June, 2014

DIRECT TAX UPDATE

KNAV
PARTNERS BEYOND BOUNDARIES

KNAV is a firm of International Accountants, Tax and Business Advisors.

Presence in |
INDIA
USA
UK
FRANCE
NETHERLANDS
SWITZERLAND
CANADA

E: admin@knavcpa.com
W: www.knavcpa.com

1. Transfer Pricing

a. Case law - Cheil India Private Limited Vs. Deputy Commissioner of Income Tax [ITA No. 1230/Del/2014]

Confirms interest adjustment on outstanding receivable beyond 30 days

Facts of the Case:

The assessee is engaged in the business of advertising, communication, publicity and merchandise, including undertaking market research, planning and providing consultancy services and training in the same field as an agent and derives income as commission on fixed percentage.

A reference was made by the assessing authority to the TPO u/s 92CA(1) of the Income Tax Act, 1961 ("the Act"), the Transfer Pricing Officer ("TPO") noticed that substantial amounts were due to tax payers from its Associated Enterprises ("AE") as there were delays in receiving the payments from AEs. The TPO treated the delayed payment as unsecured loan and the same as international transaction u/s 92B Exp. (1)(c) and 92F(v) of the Act. In order to benchmark the international transaction, TPO treated the credit rating of AE to be in "category BB" and using the data procured from CRISIL, he benchmarked using CUP method and taking return earned by investing in the bonds of Indian companies having BB credit rating and arrived at an interest rate of 17.22% to be at arm's length and accordingly made adjustment of Rs. 1,01,281/- in the proposed order.

On appeal, the DRP considered assessee's submissions and held a period of 30 days to be allowed for payment of receivables and any delay beyond the said period held to be benchmarked for charging of interest. Since normal business practice required payment of dues beyond a reasonable period, the TPO was found justified to charge interest beyond the arm's length period. Any delay beyond a period of 30 days was held to be subject matter of adjustment.

DRP also found that tax payer is operating and raising finance from Indian market, it therefore, found no justification in tax payer's argument that LIBOR rate should be adopted to determine the Arms Length Price ("ALP") with regard to loans and advances given to AE without interest. However, taking strength from the Safe Harbur Rule it directed the AO/TPO that the interest should be computed on the basis of SBI base rate as on 30th June of the relevant previous year plus 150 basis points as the amount outstanding was less than Rs. 50 crores. Thus the adjustment got reduced to Rs. 83,814.

Decision of the Tribunal:

The assessee contended that it does not charge interest from non AEs and quantum of transactions are comparable. There is thus no justification to make adjustment in benchmarking the transactions and making adjustment.

The Hon'ble Tribunal held that, the assessee did not bring on record any such similar uncontrolled transaction to show that no interest has been charged by it for similar delays nor any exact comparability has been established.

The Hon'ble Tribunal further stated thet the DRP after considering the legal position, as contemplated under explanation (1)(c) below sec. 92B of the Act, with reference to material and relevant facts on record, passed a reasoned order, there was no infirmity in the directions given by the DRP and hence the assessee's appeal stood rejected.

b. Case law - Commissioner of Income Tax - I Vs. Cushman and Wakefield (India) Private Limited [ITA 475/2012]

Benchmarking with similar transactions necessary for reimbursements.

Facts of the case:

The revenue had filed an appeal with the Hon'ble Delhi High Court with respect to an order of the ITAT reversing of disallowance of reimbursement of costs and expenses incurred by the assessee. These had been claimed by the assessee as having been costs incurred towards services performed by its two AEs, Cushman and Wakefield, Singapore ("CWS") and Cushman and Wakefield, Hong Kong ("CWHK"). The brief facts are that the assessee, an Indian company, is engaged in the business of rendering services connected to acquisition, sales and lease of real estate and other services such as the provision of advice and research on such matters, project management etc. During the year, the assessee had reimbursed certain expenses to its AE amounting to Rs. 1,06,39,865 with respect to costs incurred by the AEs for certain coordination and liaison services undertaken by the AEs. On reference to the TPO, the TPO disallowed these reimbursements of expenses incurred by the assessee since no benchmarking or a transfer pricing analysis was conducted by the assessee. The TPO noted that "*the assessee did not file any evidence to support a claim that these services were actually provided to the assessee at its request to meet the specific need of the assessee and that benefit* *actually accrued to the assessee*".

The DRP concurred with the findings of the TPO but the Hon'ble ITAT reversed the decision of the TPO.

The following question of law was framed for the Court's consideration:

"*Is the Tribunal correct in holding that benchmarking was not necessary in respect of the cost reimbursement reported by the assessee that was later subject to disallowance by the AO, since the TPO held that ALP in respect of this component was nil?*"

Decision of the High Court:

The revenue argued that through the entire exercise - no benchmarking of the costs claimed as reimbursement has been conducted. It was also argued that the costs paid by the assessee to the two must be compared to costs paid on other similar transactions, on the basis of one of the methods of calculating the ALP. In the absence of such an exercise by the TPO - who only concerned himself with whether a service was rendered or not - the finding of the ITAT is incorrect. The allowance of any expenditure as a deduction for an international transaction with an AE must pass through the funnel of ALP determination, and cannot be permitted without that exercise. On the other hand, the assessee argued thatthe ITAT's approach, is statutorily sanctioned under Section 92(3) of the Act, which states that the provisions of Section 92 of the Act will not apply if the result of the ALP determination is a reduction of the overall tax incidence.It was submitted, since it is undisputed that the AEs have - in accordance with the agreements concluded - only charged costs without any mark up and that on reference to any other controlled transaction, the amount payable by the assessee would necessarily be greater, as the cost would be supplemented with some profit margin for the international entity. It was submitted that the minimum possible amount - actual cost incurred - is paid by the assessee to the AEs, placing the case squarely within the four corners of Section 92(3) of the Act.

The Hon'ble High Court noted that the agreements only contemplate reimbursement of costs incurred for the actual benefit of the assessee. It further noted that the costs incurred by CWS and CWHK have not been disputed by the revenue. They were actually incurred. Equally, it is an admitted fact that the assessee did not attempt to benchmark this international transaction through any of the methods indicated under Rule 10C of the Income Tax Rules, 1961, to determine the ALP for these transactions. Neither was such an exercise conducted by the TPO, and accordingly, till date, that vacuum exists. This vacuum remains despite Section 92(3) of the Act of the Act. Section 92 of the Act creates a regime for determining the true value of a transaction between two related parties, in this case, the assessee and CWS/CWHK, to ensure that taxable income is not transferred to another entity or jurisdiction. The very purpose of Section 92 of the Act thus is to ensure that the total taxable income is reported correctly to increase tax collection. Clause (3) of Section 92 of the Act provides that if such an ALP results in a decrease in the tax incidence in India, the true value of the transaction will be the value stated by the assessee and not the ALP. In other words, if an assessee is paying greater income tax than would otherwise be paid in an uncontrolled transaction, Section 92 of the Act will not alter the income stated in the return. This conclusion, however, can only be reached after an assessment of the ALP and comparison with the income stated in the return.

Undoubtedly certain amounts were charged by the AEs as reimbursement for actual costs incurred. Nevertheless, whether a third party - in an uncontrolled transaction with the assessee would have charged amounts lower, equal to or greater than the amounts claimed by the AEs, CWS and CWHK has to perforce be *tested* under the various methods prescribed in Section 92C of the Act. The question thus required to be addressed - and determined, is whether an independent entity - for the same liaisoning and client interaction services as were provided by CWS and CWHK - charges an amount less than or equal to or more than the amount charged by CWS and CWHK.

Thus the Hon'ble High Court remanded the matter back to the file of the TPO for determining the ALP of the reimbursement of expense transaction of the assessee.

2. Domestic Taxation

a. Case law-Commissioner of Income tax Vs. Corrtech Energy Pvt Ltd (Gujarat)

No disallowance u/s 14A & Rule 8D can be made if the assessee does not have tax-free income & no claim for exemption is made

Facts of the case:

The assessee had borrowed as well as owned funds out of which investments were made in the AY 2009-10. The AO had applied Rule 8D and made a proportionate disallowance of Rs. 12.33 lacs by applying Rule 8D(ii)(iii). The assessee had not earned any tax free income during the year and had also not claimed any deduction. The CIT(A) upheld the disallowance made by the AO by holding that since the assessee had sufficient interest free funds to cover its investment, no part of borrowed funds can be attributed to the investments made. There were no separate portfolios maintained for business and investment activities. Further, the argument raised by the assessee that it had not earned any income during the year was also dismissed on the ground that since the assessee had made investment in shares, which will result only in dividends and which are exempt from tax, not receiving any exempt income during the year will not entitle the assessee to claim expenses relating to investments which will result only in exempt income.

Before the Hon'ble Tribunal, the AR relied upon various judicial pronouncements. The Hon'ble ITAT following the decision of the Hon'ble P&H High Court in case of **CIT Vs Winsome Textile Industries Ltd** (319 ITR 204) (P&H) held that where there is no claim for any exempt income, section 14A could have no application. The Revenue preferred appeal before the Hon'ble Gujarat High Court where the Counsel argued that the AO had rightly applied Rule 8D since the year concerned was AY 2009-10. The Hon'ble Hugh Court held as under:

Decision:

- Sub-section (1) of s. 14A provides that for the purpose of computing total income under chapter IV of the Act, no deduction shall be allowed in respect of expenditure incurred by the assessee in relation to income which does not form part of the total income under the Act;
- In the present case, the Tribunal has recorded the finding of fact that the assessee did not make any claim for exemption of any income from payment of tax. It was on this basis that the Tribunal held that disallowance u/s 14A of the Act could not be made; and
- The Tribunal relied on the decision of the P&H High Court in case of **CIT vs. Winsome Textile Industries Ltd** 319 ITR 204 (P&H) where it was held that s. 14A could have no application to a case where the assessee did not make any claim for exemption.

b. Case law-Ram Prakash Miyan Bazaz v.Deputy Commissioner of Income-tax [IT Appeal No. 182 (JP) of 2013]

Booking of two residential houses before the date of transfer would not provide ownership rights to assessee, thus, he could not be deemed to be owning two residential houses on date of transfer.

The issues before the Tribunal:

1) Whether assessee could be deemed to own two residential houses on date of transfer if he had only booked two residential houses?
2) Whether booking of residential flats could be deemed as investments for purposes of exemption under section 54F?

Decision of Tribunal:-

- Proviso to Section 54F(1) provides that if assessee owns more than one residential house, other than the new asset, on the date of transfer of the original asset then he will not be entitled to exemption.
- The meaning of term 'owns' used in proviso to section 54F has a different meaning. The owner here, means a legal owner who is

entitled to receive income from the property in his own right. In the absence of possession, registration, title, etc., question of assessing 'income from house property under section 22 of Income-tax Act (the Act) doesn't arise.

- When a flat is booked assessee has a 'right to acquire' and this right is not equivalent to 'own' a house. Therefore, by mere booking of flats, it could not be said that assessee had ownership of the flats. Thus, assessee did not own more than one residential house on the date of transfer of original asset.

- With regard to purchase of new residential house, the provision does not lay down a condition that a new house should either be complete or it should be purchased as a complete habitable house. The aim is to direct the minds of the society towards purchasing new residential houses so that the menace of shortage of houses is tackled to some extent.

- Thus, owning of a residential house at the time of transfer of the original asset has different meaning and acquisition of new asset 'which is equivalent to purchase of new residential house' has entirely different meaning. The CIT(A) had misdirected himself in giving the same meaning to the residential house owned at the time of transfer of the original asset and the investment made out of the capital gain in the purchase or construction of new house, which has been defined as 'new asset' in the Act.

Therefore, investment in new residential house by payment of booking amount only had to be allowed.

c. Case law- Manjit Kumar v. DCIT
[IT Appeal No. 175 (Amritsar - Tribunal) of 2013]

Keyman Insurance Policy assigned to its partner just two days before completion of lock-in period - The amount received under Keyman Insurance Policy would be taxable in the hands of partner.

Facts of the case:

A partnership firm had taken a Keyman Insurance Policy in the name of the partner-assessee on March 31, 2005 and paid the first premium on the same day. Second and third premiums were paid on March 31, 2006 and March 31, 2007 respectively. After payment of premium for 3 years, firm had an option to surrender the policy at any time. However, if policy was surrendered before the completion of three years from the date of policy, i.e., 31st March, 2008, its value would be *nil*. The partnership firm assigned the policy to the partner-assessee on March 29, 2008 who, in turn, without paying the premium due on March 31, 2008 surrendered the policy and transferred the funds to the firm. Assessee contended that assignment of policy in his favour had converted Keyman Insurance Policy into an ordinary life policy and, therefore, any amount received on its maturity would be exempt under Section 10(10D).Assessee contended that since the surrender value of the policy was 'zero' at the time of assignment, same could not be taxable in his hands as was held by the tribunal in the case of *Dr. Naresh Trehan* v. *Dy. CIT* [I.T.A No. 1964/Del of 2010]. Revenue filed an appeal before the Tribunal.

ITAT held in favour of revenue as under:

- In view of section 28(vi) of the IT Act any amount received by an organization under a Keyman Insurance Policy would be taxable in the hands of such an organization as business profit. If such policy is endorsed in favour of employee (Keyman) than it would be taxable as 'profits in lieu of salary' under section 17(3)(ii). If such policy is endorsed in favour of any other person then sum received under the policy would be taxed as income from other sources under section 56(2)(iv). CBDT vide Circular No.762, dated February 18, 1998 had also clarified the same.

- *Dr. Naresh Trehan* case (*Supra*) was misinterpreted by assessee as in that case it was held that the surrender value of the policy was taxable in the hands of the transferee. The contention of assessee, that there was no surrender value on the date of assignment, was baseless because for all practical purposes the policy had completed 3 years and it was only due to *malafide* intention of the assessee to evade tax that it was transferred to the partner-assessee just two days before the completion of three years.

- Considering all the facts, it was crystal clear that the firm and assessee had arranged the affairs so as to kill two birds with one stone. It had got the required funds and simultaneously it did not pay any taxes thereon.

- In these circumstances, the findings of the Hon'ble Supreme Court in the case of *McDowell & Co.* [1985] 22 Taxman 11 were squarely applicable. **Therefore, the whole affairs was rendered sham and the assessee was held liable to pay tax on surrender value received from Keyman Insurance Policy.**

d. Case law- Sumit Aggarwal v. DCIT
[IT APPEAL NO. 212 (Chandigarh - Tribunal)]

If assessee files the return of global income in India, the Revenue is bound to give effect to such return - Therefore, losses from house property located abroad is to be included in the income of resident-assessee

Facts of the case:

The assessee filed his return of income after including losses from house property located abroad. He purchased this property in

Australia which was already on rent. He obtained a loan from ANZ Bank, Australia ('ANZ') to purchase the property. The loss was computed under the head house property due to payment of interest to ANZ. During appellate proceedings, the CIT(A) referred to the decision of Apex Court in case of *CIT* v. *PVAL Kulandagan Chettiar* [2004] 137 Taxman 460 (SC) and held that as far as rent income from Australia was concerned, the assessee was required to file the return in Australia and such income could not be included in Indian income. Therefore, negative income could not be assessed in India.

Decision of the Tribunal:

The Hon'ble Tribunal while giving relief to the assessee held as under:

- In view of Section 5 of the Income-tax Act ('the Act') in case of a resident, income accruing or arising outside India had to be assessed in India. The Sec 90(2) of the Act clearly provides that wherever DTAA is applicable to assessee he has an option to apply either Indian Tax Laws or provisions of DTAA, whichever are more beneficial to him. Therefore, the assessee had an option to file return of income under the Indian tax laws where DTAA was applicable.

- In the instant case, the assessee had exercised the option of filing return under Indian laws, thus, the same could not have been refused simply because DTAA was applicable.

- The decision in case of *PVAL Kulandagan Chettiar* (supra) was distinguishable because in that case the assessee was a resident of India and Malaysia. It was due to financial connection of the assessee with Malaysian property it was held that income from Malaysian rubber plantation was taxable only in Malaysia.

- The assessee had right to file the return of global income in India and the Revenue was bound to give effect to such return. The CIT(A) was not correct in holding that income from house property in Australia was not assessable in India. Accordingly, the order of the CIT(A) was to be set aside and the **Assessing officer was to be directed to include the loss from such house property in the hands of the assessee.**

e. Advance Ruling-Royal Bank of Scotland
[A.A.R. No. 964 of 2010]

Employer's contribution to the superannuation fund could not be treated as taxable perquisite in the hands employee until they are entitled to receive it

Facts of the case:

The Royal Bank of Scotland ('Applicant') was established in

Netherlands. Its Indian branch established a superannuation fund for providing pension to its eligible employees under a 'Defined Benefit Plan'. The applicant seeks Advance Ruling on the issue whether tax was to be deducted under Sec. 192 on the contribution made to the superannuation fund (for an amount exceeding Rs. 1,00,000 per employee) as perquisite. The Revenue contended that as per section 17(2)(vii), any contribution made by employer to the superannuation fund in excess of Rs. 1,00,000 to be treated as perquisite in the hands of an employee. Hence, the applicant was liable to deduct tax at source under section 192.

The Authority for Advance Ruling held in favour of applicant as under:

- The AS-15 defines 'Defined Benefit Plan' as a plan in which amount contributed was invested to earn some return to ensure that employees would get pension as per the pre-defined formula.
- Employer's contribution to the superannuation fund assures only future benefit to employees and they didn't get any vested right at the time of making contribution to the fund. Thus, such **contribution could not be treated as taxable perquisite in the hands employee until he was entitled to receive it**.
- Mere insertion of a Sec. 17(2)(vii) didn't make any significant departure from this aspect. **Thus, applicant wasn't required to deduct tax at source on contribution made to superannuation fund.**