6. Press release dated July 01, 2016 – official meeting on DTAA between India and Cyprus

An official meeting between the authorized representatives of India and Cyprus took place in New Delhi on 28 and 29 June, 2016 to finalize the revised India-Cyprus DTAA, wherein all pending issues, including taxation of capital gains, were discussed, and in-principle agreement was reached on all pending issues. Source-based taxation of capital gains on transfer of shares was agreed to. However, a grandfathering clause was also agreed to for investments made prior to April 01, 2017, in respect of which capital gains would be taxed in the country of which taxpayer is a resident.

A link for the same is provided herewith:
http://www.incometaxindia.gov.in/Lists/Press%20Releases/Attachments/490/Press-Release-Applicability-of-Income-Computation-06-07-2016.pdf