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In this edition of our thought leadership alert, we have tracked the progress of some significant cases decided by the appellate forums across the country as well as a few recent important Notifications and Circulars issued by the Central Board of Direct Taxes.

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International taxation

Taxability of stock appreciation rights

Case law 1: Shri Soundarrajan Parthasarathy Vs deputy commissioner of income tax (ITA Nos. 335 & 209/MDS/2016)

Stock appreciation rights granted by a US parent company to the employees of India subsidiary is taxable in the hand of employees as perquisites.

Facts of the case:

A US parent company had promoted an incentive plan to motivate its employees. Options were granted to the employees (the assessee) of the Indian subsidiary for providing stock appreciation rights. During the vesting period, the assessee was a non-resident and had rendered services outside India.

Disregarding the assessee's contention of treating the stock appreciation right as a capital asset, the Assessing Officer ('AO') had considered it as a perquisite and taxed the same in the hands of the assessees. The Commissioner of Income Tax (Appeals) ('CIT(A)') upheld the decision of the AO.

Decision by the Hon'ble Madras Tribunal:

The Hon'ble Madras Tribunal had held that irrespective of the fact that the stock appreciation rights were granted by the parent company in the US to the employees of Indian subsidiary company, indirect employer-employee exists had the assessees not been the employees of the Indian subsidiary, no options would have been granted to them by the US parent company. The motivation given to the employees would directly benefit the employees of Indian subsidiary and indirectly benefit the US parent company. Thus, the benefit payment, being in addition to the salary for the service rendered to the Indian subsidiary, was to be treated as a perquisite in the hands of the assessees.

Further, it was held that, the stock appreciation rights granted to the assessees cannot be treated as a capital asset as the incentive given was in the form of compensation for services rendered and should not be treated as a transfer of capital asset or termination of any source of income.

Considering the contention of the assessees that during the vesting period, they were non-residents and services were rendered outside India, the Tribunal held that the benefit of the stock appreciation right was conferred for the services rendered to the Indian subsidiary and the same is liable to tax in India, irrespective of the residency.

Thus, the options received by the assessee ought to be construed as income in their hands since it would be regarded as perquisites u/s 17(2) of the Income Tax Act, 1961 ('the Act') or benefit in lieu of salary for services rendered.

KNAV's comments:

Indirect employer-employee relationship between the parent company and the employees of its subsidiary and the benefit granted to such employees is regarded as perquisites in the hands of the employees.

Fees for technical services and royalty

Case Law 2: Adani Welspun Exploration Ltd Vs Income Tax Officer (ITA. No: 629/AHD/2016)

Fees paid for 3D seismic data processing for interpreting report of data provided by the assessee is not considered as fees for technical services.

Facts of the case:

The assessee had made a remittance to a non-resident for rendering service of 3D seismic data processing without withholding tax u/s 195 of the Act. The AO regarded the above mentioned service as fees for technical service that was made available to the assessee. The AO contended the assessee to be an assessee in default and accordingly, additions were made for tax liability along with interest.

On appealing before CIT(A), the decision rendered by the AO was upheld.

Aggrieved by the decision, an appeal was made before Hon'ble Ahmedabad Tribunal.

Decision of the Hon'ble Ahmedabad Tribunal:

Perusing the agreement of the service rendered, it showed that the objective of the project was to carry out a 3D seismic interpretation of the data provided by the assessee. Interpretation of data through maps/designs cannot be equated to development/transfer of technical services. Further, the expression 'make available' means that the recipient of the service should be in a position to derive an enduring benefit and be in a position to utilize the knowledge or know-how in future on his own.

As it could not be proved that there was transfer of technology by the non-resident to the assessee nor the impugned transactions have made available technical expertise, skills or knowledge by processing the data provided by the assessee nor the assessee can undertake such survey independently in future, the rendered service does not satisfy the requirement of technical services.

Therefore, the assessee is not obligated to withhold tax if the rendered service is not regarded as technical services.

Case law 3: India TNT Express Worldwide (UK) Limited Vs. Deputy Director of Income Tax (IT(TP)A No. 6/Bang/2011)

If the assessee is unable to provide a bifurcation of payments made towards each kind of service forming part of a composite agreement and where no reasonable apportionment was possible, the entire service acquires the character of principal service and shall be taxed in the same manner as that of principal service.

Facts of the case:

The assessee is a foreign company incorporated in the UK. The assessee was engaged in the business of international express distribution of freight, parcels and documents. The assessee had entered into Management and Administrative Services ('MAS') agreement with TNT (India) Pvt. Ltd. ('TNT India') for providing specified services such as advice on questions of business policy of a party, management information and other automated system services, assistance in evaluation of the development in the international market etc. The assessee had filed 'Nil' income return and claimed a refund of tax deducted at source ('TDS') on the ground that there was no Permanent Establishment ('PE') in India hence this was not taxable either under section 9(1) nor under Article 13 of the Indo-UK Direct Tax Avoidance Agreement ('DTAA'). The AO held that services provided by assessee were in the nature of know-how services and therefore chargeable to tax as royalty.

The assessee filed it's objections before the Dispute Resolution Panel ('DRP') which were dismissed by the DRP. Aggrieved, the assessee appealed before the Hon'ble Bangalore Tribunal.

Decision of the Hon'ble Bangalore Tribunal:

Referring to the agreement, the Hon'ble Bangalore Tribunal opined that the services covered were prima facie in the form of information which related to the commercial and business activity of the Indian entity;

Referring to the Organisation for Economic Co-operation and Development ('OECD') commentary, the Hon'ble Bangalore Tribunal held that if the payment is received to supply the existing information or reproduce the existing material, then it will constitute imparting of information so as to fall under the purview of royalty; and

The assessee's agreement was a composite one and some of the services were purely business/commercial practice and contract services, but the assessee has not furnished bifurcation of payment to each kind of services despite lower authorities requiring such information.

Thus, where a reasonable apportionment is not possible, then the other part of the services could also be given the like-tax treatment as given to one part of the services provided, which constitutes the principal purpose of the contract.

Domestic taxation

Section 147; ESOP; contingent expenditures

Case law 1: M/s Shriram Insight Share Brokers Limited Vs The Deputy Commissioner of Income Tax (ITA Nos.733, 734 & 735/Mds/2015)

An argument stating that reopening of assessment u/s 147 of the Act due to 'change of opinion' will not stand in court if the AO had not given an opinion in the first place in the original assessment.

Expenditure for the employee stock option plan ('ESOP') expenditure does not include within its ambit, expenditure incurred in order to buy back shares given under the ESOP scheme from the employees.

Claiming expenditures of a contingent nature as revenue expenditures is not correct and will not stand in the court of law.

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General facts of the case:

The assessee is a company engaged in the business of share-broking. The assessee introduced an ESOP scheme and opted to form a Trust through which it would offer stocks to its employees. The Trust purchased 350,000 equity shares from the existing promoters of the company with the advance money received by it from the assessee at a price of INR 15/- per equity share. Thereafter, it was allotted to eligible employees at a price of INR 15/- per equity share. Subsequently, the Trust purchased 32,700 equity shares from the employees at a price of INR 340/- per equity share. The assessee granted a sum of INR 111,80,000/- to the Trust for the purpose of buying back the equity shares from its employees which was claimed as expenditure by the assessee as ESOP cost.

In the case being discussed, many issues were placed in front of the Tribunal for discussion. A few of the issues were settled/straightforward matters without involvement of any complexity and hence, have not been highlighted below.

Issue 1: Reopening of assessment u/s 147 of the Act

Facts:

The assessment passed u/s 143(3) of the Act for AY 08-09 in December, 2010, was reopened by the AO u/s 147 of the Act in March, 2012 on the ground that the ESOP cost of INR 111,18,000/- cannot be allowed as expenditure in the hands of the assessee. In the original assessment, the said claim was allowed by the AO. The Ld. Counsel of the Assessee submitted that all the particulars were available with the AO from the beginning, and the reopening of assessment is only due to change of opinion. Therefore, the reopening cannot stand in the eye of law.

Decision of the Hon'ble Madras Tribunal:

Since there was no discussion in the assessment order about the cost incurred by the assessee for ESOP scheme and the AO has not framed any opinion in the original assessment, the Hon'ble Tribunal held that it cannot be said that the AO reopened the assessment due to change of opinion. For change of opinion, an opinion must have been formed by the AO in the original assessment order. Hence, it was held that the AO has rightly reopened the assessment.

Issue 2: Disallowance of ESOP expenses

Facts:

The AO disallowed the claim of the assessee in respect of INR 111,18,000/- which was utilised to buy back the equity shares from the respective employees. The Ld. Counsel for the Department claimed that the ESOP scheme cannot be extended for reimbursing the expenditure incurred by the Trust to buy back the shares from the assessee's employees.

Decision of the Hon'ble Madras Tribunal

The Hon'ble Madras Tribunal held in favour of the AO and stated that he was right in disallowing the claim of the assessee in respect of the sum which was utilised to buy back the equity shares from the employees. This decision was arrived at after due consideration of the following points:

- There is no material available on record to suggest that the shares were allotted to the employees of the assessee;
- The arrangement of purchase of the very same shares said to be allotted at INR 15/- per equity share and bought back at INR 340/- per equity share creates a doubt whether the shares were in fact allotted to the respective employees or not; and
- It appeared that the claim of the assessee was only made to reduce its taxable income.

Issue 3: Addition of contingent liability to total income

Facts:

The assessee showed a brokerage income of a particular sum. On the other hand, it claimed revenue expenditure of the same sum as the said brokerage was the excess amount collected by it from its clients and was under dispute. If the clients refuse to pay higher brokerage, then the assessee had to refund the same to the clients and therefore, the said amount was kept pending till the dispute was resolved. The AO rejected the claim of the assessee and the CIT(A) upheld the same.

Decision of the Hon'ble Madras Tribunal:

The brokerage income was treated as a revenue receipt in the books of account and the assessee was not liable to refund the same unless the decision was made in favour of the clients. Thus, the liability of the assessee was a contingent one. Accordingly, the Hon'ble Tribunal stated that the claim of the assessee cannot be considered as a revenue expenditure.

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Thus,

- **The reopening of assessment u/s 147 of the Act is valid only when the AO has not given an opinion on the matter in the original assessment;**
- **Expenditure incurred on buying back shares given to employees under the scheme of ESOP cannot be claimed as a deduction; and**
- **Claim of expenditure based on a contingent liability is not allowable.**

Recent important circulars and notifications issued by the Central Board of Direct Taxes ('CBDT').

1. Clarification for implementation of FATCA and CRS vide press release dated May 26, 2016.

An inter-governmental agreement between India and USA was signed for implementation of Foreign Account Tax Compliance Act ('FATCA'). To provide guidance for implementation of FATCA and Common Reporting Standard ('CRS'), a guidance note was released on August 31, 2015 which was subsequently updated on December 12, 2015. Further, a clarification was issued on February 19, 2016. Based upon comments and feedback received from the financial institutions, a further clarification has been issued. Clarifications provided therein are summarised below:

Self-certification can also be obtained through internet banking platform from user account where the customer has transaction rights;

Taxpayer Identification Number ('TIN') is not required to be collected from non-residents who may be eligible to obtain a TIN but has not yet obtained a TIN; and

Valuation of securities may be done at the values regularly communicated by depository to the depository participants/brokers.

A link for the same is provided herewith:

http://www.incometaxindia.gov.in/Lists/Latest%20News/Attachments/41/Clarification-for-FATCA-and-CRS-26-05-2016.pdf

2. Circular No. 20/2016 – extension of time limit for e-filing of appeals.

Rule 45 Income-tax rules, 1962 made e-filing of appeals mandatory with effect from March 01, 2016. However, in some cases, taxpayers were unable to do so due to lack of knowledge coupled with technical issues.

In order to mitigate the inconvenience caused to the taxpayers, it was decided to extend the time limit for e-filing of such appeals. The appeals which were due to be filed by May 15, 2016 can now be filed upto June 15, 2016.

A link for the same is provided herewith:

http://www.incometaxindia.gov.in/communications/circular/circular202016.pdf

3. Notification No. 38/2016 – Equalisation Levy Rules, 2016.

The finance ministry has notified the rules for implementation of equalisation levy, meant to nullify the advantage of foreign e-commerce firms, sans a physical presence in India over local competitors.

The CBDT circular brings in the details of the levy with regards to payment, statement of specified services required to be furnished, time limits, demand notice and appeal to Commissioner of Income tax in case of any disputes.

A link for the same is provided herewith:

http://www.incometaxindia.gov.in/communications/notification/notification382016.pdf

KNAV's comments:

The 'equalisation levy' is the move by the Indian government towards aligning itself with the OECDs action plan 1, i.e. addressing tax challenges of the digital economy on Base Erosion and Profit Shifting ('BEPS') and also to tackle problems of tax erosion and evasion.

The equalisation levy shall bring within its purview those transactions which were tax exempt due to operation of the DTAA. This will trigger tax in the hands of those persons who are either a non-resident in India or who do not have a PE in India.

4. Circular No. 12/2016 – admissibility of claim of deduction of bad debt under section 36(1)(vii) read with section 36(2) of the Act.

The intention of the circular is to eliminate fruitless litigation on the issue of allowability of bad debts in cases where the assessee fails to establish that the debt has in fact, become irrecoverable.

In view of the Hon'ble Supreme Court's decision in case of TRF Ltd in cross appeals no. 5292 to 5294 and in order to rationalize the provisions, the CBDT clarified that claim for any debt or part thereof in any previous year, shall be admissible under section 36(1)(vii) of the Act, if it is written off as irrecoverable in the books of accounts of assessee for that previous year and if it fulfils the conditions stipulated in section 36(2) of the Act.

A link for the same is provided herewith:

http://www.incometaxindia.gov.in/communications/circular/circular122016.pdf

KNAV's comments:

The clarification given by the CBDT is a step towards putting an end to futile litigations. This shall bring stability and certainty in the way assessments are concluded by the assessing officers. The circular also states that no appeals shall be entertained on this ground and the appeals already filed may be withdrawn.

5. Notification No. 35/2016 – The Direct Tax Dispute Resolution Scheme Rules, 2016.

The scheme provides an opportunity for settlement of cases emanating from retrospective amendment of tax laws, by asking companies to pay the basic tax demand and get waiver on interest and penalty.

The one-time tax dispute resolution scheme shall come into force on June 1, 2016.

A link for the same is provided herewith:

http://www.incometaxindia.gov.in/communications/notification/notification35_2016.pdf

KNAV's comments:

Litigation has been a major area of concern in direct taxes. The inflow of appeals in the system is higher than the disposals. As a result, the pendency keeps on increasing.

The scheme shall reduce the huge backlog of cases and shall enable the government to realise its dues expeditiously.

6. Notification No. 33/2016 – The Income Declaration Scheme Rules, 2016.

The scheme was announced by the Hon'ble Finance Minister Arun Jaitley in the budget with an aim to fish out black money from the domestic economy. The scheme is a one-time opportunity to all persons who have not declared income in earlier years, to come forward and declare such undisclosed income.

The four-month window under the Income Declaration Scheme 2016, which commences on June 1, 2016 allows domestic black money holders to declare their ill-gotten wealth by paying a tax and penalty totaling 45%.

A link for the same is provided herewith:

http://www.incometaxindia.gov.in/communications/notification/notification33_2016.pdf