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: Gulf Energy Maritime Services (P.) Ltd. Vs Income-tax Officer [2016] 67 taxmann.com 17 (Mumbai - Trib.)

Assessing Officer ('AO') barred from rejecting the bonafide quotation as a valid input and resorting to unscientific and unrecognized methods for ascertaining the Arm's Length Price ('ALP') of the services.

Facts of the case:

The assessee is engaged in the business of providing ship management services to its parent company. The assessee received US $ 40,000 per month, from its parent company, for the services so rendered which are benchmarked on the basis of the Comparable Uncontrolled Price ('CUP') method. The quotations and the working of arm's length price, were duly produced by the assessee before the AO.

However, the AO rejected the working of the ALP on the basis that comparable cannot be considered merely on quotations wherein no real transactions have taken place. It also stated that the fees for managing the crew had been charged on a lump sum basis while the number of crew members had not remained the same throughout the year. Thus, rejecting the working of ALP, the AO recomputed the ALP and made the adjustment.

The assessee appealed before Commissioner of Income Tax (Appeals) ('CIT(A)') whereby the CIT(A) dismissed the grievances of the assessee.

Aggrieved by the decision, the assessee appealed before Income Tax Appellate Tribunal ('ITAT').

Decision of the Hon'ble ITAT:

The Hon'ble ITAT held that, while determining the ALP, the AO can decide as to what it is for services rendered, but can do so only on the basis of a legally recognized method. Even if one is to proceed on the basis that the determination of ALP by the assessee is incorrect, the AO cannot ascertain the ALP on an ad hoc basis or make ad hoc disallowances.

Further, the rigidity regarding the price for an actual transaction has been considerably relaxed when we take into account Rule10AB of the Act, which allows the hypothetical price of a transaction to be taken into account as well. Thus, as long as one can come to the conclusion, under any method of determining the arm's length price, that the price paid for the controlled transactions is the same as it would have been, under similar circumstances and considering all the relevant factors, for an uncontrolled transaction, then the price so paid can be said to be the arm's length price.

Hence, the grievances of the assessee had been upheld and the AO had been directed to delete the impugned arm's length price addition.

Therefore, the bonafide quotation could indeed be considered as a valid input under the residuary method and the AO cannot resort to an unscientific and unrecognized method for ascertaining the ALP of the services rendered by the assessee.

Case law 2: Denso India Limited Vs Commissioner of Income Tax (ITA 443/2013)

Revenue can resort to an entirely different method CUP for a few transactions, even where the assessee has preferred Transactional Net Margin Method ('TNMM') for all the transactions, on receiving non satisfactory replies from assessee.

Facts of the case:

The appellant assessee is engaged in manufacturing and sale of auto electrical products for four wheel and two wheel vehicles. Its promoters include two Japanese Companies, 'Company A' and 'Company B'. Also, Company B is an Associated Enterprise ('AE') of Company A. The two companies exercised an overall share-holding control of 58.20%. In A.Y 2002-2003, the case was taken up for scrutiny. On referring to the TPO, the transfer pricing adjustment was made pursuant to the ALP determination. On appealing before the CIT(A), it directed the AO to cancel the adjustment.
However, the Tribunal restored the adjustment

when an appeal was made by the revenue. Similar action was taken by CIT(A) and ITAT in A.Y 2003-2004 where the assessee had the same set of facts.

The assessee used to purchase raw material from Company B, which was merely a trader. The assessee was unable to shed any light on why it chose to source the materials from Company B, which it could have purchased directly from the manufacturer, i.e. Company A.

The assessee had appropriately applied the TNMM method for all the transactions in its transfer pricing report. However, the Transfer Pricing Officer ('TPO') had accepted the value of royalty, technical knowhow and testing fee on the basis of TNMM, but rejected the same for the purpose of component purchase and proceeded to apply an entirely different method i.e the CUP method, for arriving at the net value of the transactions.

Held by Hon'ble High Court:

The purchases routed through their entity were with the sole objective of camouflaging the obvious fact that the assessee made purchases from an AE, i.e. Company A which was the manufacturer. This would have been a commercial decision, which revenue authorities would not question. However, interestingly, the vendor of the components (which constituted over 85% of the raw materials imported and about 38% of the total raw materials sourced) was also connected with both the assessee and the manufacturer.

Thus, if these realities emerged during the TP exercise, compelling the TPO to closely scrutinize the value of such imports and seek further details from the assessee, and to justify its decision, the onus was clearly on the assessee to afford a convincing and reasonable explanation. However, the explanations given by the assessee were unconvincing which influenced the TPO and the AO to resort to transfer pricing adjustment and determine ALP by adopting the CUP method for the procurements from Company B.
Thus, the decision is rendered in favour of the revenue and against the assesse.

Therefore, non-satisfactory replies can give power to the TPO to segregate a portion of transactions and recompute the ALP in an entirely different method.

Case Law 3: Essilor India Pvt. Ltd. Vs. DCIT [IT(TP)A No. 29/Bang/2014 and IT(TP)A No. 227/Bang/2015]

Advertisement, Marketing and Promotion ('*AMP ') expenditure not to be inferred as an international transaction*.

Facts of the case:

The taxpayer, Essilor India Pvt. Ltd. ("Essilor India" or "taxpayer") a wholly owned subsidiary of Essilor International SA ("AE") was engaged in the business of trading in finished, semi finished ophthalmic lenses, optical meters and processing of semi finished ophthalmic lenses. During the year under consideration, the taxpayer has international transactions in nature of import of lenses, instruments, royalty, purchase returns, export of lenses, cost sharing and other related transactions and had benchmarked the transactions using TNMM and operating profit to turnover as the Profit Level Indicator ('PLI'). The tax payer's PLI was greater than that of the comparable selected by it. However, the TPO made a separate adjustment for the AMP expenses incurred by the tax payer. This adjustment was also confirmed by the Dispute Resolution Panel ('DRP').

Tribunal's ruling:

- The AMP expenses incurred by the taxpayer give no benefit to the AE and there was no international transaction with respect to the AMP expenditure as envisaged u/s 92B of the Act.
- The Tribunal relying on the decisions of the Hon'ble Delhi high Court in case of Maruti Suzuki India Ltd. Vs. CIT, Bausch & Lomb Eyecare (India) Pvt. Ltd. Vs. ACIT and Yum Restaurants (India) Pvt. Ltd. held that no TP adjustment can be made by deducing the difference between AMP expenditure incurred by the taxpayer and AMP expenditure incurred by the comparable companies if there is no explicit arrangement between the taxpayer and the AE.
- It was further held that there was no machinery provided in the Act to ascertain the price incurred by the taxpayer to promote the products of the AE under Chapter X of the Act.
- Merely because AMP expenditure was incurred by the taxpayer, it cannot be inferred that there exists an international transaction.

KNAV comments:

Taxpayers need to contest that AMP expenditure is not an international transaction under Chapter X of the Act. There should not be any explicit agreement or arrangement to incur such expenses on behalf of the AE. The onus is on the revenue to demonstrate the existence of some arrangement or understanding between the taxpayer and the AE to incur the AMP expenses.

Business connection and Permanent Establishment ('PE') in India

Case law 1: Deputy Commissioner of Income-tax Vs Vertex Customer Management Ltd [2016] 67 taxmann.com 105 (Delhi - Trib.)

Various tests explained to determine business connection in India, fixed place PE in India, service PE in India, agent PE in India.

Facts of the case:

The assessee company is incorporated in the UK and is a non-resident engaged in outsourcing sales for its clients in the finance, utility and public sectors. The main service provided by the appellant is customer management outsourcing, service outsourcing and transfer of technology.

Vertex Customer Service India Pvt. Ltd (Vertex India) is an Indian entity in the group which is also involved in outsourced work from the assessee. Out of the total revenue earned, a sum of the revenue was retained by the assessee as cost incurred in UK. The assessee allowed Vertex India to use certain equipment located outside India, and claimed reimbursement of expenses incurred by the assessee on behalf of Vertex India. Also, royalty income was received by the assessee from Vertex India for giving the right to use the equipment located outside India. The reimbursement claimed by the assessee was considered as non-taxable as it was on a cost to cost basis.

To this, the AO held that the assessee had PE in India. Due to the business connection, the profit attributable to PE is taxable in India. Further, the reimbursement and royalty were also considered as business profit of the PE in India.
Aggrieved by this, the assessee appealed before CIT(A). The CIT(A) held that

- The assessee has fixed PE in India but does not have service PE and dependent agent P.E in India.
- The assessee has business connection in India.
- Profits attributable to PE are not taxable in India.
- Royalty cannot be taxed as business income.
- Reimbursement of expense is not chargeable to tax.

Aggrieved by the decision, the revenue appealed before the Hon'ble Tribunal.

Decision of the Hon'ble Tribunal:

The Tribunal held that since the assessee has continuous revenue generating business activities with Vertex India and a real and intimate relationship existed between activities of the non-resident, and those within India,then, it has a business connection in India.

Further, it held that Vertex India cannot be said to be a fixed place PE, a service PE, and a dependent agent of assessee in India due to following reasons:

- Fixed place PE: The 'disposal test' under Article 5(1) of India-UK DTAA is not satisfied as the space provided in India is not at the disposal of the assessee company since it has no right to occupy the premises but is merely given access for the purposes of the work.
- Service PE: It has not sent any employees to India.
- Dependent agent PE: Carrying on the business in other state through a broker, general commission agent, or any other agent of an independent status cannot be the mere reason for dependent agent PE in India.

For considering the amount as royalty or business profit, it held that the said amount was not effectively connected to the PE and hence cannot be taxed as business profits. Also, it had concluded that no further profits can be attributed to the PE.

For reimbursement of expenses, the argument of the assesse, that there was no element of income in the entire amount of reimbursements cannot be accepted as it cannot be said with certainty whether the amount allocated by the assessee was on a cost to cost basis or not.

Based on the various issues raised by the revenue before the Hon'ble Tribunal, the Hon'ble Tribunal allowed few issues and disallowed the remaining, thus giving decision partly in the favour of the assessee.

KNAV comments:

Business connection through a PE in India can be determined only after considering various factors and tests as has been laid down by judicial precedence from time to time. Timely tests and measures need to be taken to avoid existence of business connection through a PE in India.

Reassessment

Case Law 1: Standard Chartered Finance Limited Vs. Commissioner of Income Tax (SLP No. 13512/2012)

As per the Interest-tax Act, 1974, reassessment cannot take place in cases where no assessment order has been passed pertaining to original assessment.

Facts of the case:

The issue for consideration arises under the Interest-tax Act, 1974. No assessment order was passed for the original proceedings in the assessee's case for AY 1997-98. The AO sought to reopen the assessment and issued notice for the same which was challenged by the assessee and carried in appeal on the ground that no reassessment can take place in cases where original assessment is still pending. Contention of assessee was upheld by CIT(A) and also by the Hon'ble Tribunal.

On further appeal by the revenue, the Hon'ble High Court reversed the view taken by the Tribunal holding that even if there was no original assessment order passed, there could be re-assessment.

Decision of the Hon'ble Supreme Court:

Relying upon the ratio laid down by the Hon'ble Supreme Court in case of Trustees of H.E.H. The Nizam's Supplemental Family Trust v. CIT [2000] 242 ITR 381 (SC), reversed the order of the Hon'ble High Court and held that there could not be any reassessment when the original assessment is pending.

Thus, there cannot be a notice for re-assessment inasmuch as the question of re-assessment arises only when there is an assessment in the first instance.

KNAV comments:

Explanation 2 to section 147 of the Act deems certain instances where income chargeable to tax has escaped assessment. However, no such instances exist under the Interest-tax Act, 1974 thereby giving arbitrary powers to the AO to reopen assessment.

Case law 2: Bayer Material Science Private Limited Vs. Deputy Commissioner of Income Tax (Writ Petition no. 2502/2015)

Passing reassessment order without disposing off objections raised by assessee is in defiance of Supreme Court's decision and not sustainable by virtue of being without jurisdiction; Reasons of belief that income has escaped assessment has to be formed only by the AO.

Facts of the case:

The assessee had filed a return of income, declaring a total income of Rs.12.77 Crores for AY 2007-08. Thereafter, the AO issued a notice on February 6, 2013 seeking to reopen the assessment for the above mentioned AY. In response to the same, the assessee filed its revised return of income and sought reasons recorded in support of the notice on March 15, 2013.

After repeated communications by the assessee, the AO furnished the reasons for issuing notice only on March 19, 2015 stating that <u>the reasons could be provided only after TPO passed his order on transfer pricing</u>. Objections were filed against the reasons by the assessee. However, the AO proceeded to <u>pass the draft assessment order without disposing off the objections.</u> The assessee filed a writ petition against the same.

Decision of the Hon'ble Bombay High Court:

- The recording of reasons for issuing the reopening notice is to be on the basis of the AO's reasons.
- The TPO's reasons on merits, much after the issue of the reopening notice does not have any bearing on serving the reasons recorded upon the party whose assessment is being sought to be reopened.
- Also, passing of the draft assessment order without having disposed of the objections is in defiance of the Supreme Court's decision in GKN Driveshafts (India) Ltd 259 ITR 19 (SC);
- It is only if the AO rejects the objection that he can proceed with the assessment proceedings of the reopened assessments;

Thus, passing the draft order without disposing off the assese's objections is, clearly, without jurisdiction and therefore, not sustainable.

KNAV comments:

The Hon'ble Supreme Court has laid down the following procedure in its decision in case of GKN Driveshafts (India) Ltd (mentioned above).

Whenever a reopening notice is issued under Section 148 of the Act, the AO is to make available to the assessee, on request, a copy of the reasons recorded while issuing the notice for reopening the assessment. The assessee is then entitled to file its objection to the grounds in support of the reopening notice and the AO is required to dispose of the assessee's objection to the reasons recorded by a speaking order. It is only once the AO rejects the objection (by passing a speaking order) that he can proceed with the assessment proceedings of the reopened assessment.

No TDS, admissibility of expense

Case law 1: ANZ Grindlays Bank Limited Vs. Deputy Commissioner of Income Tax (ITA No. 32/2004)

Salaries paid to employees overseas / to a non-resident, are allowed as deduction even though the tax, so deducted, is not paid within time limit provided under section 40(a)(i) of the Act.

Facts of the case:

The assessee had paid salaries to expatriate employees overseas on which tax was deducted and paid only after issuance of the Central Board of Direct Taxes ('CBDT') Circular dated 685 dated 17/20 June 94 and Circular 686 dated 12.8.94. The AO denied deduction of expenses on account of failure on the part of the assessee to deduct and deposit tax under section 40(a)(iii) of the Act within the time prescribed under section 40(a)(i) of the Act.

The same was upheld by CIT(A) and later by the Hon'ble Delhi Tribunal. The assessee appealed against the same at the Hon'ble Delhi High Court.

Decision of the Hon'ble Delhi High Court:

- It is seen that where the legislature wanted to make payment of tax within a specified time a necessary pre-condition, it had expressly indicated so i.e. proviso to section 40(a)(i) of the Act;
- Amendment brought vide the Finance Act (No.2), 2014 is applicable only to section 40(a)(i) of the Act. The same cannot be read into section 40(a)(iii) of the Act;
- No such condition for depositing the tax within a prescribed time was introduced in section 40(a)(iii) of the Act;

Thus, salaries paid to expatriate employees overseas shall be allowed as a deduction even if the tax deducted under section 40(a)(iii) of the Act is not deposited within date mentioned in Section 40(a)(i) of the Act.

Jurisdiction and binding nature of a Circular

Case law 1: Vodafone Essar Mobile Services Ltd. Vs. UOI (67 taxmann.com 124)

If circular issued by CBDT favours the assessee, then it should be followed even if it is against legislative intent.

Facts of the case:

A writ petition was filed by the petitioners against the validity of the action initiated by the Income Tax Department for treating the petitioner as assessee in default u/s 201(1) and 201(1A) of the Act for non deduction of TDS for periods earlier than four years prior to 31st March 2011. Finance (No. 2) Act, 2009 amended the provisions of section 201 by inserting sub section (3) and (4) which provided time limits for passing order u/s 201(1) of the Act for holding a person to be an assessee in default. The CBDT issued a Circular explaining the amendment to section 201(1) of the Act by providing that proceedings for a financial year beginning from 1st April, 2007 and earlier years can be completed by the 31st March, 2011. The Department understood the above amendment / explanation as providing "sufficient time for pending cases" in respect of which the proceedings were to be completed by 31st March, 2011 and permitting it to initiate proceedings u/s 201 of the Act for treating an assessee as an assessee in default even in respect of alleged failure to deduct TDS for a period more than four years earlier to 31st March, 2011.

High Court's ruling:

The department argued that the Circular has to be harmoniously construed with Section 201(3) of the Act, to glean an intention to permit the department to initiate cases four years earlier than 31st March, 2011. The only requirement was that orders had to be passed by 31st March, 2011. However the Hon'ble High Court refused to agree with the above construction of the Department and held that the circular is an external aid of construction of section 201(3) which gives an instance of contrary understanding of the legal position by the department itself.

It further held that it is well settled that if a Circular issued by the department favours an assessee then it should be so done even where such interpretation goes contrary to the legislative intent.

Thus, the Hon'ble High Court, whilst allowing the writ held that notices to initiate proceedings for declaring an assessee in default, cannot be issued for years earlier than four years prior to 31st March 2011.

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