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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 press release and clarification issued by the Central Board of Direct Taxes.

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Transfer pricing

Case Law 1: Copal Research India Pvt. Ltd. Vs. DCIT (ITA No. 7079/Del/2014)

Companies engaged in knowledge processing outsourcing (‘KPO’) business couldn’t be taken as a comparable for benchmarking the transactions entered into by a company involved in provision of information technology enabled service (‘ITES’) back-end support services.

Facts of the case:

The assessee was engaged in providing information technology (‘*IT*’) enabled back office support services and software development services to its group entities. For rendering such services, the assessee was remunerated on cost plus mark-up basis. For the purposes of benchmarking the transaction, the assessee had used multiple year data which was objected by the transfer pricing officer (‘*TPO*’). Later, the TPO carried on a fresh search and arrived at a profit level indicator (‘*PLI*’) at 29.87% by proposing a set of 10 fresh comparables. Further, the TPO also charged interest at the rate of 14.88% p.a. for delay in receipt of payments from its associated enterprise’s (‘*AE*’) in respect of the services rendered.

The assessee filed it’s objections before the dispute resolution panel *(‘DRP’)*. However, the TPO passed the order without giving effect to the directions given by the DRP and after selecting a certain set of comparables.

Aggrieved, the assessee preferred an appeal before the Hon’ble Tribunal against the action of the TPO which excluded six comparables chosen by the assessee *(reason being the comparables didn’t meet the export earning filters)* and included another six comparables for the purpose of deriving at final PLI.

Held by Hon’ble Tribunal:

The Hon’ble Tribunal agreed with the action of TPO in respect of excluding six comparables because of them failing in respect of export earning filters. Further, in case of six comparables that were included additionally by the TPO, the Hon’ble Tribunal, deleting the same, stated as follows:

- There is a difference between the KPO and low-end ITES enabled service provider. A KPO is a high-end value added process chain wherein the processes are dependent on advanced skills, domain knowledge and the experience of the persons carrying on such processes.
- Further, if the entity has undergone an extraordinary event by way of amalgamation/acquisition, and net profitability of which had been impacted, such comparable shall not be included.
- Also, comparable owning significant intellectual property rights (‘*IPRs’)* brands which impact net profitability, shall be excluded.

Based on the aforementioned principles, the assessee’s appeal was partly allowed.

Case Law 2: M/s Visteon Asia Holdings Inc. Vs. DCIT (ITA No. 723/Mds/2016)

Shares have to be valued in accordance with the discounted cash flow (‘DCF’) method after giving due consideration to the factors such as time gap and market fluctuations.

Summary of the case:

The assessee company, incorporated in USA, held shares of its Indian entity which were valued at INR 10.32 per share. These shares were sold to its Mauritian holding entity at INR 10.32. However, the assessing officer (‘*AO’)* estimated the valuation of such shares at INR 36.31 per share. Thus, the AO considered the sale consideration to be underestimated and accordingly levied capital gain tax.

Aggrieved, the assessee preferred an appeal before the higher appellate forums. The matter travelled upto the Hon’ble Chennai Tribunal which held as under:

- Since the shares were sold to the subsidiary entity, the transaction is considered between the associated enterprises and hence the sale proceeds have to be determined by ascertaining arms’ length price.

- The shares are to be valued by DCF method.
- Since the issue under consideration pertained to AY 2013-14, share valued by separate chartered accountant and accepted by the Tribunal for AY 2007-08 cannot be considered.
- Due to time gap, the fluctuation in the market rate and value of capital asset of the company have to be taken into consideration for the purpose of valuing the shares under DCF method.
- Therefore, the shares valued by the AO using the DCF method for AY 2013-14 i.e. INR 36.31 shall be considered for computing capital gain tax.
- Further, the assessee had raised an additional issue stating that since no original assessment was made, the AO cannot reopen the case. To this, the Hon'ble Tribunal held that even though no original assessment was made, AO can always reopen the assessment u/s 147 of the Income tax Act, 1961 ('*the Act*').

Case Law 3: Principal Commissioner of Income Tax Vs. Adani Enterprises Ltd. (Tax Appeal No. 574 of 2016)

Upward adjustment of guarantee commission cannot be made where the assessee did not provide any guarantee to its AE, even if it had originally intended to do so.

Summary of the case:

- The assessee's AE in Singapore raised a term loan from ICICI Bank Ltd. for which the assessee intended to provide guarantee by pledging shareholding of Mundra Port and SEZ Limited owned by the assessee. However, before the same could be done, permission of the Reserve Bank of India ('*RBI*') was required to be obtained. The RBI did not grant such approval and therefore the assessee couldn't give the guarantee.
- The AO referred this matter to the TPO who stated that despite the refusal of the RBI, the assessee may have proceeded to provide the guarantee and consequently, AE and the bank may have proceeded further with the term loan on the basis of such guarantee. He further claimed that the RBI letter was regarding pledging of shares in favour of M/s. IDBI Trusteeship Services Limited and not concerning ICICI Bank Limited. Based on the TPO's order, the AO proceeded to make an upward adjustment.
- On carrying the matter in appeal before the CIT(A), the CIT(A) reversed the decision of the AO observing that since IDBI Trusteeship Ltd is the security trustee of ICICI Bank Limited, Singapore, RBI's letter refusing permission for pledge of the shares refers to the same transaction. Since it was clear that the assessee did not provide guarantee service by pledging the shares, upward adjustment of guarantee commission could not be made.
- The Revenue filed an appeal before the Hon'ble Tribunal, which upheld the view of the CIT(A) stating that since there was no international transaction within the meaning of section 92C of the Act, no adjustment could be made.
- The Revenue further preferred an appeal before the Hon'ble Gujarat High Court. The Hon'ble High Court held that there is nothing on record to show that the assessee went on to pledge the shares despite the refusal received from the RBI. The Hon'ble High Court upheld the view of the CIT(A) and the Hon'ble Tribunal and accordingly, dismissed the appeal.

Case Law 4: M/s. Lason India Pvt. Ltd. (Now M/s. Source HOV India Pvt. Ltd.) Vs. Joint Commissioner of Income (ITA No. 1026/Mds/2014)

Pass through costs do not include payments made by the assessee to its subsidiary and other independent units if it is proved that these payments have not been made on behalf of the AE of the assessee.

Facts of the case:

The assessee is a wholly owned subsidiary of Lason System Inc. USA which is in turn held by Lason Inc., Michigan USA. The assessee is engaged in rendering data conversion services to its ultimate parent company Lason Inc., Michigan USA ('*parent company/AE*') in the area of forms processing, e-publishing and support systems and software services. The assessee's return for AY 2009-10 was selected for scrutiny and was further referred to the TPO for computation of ALP as the assessee had initiated international transactions exceeding INR 15 crores. The TPO passed an order u/s 92CA of the Act making an upward adjustment.

The assessee filed its objections before the DRP wherein the DRP accepted certain objections and issued directions to the AO accordingly. However, the DRP upheld the action of the TPO with regard to the other objections.

Aggrieved, the assessee preferred an appeal before the Hon'ble Tribunal on the following issues:

Issue 1: Whether cost on outsourced work by the assessee is to be included in operating cost while computing the PLI?

Facts:

The assessee outsources its work to its Indian subsidiary and other independent units. The parent company reimburses the assessee on cost plus 7% mark up. The assessee claimed that the pass through cost paid to the Indian subsidiary should be excluded from both the income and expenditure of the assessee while computing the PLI as it has no nexus with the actual operating income and expenditure of the assessee. The TPO rejected the contention of the assessee. Upholding the decision of the TPO, the DRP held that the abovementioned cost cannot be considered a pass through cost at all. The assessee had raised the bills upon its AE and received the payment from its AE. For the work got done by the assessee from its subsidiary and other independent units the bills have been raised by these entities on the assessee and the assessee has made the payment to them on its own account and not on behalf of the AEs.

Decision of the Hon'ble Tribunal:

The Hon'ble Tribunal held that the TPO is justified in considering the pass through cost for arriving at the operative cost. The undermentioned points were taken into consideration by the Hon'ble Tribunal:

- The assessee itself included the pass through cost in its profit and loss account.
- The assessee raised bills upon its AE as payment from its AE and received the payments from its AEs. The work got done by the assessee from its subsidiary and other independent units, the bills were raised by these entities on the assessee and the assessee made the payments to them on its own accounts and not on behalf of the AEs.

Thus, the payments by the assessee to its subsidiary and other independent units cannot be treated as pass through cost as it is not the payment from the AE to subsidiary of the assessee.

Issue 2: Whether certain companies are acceptable as comparables of the assessee?

Facts:

The assessee preferred an appeal on the ground that the TPO grossly erred in choosing certain comparables which were functionally different or had extra-ordinary activities.

Decision of the Hon'ble Tribunal:

The Hon'ble Tribunal considered each company individually and held whether they were appropriate to be taken as a comparable or not. The summary of the decision of the Hon'ble Tribunal is mentioned hereunder:

- In a case wherein the considered company is mainly engaged in the same business as the assessee *(i.e. the business of ITES)*, and neither its receipts nor expenditure have influenced its financials, there is no reason to exclude the said company from the comparables.
- In a case wherein the acquisition of another company by the considered company is of no relevance to the assessment year in consideration, there is no reason to exclude it from the comparables.
- In a case wherein there is an extraordinary event like merger/de-merger involving the considered company, which will affect the profitability of the company in the assessment year in consideration, such company cannot be considered as a comparable of the assessee.
- In a case wherein the considered company has super profits, or high turnover, or it's a loss making company, it cannot be considered as a comparable if the same are regarded as exceptional items.

International tax

Case Law 1: M/s Mahindra-BT Investment Company (Mauritius) Limited (AAR No. 991 of 2010)

Factors leading to determination of control and management of entity outside India examined.

Summary of the case:

The applicant, a Mauritian resident, had acquired certain shares in Tech Mahindra Limited ('*TML*'). AT&T International Inc. ('*AT&T*'), the applicant and TML entered into an options agreement whereby, AT&T was given an option to purchase 9,931,638 shares of TML held by applicant on achieving certain milestones stipulated in the agreement.

The milestone was achieved by AT&T and subsequently shares were transferred by applicant to AT&T and long term capital gain was earned on such transfer. The applicant raised question before the Authority of Advance Rulings *('AAR')* as to whether the capital gains earned by applicant is chargeable to tax in India after considering Article 13(4) of the DTAA?

Arguments of the revenue:

- The only activity of the applicant is acquisition of shares of TML and holding the same for the purpose of transfer. The applicant was incorporated without any economic substance with sole purpose to hold the shares to facilitate a tax neutral transfer of shares.
- The shareholder agreement says that the applicant will cease to exist on execution of the transfer of shares to AT&T.
- The financial statements of the applicant show no business activity other than holding investments in TML.
- The real transaction was between TML and AT&T and therefore, the control and management of the applicant should be treated as situated in India.

Arguments of the applicant:

- The applicant was set up for a commercial purpose and there is nothing in law that prohibits incorporating a company for a special purpose.
- The arguments of the Revenue that the incorporation and existence of the applicant was for the sole purpose of transferring shares of TML to AT&T is factually incorrect as the applicant even today continues to hold shares of TML.
- Further, various important decisions on financial matters, approving financial budget, dividend declaration decisions, share buy-back, option agreements, etc. were taken in Mauritius by the applicant's Board of Directors *('BoD')*.

Ruling of the AAR:

The AAR cited that there is nothing wrong in the applicant holding the shares and transferring the same at a later stage as per the options agreement. Merely the argument that real transaction was between TML and AT&T and thus, the control and management was situated in India finds no force. Thus, it was held that the income earned by applicant was not chargeable to capital gains tax in India.

KNAV comments:

Certain factors that help in substantiating existence of control of management outside India are:

1. ***The entity must be managed independently by the BoD residing in the relevant foreign jurisdiction;***
2. ***Governing documents of the entity must give power to the BoD;***
3. ***All the directors should be competent and independent;***
4. ***All the meetings of the BoD must have been conducted in that relevant foreign jurisdiction;***
5. ***Statutory books of account, minutes of the meeting and other relevant records should be kept and maintained at the registered office of the entity;***
6. ***Banking account must be in that relevant foreign jurisdiction and all banking transactions should be conducted through that bank account; &***
7. ***All decisions relating to financial matters, approval of financial budgets and statements, decisions on declaration of dividends should be taken by the BoD in the relevant foreign jurisdiction.***

Case Law 2: Shri Praful Chandaria Vs. Assistant Commissioner of Income Tax (ITA No. 4313/Mum/2011)

The consideration received by an assessee, not being a consideration for the transfer of shares but consideration for transfer of substantial rights in shares, to be taxed as capital gains and not income from other sources.

When assessee receives consideration for transfer of substantial rights in a share, assessee is to be given the benefit wherein the taxing rights is given to the state where assessee is resident.

Facts of the case:

The assessee, a Singaporean resident, had acquired 99.99% of the shareholding in Purse Holding (India) Pvt Ltd. ('*PHIL*'). PHIL was established as a special purpose vehicle ('*SPV*') along with ING Barring Mauritius ('*BM*') to invest in an Indian company named as ING Barring India Pvt Ltd. ('*BI*').

The assessee along with two other directors having one equity share each, entered into a 'call option agreement' with BM to sell their stake in PHIL to BM at USD 1 to be exercised within 150 years.

A few important terms of the agreement as carried out are mentioned hereunder:

- Upon the receipt of call notice and the payment of call value, the first shareholders shall be obliged to transfer the shares to BM within one month of the payment of call value.
- An irrevocable power of attorney has also been executed by the assessee in favour of the ING Bank in respect of all the shares in PHIL.
- Assessee has given powers to attend otherwise take part in all the meetings held in connection with PHIL in relation to all the shares in the company held by him from time to time.

The assessee had received payments of USD 2,450,000 for writing the aforesaid call options. The AO taxed the aforesaid payments as income from other sources, stating that the income was arising out of transfer of property situated in India or from an asset and source of income in India as per section 5(2) read with section 9(1)(i) of the Act and hence should be taxed as 'income from other sources'.

On an appeal by the assessee, the CIT(A) upheld the decision of AO. Aggrieved, the assessee filed an appeal with the Hon'ble Tribunal on the following issues:

Decision of the Hon'ble Delhi Tribunal:

Issue 1: Whether the income is to be taxed as income from other sources or capital gains?

It was held that the said amount cannot be taxed as 'income from other sources' since the peculiar conditions under the call option agreement has to be reckoned as transfer of a valuable and substantive right, which would certainly be a 'capital asset' referring section 2(14) read with section 2(47). Hence, the same should be taxed as 'capital gains'.

Issue 2: Whether the taxing right is to be given to India or Singapore?

It was held that in a case wherein a non-resident is being subjected to tax for any income accrued or arising in India, the Articles of the DTAA have to be considered and the resultant benefits have to be given. The amount held to be taxed as 'capital gain' cannot be brought to tax in India, as Article 13 of India-Singapore-DTAA states that the taxing right has to be given to a resident state i.e. Singapore in case of alienation of any asset or property.

Domestic tax

Case Law 1: Jitendra Kumar Soneja Vs. Income Tax Officer (ITA No. 291/Mum/2015)

A capital receipt, in principle, is outside the scope of income chargeable to tax and a receipt cannot be taxed as income unless it is in the nature of revenue receipt or is brought within the ambit of income by way of a specific provision in the Act.

Facts of the case:

The assessee, a member of cooperative housing society, received compensation from developer towards hardship caused to assessee on redevelopment and also received money for paying rent while development of the project was taking place. The AO made addition to the income of the assessee, with regards to money received as corpus fund by the assessee during FY 2006-07 and also rental appearing as credited to his bank account, for which assessee failed to explain the reasons for non-disclosure in his return of income.

Accordingly, the AO treated the same as unexplained credits and added the same to the assessee's income under the head 'income from other sources'.

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

Decision of the Hon'ble Tribunal:

The Hon'ble Tribunal placed reliance on the decision of coordinate bench in the case of Kushal K Bangia Vs. ITO (ITA No.2349/Mum/2011) wherein it was held that as section 2(24)(vi) of the Act provides that income includes 'any capital gains chargeable u/s 45', it is clear that a capital receipt simpliciter cannot be taken as income, and no matter how wide be the scope of income u/s 2(24) it cannot obliterate the distinction between capital receipt and revenue receipt. It was further explained that the compensation received by the assessee is not in the revenue field because the residential flat owned by the assessee in society building is certainly a capital asset in the hands of the assessee and compensation is referable to the same.

In view of these discussions, the Hon'ble Tribunal held that same would be outside the ambit of income u/s 2(24) of the Act. However, it will end up reducing the cost of acquisition of the asset, i.e. flat, at the time computing capital gains in respect of the said asset.

Subject to these observations, the Hon'ble Tribunal upheld the grievance of the assessee.

With regards to the addition of the rental amount, the assessee had in fact submitted that he had made an expenditure of a substantial amount towards rent while development activity of the project had taken place. Thus, the Hon'ble Tribunal directed the AO to allow the claim of assessee to same extent because it is not the assessee's income but compensation received by assessee for paying rent.

In view of the above, receipts, unless it is in the nature of revenue receipt or is brought within the ambit by way of a specific provision in the Act cannot be taxed under the Act.

Recent important press release and clarification issued by the Central Board of Direct Taxes ('*CBDT*')

1. Press release dated September 09, 2016 – CBDT extends due date for filing of income tax returns:

The due date for filing of income tax returns by tax payers whose accounts are required to be audited under the Act is September 30 of the following year. Taking into consideration the last date for making declarations under the Income Declaration Scheme 2016 is also September 30, 2016, the CBDT has decided to extend the last date for such returns to October 17, 2016 in order to remove inconvenience and to facilitate ease of compliance.

A link for the same is provided herewith:

http://www.incometaxindia.gov.in/Lists/Press%20Releases/Attachments/520/Press-release-Extension-of-date-ITRs-09-09-2016.pdf

2. Clarification F. No. 225/195/2016-ITA dated September 14, 2016:

In line with the press release issued by CBDT on September 09, 2016 relating to extension of the due date to file income tax returns, the board has clarified that the extended 'due date' would also apply for the purpose of section 44AB of the Act i.e. for the purpose of filing of tax audit reports.

A link for the same is provided herewith:

http://www.incometaxindia.gov.in/Lists/Latest%20News/Attachments/77/Clarification-us-119-of-the-Income-tax-Act-1961-14-09-2016.pdf

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