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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 an important notification and circular issued by the Central Board of Direct Taxes.

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Transfer pricing

Case Law 1: Delphi Automotive Systems Pvt. Ltd. Vs. DCIT (ITA No. 1559/Del/2016)

In a case wherein one company has been held to be incomparable to another company in a particular judicial precedent, it does not mean that the aforesaid company stands incomparable for all other companies of a similar functional profile.
A refund cannot be adjusted against a demand in a case wherein the refund itself has not yet been crystallized.

Facts of the case:

The assessee had been involved in two international transactions i.e. provision of software development services and import of goods undertaken in manufacturing segment during the relevant previous year. During the assessment proceedings, the assessing officer (*'AO'*) raised demand on account of two transfer pricing (*'TP'*) adjustments pertaining to the aforesaid international transactions. Further, the AO had granted stay to the assessee subject to payment of 15% of the demand in two instalments. The assessee paid one of the instalments and proceeded to submit a stay application before the Hon'ble Tribunal. Before the Hon'ble Tribunal, relying on certain judicial precedents, the assessee contended that if 3 companies were excluded from the list of comparables and 1 company, which was rejected by the transfer pricing officer(*'TPO'*), was included as a comparable for assessee's software development services segment, then the TP adjustment would stand deleted.

Further, the assessee submitted that if the Bench was not convinced with the grant of stay, then the remaining amount payable should be allowed to be adjusted against the refunds amounting to INR 2.86 crores due to the assessee.

Decision by the Hon'ble Tribunal:

The Hon'ble Tribunal, rendering its decision, laid down an important principle pertaining to TP. It stated that axiomatically, when company 'A' is functionally different from company 'B', then such company cannot be considered as comparable. Further, notwithstanding the functional similarity, many a times a company ceases to be comparable because of other relevant reasons.

The Hon'ble Tribunal held that the crux of the matter was that the mere fact that company 'A' had been held to be incomparable in a judicial order passed in the case of company 'B', did not per se make it incomparable in all the subsequent cases to follow.

Thus, in view of the above principles, the Hon'ble Tribunal held that there can be no hard and fast rule that if a particular company has been held to be not comparable in the case of another company, then such former company would also cease to be a comparable to the assessee company as well.

With regard to the assessee's submission pertaining to adjustment of the demand against the refund due to the assessee, the Hon'ble Tribunal noted that the total refund of INR 2.86 crore comprised of refunds pertaining to AY 2013-14, AY 2014-15 and AY 2015-16. Noting that the assessment for AY 2013-14 was still in progress and there was time available for the scrutiny assessment, the Hon'ble Tribunal opined that the so called refunds, as claimed by the assessee as due to it, had not yet been crystallized.

Thus, the Hon'ble Tribunal held that when the refunds have not been determined, there can be no question of carrying out any adjustment against such refunds. Consequently, the Hon'ble Tribunal jettisoned this argument.

KNAV comments

The comparability of each company needs to be ascertained only after matching the functional profile and the relevant aspects of the concerned company. Sometimes, even though the functional profile of the assessee company and the company under consideration are similar, it is possible that the companies may not be comparable due to other relevant reasons. A few examples of relevant aspects that need to be considered to ascertain comparability have been listed as under:

- ***It is possible that the comparable company has related party transactions crossing a particular level;***
- ***It is possible that the comparable company only exports its products/services whereas the assessee company mainly focusses on domestic trade; &***
- ***It is possible that even though the functional profiles of the two companies are similar, the comparable company has a much higher turnover than the assessee company.***

Consideration of all the other relevant reasons is of high importance while listing down the comparable companies in the TP study process.

Case Law 2: Aithent Technologies Private Limited Vs. DCIT (ITA No. 6446/Del/2012)

Transaction between a head office in India and a branch situated in a foreign jurisdiction cannot be subjected to arms length price ('ALP') determination so as to make a TP addition.

Summary of the case:

The assessee is an Indian company having a branch office in Canada. In addition to that, it has a wholly owned subsidiary in USA. There were certain transactions between the assessee and its branch office in Canada, which were treated by the TPO as an international transaction and accordingly, adjustments were made by determining their ALP. The matter travelled till the Hon'ble Delhi Tribunal.

Decision of the Hon'ble Delhi Tribunal:

- Going by the definition of international transaction given under section 92B(1) of the Income tax Act, 1961 ('*the Act*'), there can be an international transaction only between two or more associated enterprises ('*AE*'). Since branch office is not a separate enterprise, there can be no question of treating transaction between head office and branch office as an international transaction;
- The practise of subjecting transactions between a head office and branch to TP provisions loses its essence when the head office is an Indian entity and the branch office is located outside India since section 5 of the Act taxes the entire global income earned by the Indian resident. The same could be illustrated as under:

Particulars	A *(ALP 100)*	B *(ALP 110)*
Purchase cost of Indian head office	95	95
Sale to branch/ purchase cost of branch	100	110
Sale to final customer by branch	120	120
Profit made by head office	5	15
Profit made by branch	20	10
Total profit taxed in India	**25**	**25**

Thus, there can never be any reason for an Indian head office to over or under invoice the goods or services to its foreign branch office; &

- Lastly, such a rationale can only be applied on transactions between Indian head office and foreign branch office. It is not the other way around and thus, if a foreign head office has a branch office in India, such Indian branch office will be considered as an AE and the transactions between the foreign head office and the Indian branch office will be `international transaction' subjected to ALP determination.

Thus, making a TP adjustment in respect of the international transactions between the Indian head office and the foreign branch office will result into charging tax on income which is more than legitimately due to the exchequer. Thus, the same cannot be made.

Case Law 3: Tega Industries Ltd Vs. DCIT (ITA No. 1912/Kol/2012)

Based on the facts of the case, if the intention of the assessee is not to earn interest or guarantee fees by providing loan or guarantee, no TP adjustments could be made.

Ground 1

Facts of the case:

The assessee is engaged in the business of manufacturing and specializing in the designs, production and application of water resistant rubber lining. During FY 2006-07, the assessee had set up an AE/subsidiary as a special purpose vehicle in Bahamas for acquiring two South Africa based companies. The assessee had provided interest-free loan and corporate guarantee to its AE , and used comparable uncontrolled price (*'CUP'*) as the most appropriate method for measuring the transaction at ALP. The assesse had *suo-moto* offered interest on such loan at LIBOR+ 100 bps. However, the TPO disregarded the contentions of the assessee, preferred cost plus method (*'CPM'*) and made upward adjustments for the same. Aggrieved by the order, the assesse filed an application before the dispute resolution panel (*'DRP'*), which confirmed the order of the TPO. Further aggrieved, the assessee filed an appeal before the Hon'ble Tribunal.

Decision of Hon'ble Tribunal:

- The assessee had injected loan to its subsidiary and provided guarantee for commercial expediency as the assessee had merged to expand its foreign operations;
- Thus the loan injected by the assessee was a kind of a quasi-equity i.e. in the form of equity;
- Further, the Hon'ble Tribunal preferred internal CUP or external CUP as the most appropriate method for applying in such transactions;

- The TPO had placed reliance on four out of seven ratios as prescribed by S&P Criteria to arrive at the credit rating and had identified a single loan transaction as comparable from 'Loan connector' having 'B' rating commanding a spread of 3% for the risk associated with its rating; &
- The Hon'ble Tribunal had restored the issue to the TPO to compute the credit rating of the entities a fresh by applying the scientific and logical method.

Ground 2

Facts of the case:

The assessee had provided corporate guarantee to ICICI bank UK, to provide funds to its subsidiary. As no guarantee fees were charged by the assessee, the TPO made transfer pricing adjustment @ 2.5% for the same.

Decision of the Hon'ble Tribunal:

In this regard the Hon'ble Tribunal held that since the assessee's intention for providing guarantee was not to act as a guarantor and thereby earn guarantee fees, but the intention was to protect the investment interest and expand its business operation. Thus, the TP adjustment on account of guarantee fees was directed to be deleted.

Since, the guarantee given by the assessee is a shareholder's function, no TP adjustment on account of corporate guarantee is required.

International tax

Case Law 1: M/s. Kotak Mahindra Bank Limited Vs. Income Tax Officer (ITA No. 3901/Mum/2013)

In order to be covered by the exception to royalty and fees for technical services under the provisions of the Act, it is not necessary that the payment should be in relation to an existing source of income.

When a payment falls under the purview of more than one Article in the Double Tax Avoidance Agreement ('DTAA'), the Article being of a more specific nature will override the Article being of a general nature.

Facts of the case:

The assessee, engaged in the banking business, paid certain legal fees to one legal firm situated in UK. As per the agreement, withholding tax @20% on gross amount was to be duly deducted and deposited by the assessee. In order to file an appeal u/s 248 of the Act, the assessee duly deposited the amount with the revenue authorities. Further, he preferred an appeal before the Commissioner of Income Tax (Appeals) ('*CIT(A)*') and contended that:

- The impugned payment was made to obtain market survey for the purpose of possible acquisition of a bank in foreign country and hence the impugned payment was incurred for the purpose of making or earning a source of income which is situated outside India;
- The impugned payment was not liable to be taxed in India as per the domestic laws as it is covered by the exception in section 9(1)(vi)/(vii) of the Act. As per the provisions stated in the section, royalty/FTS income paid by a resident of India is income deemed to accrue or arise in India except when it is for the purposes of making or earning any income from any source outside India; &
- The impugned payment was not liable to be taxed in India as per the Treaty provisions as well and hence, there was no liability to deduct tax at source in respect of this payment.

These contentions were considered but dismissed by CIT(A). Further, the CIT(A) held that impugned payment constitute royalty as per Treaty provisions on the ground that assessee is provided with specialized knowledge, skill and experience in the field of regulatory norms prevalent in the US which can be utilized independently by the assessee on his own without recourse to the service provider. Not agreeing to the assessee's contentions in respect of the income not being taxable under the domestic laws, the CIT(A) concluded that impugned payment is taxable both under domestic laws as well as under the Treaty provisions.

Aggrieved, the assessee preferred an appeal before the Hon'ble Tribunal.

Decision of the Hon'ble Tribunal:

The Hon'ble Tribunal considered the contentions of the assessee. The Tribunal placed reliance on the decision rendered in the case of ITO (International Taxation) Vs. Bajaj Hindustan Ltd. (ITAT Mumbai) (13 Taxmann.com 13) wherein it was held that it is no doubt true that the source of income had not come into existence. But there is nothing in section 9(1)(vii)(b) of the Act to show that the source of income should have come into existence so as to exempt the payment of fees for technical services. There is nothing in the language of section 9(1)(vii)(b) of the Act, which would go to show that the same is restricted to only an existing source of income.

Further, the Hon'ble Tribunal placed reliance on the observation of the Apex Court in the case of Commissioner of Income Tax Vs. Rajendra Prasad Moody (115 ITR 519) which stated that it is not necessary to show that the expenditure was a profitable one or that in fact any profit was earned. It was further observed that it is nowhere necessary that the purpose must be fulfilled to qualify the expenditure for deduction and it is not necessary that the expenditure must fructify into any benefit by way of return in the shape of income.

The Hon'ble Tribunal thus accepted the contention of the assessee that the impugned payment falls under the ambit of the exception in section 9(1)(vi)/(vii) of the Act and therefore, is not taxable as per the domestic laws.

The next argument relates with applicability of relevant Article of Treaty. Article 13 deals with 'Royalty and fees for technical services' whereas Article 15 deals with 'Independent professional services'. The Tribunal considered the nature of services being obtained by the assessee as contained in letter of engagement issued by the legal attorneys. The assessee had obtained legal services and such services find specific treatment as per Article 15 of the Treaty and therefore, is not covered by Article 13 which deals with 'Royalty and fees for technical services'.

Placing reliance on a few judicial precedents, the Hon'ble Tribunal observed that if there is an apparent conflict between two independent provisions of law, the special provision must prevail. The provisions of Article 13 have to give way to more specific provisions of Article 15 which will hold field in the present case. In accordance with the above observations, the Hon'ble Tribunal held that the impugned payments are not taxable in India as per the Treaty provisions.

Thus, the Hon'ble Tribunal was of the considered view that impugned payments are not taxable in India as per the domestic as well as the Treaty provisions. Hence, it held that the assessee was not liable for tax deduction at source from impugned payment.

Domestic tax

Case Law 1 : M/s. Stovec Industries Ltd. Vs. Addl. CIT (ITA No. 2812/Mum/2013, ITA No. 2449/Mum/2013)

It is the assessee's decision as to whether a particular expenditure should be incurred for the purpose of the business or not. The AO cannot determine the commercial expediency of the expenditure from the point of view of the revenue. Receipt on sale of goodwill to be taxed as long term capital gains, and not under the head of income from other sources.

Ground 1

Facts of the case:

The assessee was engaged in the business of manufacturing of rotary screens. The assessee had entered into an agreement with ATEMPL for sale of its products for a period of five years *(i.e. from November 28, 2002 to November 27,2007)*. As per the terms of the agreement, assessee was required to pay commission and in case of termination of agency ATEMPL was entitled to get compensation as per the formula given in the agreement. The assessee terminated the agreement in respect of the graphic division products since it closed the business of graphic division and consequently, paid the compensation. ATEMPL had offered the compensation received from the assessee to tax.

The AO disallowed the compensation and held it be capital expenditure.

On appeal before CIT(A), the assessee submitted that it had not acquired any enduring benefit or any income yielding asset and thus the said expenses was allowable as an expenditure u/s 37 of the Act.

However, CIT(A) upheld the decision of the AO.

Decision of the Hon'ble Tribunal:

The Hon'ble Tribunal noted that the assessee had incurred a loss of INR 98.2 lakhs from the graphic division and as a result of hive off, it was prohibited from dealing the same or similar products as that of graphic division. The Hon'ble Tribunal opined that it was up to assessee to decide as to how much and when certain expenditure ought to be incurred or not.

Thus, the Hon'ble Tribunal held that the AO cannot sit in the proverbial 'armchair' of the assessee to decide the incurring of expenditure. It is the prerogative of the assessee to run the business in a particular manner. The Hon'ble Tribunal further stated that if the expenditure was incurred, the AO could not question the justification of incurring of the expenditure unless the said expenditure was incurred for the purposes prohibited by the law.

Therefore, applying the test of commercial expediency, to determine whether the expenditure was wholly and exclusively laid out for the purpose of the business the reasonableness of the expenditure has to be just from the point of view of the businessman and not the revenue. The jurisdiction of the revenue is confined to 'deciding the reality of the expenditure' namely whether the amount claimed as deduction was factually expended or laid down and whether it was wholly and exclusively for the purpose of the business.

Ground 2

Facts of the case:

The assessee received INR 10 lakhs on sale of goodwill from TISIPL. The assessee claimed it as long term capital gain ('*LTCG*'). The AO held that the said amount was received as non-compete fee as per the agreement, thus treating it as income from other sources. On appeal, CIT(A) upheld the order of the AO.

Aggrieved, the assessee preferred an appeal before the Hon'ble Mumbai Tribunal.

Decision of the Hon'ble Tribunal:

- The Hon'ble Tribunal noted that the assessee had disposed off the assets for a total consideration of INR 15.24 crore and the break-up of the consideration included INR 10 lakhs under the head goodwill, marketing information, know-how and approvals;
- It further noted that section 55(2)(a)(ii) of the Act deals with the cost of acquisition in respect of goodwill of business or a right of manufacture, produce or process any article or thing right to carry on business;

- The Hon'ble Tribunal accepted the assessee's contention that assets under consideration were self-created/generated assets and therefore, the cost of acquisition was to be taken as 'nil' as per section 55(2)(a)(ii) of the Act. It also noted that the assessee did not claim any depreciation u/s 32 of the Act with regards to goodwill; &
- Considering the above, the Hon'ble Tribunal held in favour of the assessee stating that the assessee had rightly offered the entire sale consideration as LTCG and the amount was not taxable under income from other sources.

Case Law 2: Oil and Gas Corporation Ltd. Vs. Addl. CIT (TDS) ([2016] 73 Taxman.com 273)

Interpretation of the word 'uniform' in the context of dressing carries a vastly different connotation and would include precise instructions.

Facts of the case:

- Oil and Gas Corporation Ltd (*'ONGC/the company /the appellant/the employer'*) was providing the benefit of uniform allowance to its employees u/s 10(14)(i) of the Act. Thus, the payment made to the employees was exempt in the hands of the employees;
- No tax was deducted at source (*'TDS'*) by the employer on such payment;
- However, it was recorded by the TDS officer that the employer had not prescribed any uniform for the organisation and hence, the payment to the employees would not be covered under the purview of section 10(14)(i) of the Act;
- Further, the TDS officer also relied on the fact that the company had prescribed uniform for its employees earlier which was however discontinued in 1995. The same was also corroborated by one of the senior staff;
- In this regard the appellant stated that a circular was issued by the company pertaining to the dress code prescribed for the employees; &
- The assessee was of the opinion that the dress code at work place would qualify as uniform.

Decision of the Hon'ble Tribunal:

- The term 'uniform' in the context of dressing carries a vastly different connotation and would necessarily include precise instructions as to the dress, design and also colours which will achieve a uniformity in dressing at work place;
- However, the term 'uniform' in the context of dressing carried a precise meaning and a meaning which was entirely different from a far broader concept of a dress code;
- Thus, it was held that the dress code provided by the employer was not considered as uniform;
- Therefore, the payments made in the nature of uniform allowance to the employees is not exempt in the hands of the employees; &
- Hence, the employer was liable to deduct tax at source.

Thus the words 'uniform' and 'dress code' cannot be read in the same parlance as there is a vast difference in their meaning.

Recent important circular and notification issued by the Central Board of Direct Taxes ('*CBDT*')

1. Circular No. 35/2016 dated October 13, 2016 – Applicability of TDS provisions of section 194-I

The CBDT has clarified herewith by way of a circular that lump sum lease premium or one-time upfront lease charges, which are not adjustable against periodic rent, paid or payable for acquisition of long-term leasehold rights over land or any other property are not payments in the nature of rent within the meaning of section 194-I of the Act. Therefore, such payments are not liable for TDS under section 194-I of the Act.

A link for the same is provided herewith:

http://www.incometaxindia.gov.in/communications/circular/circular35_2016.pdf

2. Notification No. 94/2016 dated October 17, 2016 – Special provisions relating to tax on distributed income of domestic company for buy-back of shares.

The CBDT has hereby provided rule 40BB for the purpose of section 115QA of the Act stating that the amount received by a company in respect of the shares issued by it, being the subject matter of buy-back referred to in section 115QA of the Act, shall be determined in accordance with rule 40BB. The said rule shall be applicable from June 1, 2016.

A link for the same is provided herewith:

http://www.incometaxindia.gov.in/communications/notification/notificaiton942016.pdf

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