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DIRECT TAX UPDATE

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1. Transfer Pricing

a. Case law - Bharti Airtel Limited Vs. Addl. Commissioner of Income Tax [I.T.A. No.: 5816/Del/2012]

A transaction such as a corporate guarantee which has no bearing on profits, incomes, losses or assets of the enterprise is not an 'international transaction' u/s 92B(1) and not subject to transfer pricing.

Facts of the case:

The assessee had issued a corporate guarantee to Deutsche Bank, New Delhi Branch on behalf of its associated enterprise ("AE"), Bharti Airtel (Lanka) Pvt. Ltd., for the repayment of working capital facility enjoyed by the AE. The assessee had not incurred any costs or expenses on account of issue of such guarantee, and the guarantee was issued as a part of the shareholder activity for NIL consideration. However, based on market quote of such corporate guarantee, the assessee, in its transfer pricing study, determined arm's length commission for issuing such guarantee @ 0.65% p.a. of the guarantee amount.

The Transfer Pricing Officer ("TPO") while benchmarking the said transaction relied on Para 7.13 of the OECD guidelines which states that "but an intra -group service would usually exist where the higher credit rating were due to a guarantee by another group member" and further held that the said transactions had to be benchmarked applying CUP method, and, accordingly, determined arm's length price of the guarantee commission income @ 2.68% plus a mark-up of 200 basis

points on the basis of data obtained from various banks under section 133(6) of the Act. The TPO also referred to the decision of the Tax Court of Canada in case of GE Capital Canada Inc Vs. The Queen (2009 TCC 563).

The Dispute Resolution Panel ("DRP") rejected the assessee's objection of "this transaction does not attract transfer pricing provisions" on ground that the issue was decided in light of the amendment to Section 92 B and that "retrospective amendment to Section 92B by the Finance Act 2012 makes this *(issuance of a corporate guarantee)* an international transaction".

Decision of the Tribunal:

The Hon'ble Tribunal:

- undertook a thorough analysis of Section 92B and held that in a situation in which a transaction has no bearing on profits, incomes, losses or assets of such enterprise, the transaction will be outside the ambit of expression 'international transaction';

- that the guarantees do not cost anything to the enterprise issuing the guarantees and yet it provides certain comfort levels to the parties doing dealings with the associated enterprise. Such guarantees thus do not have any impact on income, profits, losses or assets of the assessee; and

- in such cases, the onus is on the revenue authorities to demonstrate that the transaction is of such a nature as to have "bearing on profits, income, losses or assets" of the enterprise so as to include it in the ambit of transfer pricing.

Thus, even after the amendment in section 92B, by amending Explanation to section 92B, a corporate guarantee issued for the benefit of the AEs, which does not involve any costs to the assessee, does not have any bearing on profits, income, losses or assets of the enterprise and, therefore, it is outside the ambit of 'international transaction' to which ALP adjustment can be made.

Before parting with the issue, the Hon'ble Tribunal has also distinguished the foreign decision in case of GE Capital Canada Inc Vs The Queen (2009 TCC 563), on the issue of ALP adjustments in

guarantee commission, where the Tax Court of Canada had indeed dealt with ALP determination of the guarantee fees but it was done in the light of Canadian domestic law provisions which were quite at variance with the Indian transfer pricing legislation. Unlike elaborate wordings of Section 92 B of the Indian Income Tax Act, 1961 defining ' international transaction', Section 247 of the Canadian Income Tax Act only gives an inclusive definition which does not even really attempt to define the expression ' transaction'.

b. Case law - Honda Trading Corpn. India Private Limited Vs. Deputy Commissioner of Income Tax [ITA No. 4811/Del/2012]

TPO not justified in rejecting audited segmental profitability.

Facts of the case:

The assessee, subsidiary of Honda Trading Corporation, Japan, is engaged in the business of trading of a variety of products such as steel products, dies, components of auto-mobiles, motorcycles, scooters and other automotive components, and equipment etc. It had entered into import and export transactions with its AE. For benchmarking the international transaction of export and import of parts and steel/resin, search and screening process undertaken by the assessee, in the transfer pricing document, resulted in 2 comparable companies, earning a mean operating margin of 0.21% vis-à-vis
the assessee's operating profit margin (OP/OC%) of 5% which was based on an audited segmental profit & loss statement. The TPO rejected the said profit & loss statement on the grounds that such segmentation was not a part of the audited accounts of the assessee and has been prepared based on test checks.

Decision of the Tribunal:

The Hon'ble Tribunal has relied on:

- Standard of Accounting (SA) 530 (Revised) which allows the use of sampling and test checks in order to draw true and fair picture of the accounts; and

- The decision of Technimount ICB India P. Ltd. vs. ACIT [ITA No. 7098/Mum/2010] wherein it has been held that segmental results

should be taken into account while arriving at the arm's length price.

c. Case law - Adaptec India Private Limited Vs. Assistant Commissioner of Income Tax [ITA No. 1758/Hyd/2012]

Exclusion of Infosys Technologies Limited and Wipro Limited as comparables, considering enormity of turnover.

Facts of the case:

The assessee was engaged in the business of software design, development and testing in the areas of high performance storage solutions. It also rendered software development services to its AE i.e., Adaptec Inc, USA for which it was remunerated on a cost plus mark-up.

The TP study was rejected by the TPOon the ground that multiple year data was considered while selecting comparables and that the companies engaged in software development have been treated as comparables irrespective of the verticals/horizontals of software services. The TPO selected 19 companies as comparables with average margin of 26.20% and made an adjustment of Rs. 1,82,73,532.

Before the DRP, the assessee contended that the TPO had excluded companies having turnover less than Rs. 1 Crore and thus companies having extraordinary high turnover should also be excluded for comparability analysis. The assessee's objections were rejected by the DRP.

Decision of the Tribunal:

The Hon'ble Tribunal observed that Infosys Technologies Limited and Wipro Limited had turnover of more than 900 times of that of the assessee and have emerged as market leaders and IT giants performing additional functions, assuming risks and employing unique intangible assets. Relying on the ratio laid down by the Hon'ble Delhi High Court in the case of CIT Vs. Agnity India Technologies Private Limited, the Hon'ble Tribunal directed the AO/TPO to exclude Infosys

Technologies Limited and Wipro Limited since the said comparables were big companies and couldn't be compared to small captive service providers.

d. Case law - Deputy Commissioner of Income Tax Vs. The Indian Hotels Company Limited[ITA No. 6712/Mum/2008]& [ITA No. 2678/Mum/2009]

Facts of the case:

a) Loan to AE

The assessee had given a loan to one of its AEs by charging interest at LIBOR as per the approval of the RBI and to another AE @9%. During the proceedings, the TPO took this as an internal comparable and made an adjustment thereof. The CIT (A) deleted the said adjustment on the grounds that the loan to the other AE was a controlled transaction and the RBI approval was to be considered as CUP.

b) Corporate Guarantee on behalf of AE

The assessee had provided letter of comfort to 3 banks in respect of the borrowings by its AE and had not charged any guarantee fees thereof. The TPO made an adjustment @0.6% towards guarantee fees. On appeal, the CIT (A) held that the Comfort letters required the assessee mainly to intimate the banks in case it decides to divest/dilute its stake in the subsidiaries and there was no mention/obligation or liability on the assessee to repay the loans in case its subsidiaries failed to do so. It was further held that the letters of comfort thus could not be equated with guarantee and addition made by the AO/TPO by way of adjustment treating the same as bank guarantee was deleted by the CIT(A).

c) Sales and Promotion services rendered by AE

The AE rendered sales and promotion services to the assessee for which it was remunerated on cost plus mark-up of 10%. The assessee benchmarked the transaction using Indian Comparable Companies which was rejected by the TPO on the ground that assessee itself cannot be taken as the tested party and a fresh study by taking the US AE as the tested party was conducted. The assessee selected 16 US comparable companies and arrived at an arithmetic mean of 11.49%.

The TPO rejected 2 comparables of the assessee and thus this resulted in an arithmetic mean of 6.78% vis-à-vis the 10% paid by the assessee and an adjustment was made thereof. On appeal, the CIT(A) held as under:

- there was nothing wrong on the part of the assessee to take itself as tested party since the data of Indian comparable companies was easily available in the public domain;
- the relevant data in the case of US comparable companies, on the other hand, was available to the limited extent and there was no justification given by the AO/TPO to take the AE of the assessee in US as a tested party; and
- since the profit margin earned by the assessee at 8.75% (entity) was higher than that of the average profit margin earned by Indian comparable companies at 2.36% (entity), the transaction was at arm's length.

Accordingly, the adjustment made by the AO/TPO on this issue was deleted.

Decision of the Tribunal:

a) Relying on the decision of Hinduja Global Solutions Ltd. Vs. ACIT [ITA No. 254/mum/2013], the Hon'ble Tribunal held that the CUP method is the most appropriate method to determine the arm's length rate of interest of the international transaction involving lending of money by the assessee company in foreign currency to its AE and LIBOR being inter-bank rate fixed for the international transaction has to be adopted as arm's length rate and the ground of the revenue was thus dismissed.

b) The Hon'ble Tribunal restored the issue back to the file of the AO/TPO for adjudicating afresh since neither the TPO nor the CIT(A) had given any finding/observation regarding the assessee's argument that the giving a letter of comfort was not in nature of international transaction.

c) The Hon'ble Tribunal dismissed the revenue's appeal by holding as under:

- the relevant data for the US comparable companies was incomplete and unreliable to justify the adjustment made by the AO/ TPO.
- the finding recorded by the CIT (A) has not been rebutted or controverted by the DR; and
- the DR wasn't able to point out any reasons given by the AO/TPO to justify the change of tested party from the assessee company to the AE in US.

2. Domestic Taxation

a. Case law - Neelkamal Cables Pvt Ltd vsACIT,Palanpur [ITA No 1831/Ahd/2012]

Transfer of factory building & land considered as a case of transfer of series of assets individually and not as transfer of the entire business undertaking as a whole.

Facts of the Case:

The assessee sold its factory land and factory building along with bore well for composite consideration and considered the same as sale of undertaking and disclosed the gains derived there from as long-term. The Assessing Officer ("AO") held that the depreciation was claimed by assessee on factory building and as transaction was sale of a depreciable asset; he treated capital gains derived there from as short-term capital gains.

The CIT(A) held that transfer of capital asset in question could be treated as transfer of an undertaking and therefore capital gains derived there from was to be treated as long-term capital gains and directed AO to accept same as long-term capital gains as disclosed by assessed in return.

The Revenuefiled appeal before the Tribunal on the sole ground that the CIT(A) has erred in law and on facts in directing the AO to allow capital gains as long term.

Tribunal's decision:

The Hon'ble Tribunal has held that:

- no material was brought on record to show that any business as such was transferred by assessee. Thus, the sale of factory land and factory building along with bore well by assessee cannot be construed as sale of an undertaking and accordingly consideration received by assessee should be bifurcated in respect of each of assets on reasonable basis.

To conclude, the Tribunal held that for purposes of computing capital gains, consideration received on sale of factory land was to be treated as long-term capital gains and profit derived on sale of depreciable assets i.e. factory building and bore well was to be treated as short-term capital gains.

b. Tektronics Engineering Development (India) (P.) Ltd. Vs DCIT, Bangalore [ITANO. 409 OF 2013 HIGH COURT OF KARNATAKA]

Rental income from unused portion of business premises owned by assessee engaged in software business was held to be income from house property

Facts of the Case:

The assessee was engaged in the business of development of computer software. It had shown a sum of Rs. 28,11,600 received as rent as part of income from business and claimed depreciation in respect of house property.

The Assessing Officer held that said income would be treated as income from house property and disallowed depreciation in respect of said house property.

On appeal, the Commissioner (Appeals) held that the income arose from exploitation of the commercial assets of the assessee. Thus, it should be assessed under head 'business' and, further, depreciation would be allowed in respect of building.

On appeal before the Tribunal, it held that income of Rs. 28,11,600 received by the assessee had to be assessed as income from house property and remanded the matter back to Assessing Authority to give deduction treating the said income as a rental income.

High Court's decision:

The Hon'ble High Court has held that:

- the assessee was not in business of constructing or letting out of building; only business of assessee was development of software;
- the assessee was not in need of scheduled premises so, they let out premise so as to earn some rental income;
- the Tribunal has rightly held that it is not a business income but income from the house rental and the assessee is entitled to the benefit of certain deductions in respect of rental income from house property that has not been extended by the assessing authority.

Therefore, the Tribunal was justified in remanding the matter to the assessing authority to give the benefit of said deductions after treating the income as 'income from house property'.

c. AT&T Communication Services India (P) Ltd v Commissioner of Income Tax [High Court of Delhi WP (C) 811/2012]

Validity of special audit directed by AO under section 142(2A) of the Act

Facts of the case:

The assessee is engaged in three business segments namely (i) Market research, administrative support and liaison services; (ii) Network connectivity services; and (iii) Managed network services. The assessee had filed E-return declaring total income of Rs.6,95,74,835/- on 30.09.2008 for AY 2008-09.

The AO issued scrutiny assessment notice to Assessee on 06.08.2009.Subsequent to scrutiny assessment notice, AO issued

notices under other provisions of the Act calling upon the assessee to furnish the information, explanations and clarifications pertaining to return of income filed and the various claims made by the assessee.

The AO had referred special audit to CIT who accorded his approval to special audit proposed in case of assessee and had appointed special auditors. Thereafter, the AO issued show cause notice to assessee to conduct special audit u/s 142(2A) having regard to nature and complexity in financial statements of assesse in response to which the assessee submitted an elaborate reply stating that there was no complexity in its accounts and that provisions of section 142(2A) not only require complexity in accounts, but also require that there must be some prejudice to interests of revenue.

Aggrieved, the assessee filed a Writ Petition under Article 226 of the Constitution of India in the High court of Delhi challenging the direction of aspecial audit of its accounts under Section 142(2A) of the Income Tax Act, 1961 for the assessment year 2008-2009.

Contention of Assessee before the High Court:

The books of account were not called for or examined by the AO and no special audit can be ordered without such examining since the AO wouldn't be in a position to assess the nature and complexity of the accounts. No show cause notice was issued by the AO before ordering a special audit and thus there was a breach of rules of natural justice.

High court decision:

While deciding the contention that the AO cannot direct a special audit unless he examines books of account, the Hon'ble High Court held that sub-section (2A) of Sec.142 (i.e. Special Audit) does not require "books of account" to be examined by the AO. It empowers the AO, with prior approval of CIT, to direct the assessee to get accounts audited, if he was of opinion that it was necessary to do so having regard to nature and complexity of accounts of assessee and interests of revenue. It has been held by a Division Bench of this Court in Rajesh Kumar v DCIT (2005) that by expression "accounts" used in 142(2A) does not refer merely to "books of account" of assessee but include books of account, balance sheets and all other

records which are available to AO during assessment proceedings.

As regards the contention that no show cause notice was issued by the AO, the High Court held that the fact that the assessee had submitted an elaborate reply in response to various notices issued by AOclearly refers to request made by AO to assessee to show cause as to why special audit should not be conducted because of nature and complexity in financial statements and hence the assessee was given an opportunity of being heard before issuing a direction for special audit and the rules of natural justice were adhered to.

d. Jawahar Kala Kendra vs CIT [ITA NO. 121 OF 2012] (Raj)

Beneficial ownership of assets is sufficient to claim depreciation even if it's not followed by registered title

Facts of the case:

The assessee-society was constituted as an autonomous body by the Government of Rajasthan vide order dated 11-8-2003 to preserve and promote art and culture in Rajasthan and to contribute to the cultural and social development of the people of the State. Subsequent to the order dated 11-8-2003, the assessee-society came to be formed and was registered under the Societies Registration Act, 1958 on 19-9-2003. It had also been granted registration under section 12AA with effect from 1-4-2005.

Prior to the constitution of the assessee-society, Jawahar Kala Kendra [J] was managed by the Government of Rajasthan. On its constitution as a society, all the assets and liabilities of 'J' were transferred and incorporated in the books of the assessee-society.

The assessee started claiming depreciation on the above transferred assets from AY 2005-06. The AO allowed the depreciation on the assets in question in the AYs 2005-06 and 2006-07.

The AO disallowed the claim of depreciation for the AY 2007-08 by holding that there was no evidence to prove the change of ownership of the assets from Government of Rajasthan to the assessee-society and on records the title still continued to be with the State of Rajasthan. Since the assessee-society was not the owner, the

depreciation could not be allowed.

On appeal, the CIT(A) directed the Assessing Officer to allow the claim of depreciation which was upheld by the Tribunal as well.

High court decision:

The Hon'ble High Court has held that merely because title is not transferred or registration under the Indian Registration Act is not obtained, depreciation cannot be disallowed. On the face of record, the assessee-society had rightly been allowed depreciation by the CIT(A) and the Tribunal, as the assessee-society became owner of the said assets and was actually using the property in its own right as an owner on and from the date of order of the Governor.

e. DawoodiBoharaJamat v. CIT, Ujjain [CIVIL APPEAL NO. 2492 OF 2014 SC]

A trust carrying on its objectives with dual purposes, i.e., charitable and religious purposes would not be denied registration under section 12AA by virtue of exception provided under the provisions of section 13(1)(b)unless its activities are exclusively meant for a particular religious community.

Facts of the case:

The assessee is a registered Public Trust with the following objects:

a) Provision of food to the public on religious days of the DawoodiBohra community;

b)Establishment of Madarsas and organizations for dissemination of religious education

c) To assist/help to the needy people for religious activities; and

d) To carry out all religious activities according to Shariat and direction of Shariat-e-Mohammediyah for the prosperity of the DawoodiBohra community.

The assessee filed an application for registration before CIT for availing of exemption under section 11 of I-T Act which was declined on the ground that the trust was working only for a particular religious community and the same would attract the provisions of section 13(1)(b).

On appeal, the Tribunal set aside the order of CIT and directed it to grant trust registration under section 12AA which was upheld by the High Court. Aggrieved, the revenue filed the appealbefore the Hon'ble Supreme Court.

Supreme Court decision:

The Hon'ble Apex Court has held that:

- the objects of the trust were based on religious tenets under Quran according to religious faith of Islam. The perusal of the objects and purposes of the trust would clearly demonstrate that the activities of the trust, though, were both charitable and religious, yet were not exclusively meant for a particular religious community; and
- the objects of trust did not channel the benefits to any community and, thus, would not fall under the provisions of section 13(1)(b).

Thus, the assessee was indeed, a charitable and religious trust which did not benefit any specific religious community and, therefore, it would be eligible to claim exemption u/s 11.

3. Other Circulars

a. Circular no. 8 of 2014 dated 31st March, 2014

Clarification on interpretation of provisions of section 10(2A)- share of profits to partner of firm in cases where income of firm is exempt

The CBDT, in exercise of its powers u/s 119 of the Act hereby clarifies that 'total income' of the firm for the purpose of share of profits to partner of firm includes income which is exempt/deductible under various provisions of the Act.

The CBDT has further clarified that the income of a firm is to be taxed in the hands of the firm only and the same can under no circumstances be taxed in the hands of its partners. Accordingly, the entire profit credited to the partners' accounts in the firm would be exempt from tax in the hands of such partners, even if the income chargeable to tax becomes NIL in the hands of the firm on account of any exemption or deduction as per the provisions of the Act.

Our comments

In the epoch where uncertainty of Income tax is at its epitome in India, issuing such a Circular will unquestionably bring in certainty in relation to exemption from tax for income received from firm, as share of profit, where such income is already exempt in the hands of the firm under various provision of the Act.

Source: RIA Checkpoint