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DIRECT TAX UPDATE

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1. Transfer Pricing

a. Case law - Panasonic AVC Networks India Co. Limited [ITA No. 4620/Del/2011]

Adjustment to profit margin for "capacity underutilization" can be made.

Facts of the case:

The international transactions entered into by the assessee with its Associated Enterprises ("AEs") were referred to the Transfer Pricing Officer ("TPO") for determination of arm's length price. The TPO did not agree on the adjustments for capacity utilization adopted by the assessee and rejected the claim of capacity utilization on the ground that "all the comparables were also operating in same economic environment and all were playing same game of price cutting and volume generation" and "therefore, any adjustment on account of these two factors *(i.e. capacity adjustment and risk adjustment)* will change the level playing field and benchmarking of international transaction will not be correct reflection of economic activities undertaken by the assessee". The matter was carried in appeal by the assessee before the Commissioner of Income Tax (Appeals) ("CIT (A)"). CIT (A) took note of assessee's submission that the assessee's production in the relevant previous year was much below the installed capacity and the assessee had utilized only 31.75% of its installed capacity. Thus he directed the Assessing Officer to allow capacity underutilization adjustment by making adjustments in depreciation figures of the tested party as also of the comparables. The revenue being aggrieved by the directions of the CIT (A) sought appeal in the Hon'ble Tribunal.

Tribunal's decision:

The Hon'ble Tribunal in upholding the decision of the CIT (A) has referred to Rule 10 of the Income Tax Rules, 1962 and has held that capacity underutilization by enterprises is certainly an important factor

affecting net profit margin in the open market because ***lower capacity utilization results in higher per unit costs, which, in turn, results in lower profits.***

b. Case law - Air Liquide Engineering India P. Limited [ITA No.1040/Hyd/2011, ITA No.1159/Hyd/2011 and ITA No.1408/Hyd/2010]

TPO cannot sit in judgement on commercial expediency. RBI approval means the payment is at ALP. If overall TNMM analysis done, royalty cannot be analyzed separately

Facts of the case:

The international transaction entered into by the assessee with its AEs pertaining to royalty fees was referred to the TPO for determination of arm's length price. The TPO noted that the assessee had paid royalty @5% on domestic sales and 8% on export sales amounting to Rs. 1,42,84,061/- to the AE on account of sale made to unrelated party through the AE. The TPO further observed that royalty is being paid to an AE on the sales made to AEs of the same group. He further noted that the royalty paid by the assessee to the AE abroad, on sales made to the AE by utilizing the know-how given by the AE would amount to compensating one own-self and in that case such payment would be far away from the definition of arm's length transaction, in a business sense. The CIT (A) partly allowed appeal of the assessee by deleting 50% of the adjustment on an ad hoc basis.

Tribunal's decision:

The Hon'ble Tribunal has held that the ***TPO was sitting on judgment of the business and commercial expediency of the assessee which is erroneous*** as per held by the Hon'ble Delhi High Court in EKL Appliances (345 ITR 241) wherein the Hon'ble High Court has stated that **"so long as the expenditure or payment by assessee has been demonstrated to have been incurred or laid out for the purposes of business, it is no concern of the TPO to disallow the same on any extraneous reasoning"**. Further, the Hon'ble Tribunal while relying on decisions of various Tribunals, has also taken view that **RBI approval of the Royalty rates itself implies that the payments are at arm's length.**

c. Case law - Lummus Technology Heat Transfer BV [ITA No.: 6227/Del/2012]

Unaudited segmental accounts can be relied upon for comparing profitability of controlled transactions with uncontrolled transactions. While size is relevant in entity level comparison, it is not relevant in transaction level comparison within the same entity

Facts of the case:

Lummus Technology Heat Transfer BV, a Dutch company specializing in heat treatment equipment, has a permanent establishment ("PE"), by way of a branch, in India. The PE in India is engaged in providing certain engineering services to its Head Office. The PE in India has also rendered these services to independent enterprises, i.e. non AEs. The assessee had used TNMM for determining the arm's length price of its transactions with the AEs, and had benchmarked their profitability on the basis of profitability of its transactions with non AEs, i.e. independent enterprises. The assessee had produced segmental accounts separately reflecting three segments, i.e. (a) Business with AEs; (b) Business with Non AEs; and (c) Idle capacity. The assessee's claim was that since its margin on the business with AEs was better than margin on non AEs, the transactions with the AEs are to be accepted as on arm's length price under the TNMM. The TPO did not accept the claim of the assessee and was of the view that since the assessee was not subject to tax audit, the allocation of expenditure cannot be relied upon to determine segmental results. The TPO also rejected the segmental accounts since the non AE revenue was only 0.94% of the total revenue and thus made an upward adjustment. The Dispute Resolution Panel also upheld the adjustment.

Tribunal's decision:

The Hon'ble Tribunal has referred to Rule 10 of the Income Tax Rules, 1962 which provides that "**the net profit margin realised by the enterprise** *(i.e. the assessee)* **from an international transaction entered into with an associated enterprise is computed in relation to costs incurred or sales effected or assets employed or to be employed by the enterprise or having regard to any other relevant base**" iscompared with " **the net profit margin realised by the enterprise** *(i.e. theassessee)* **or by an unrelated enterprise from a comparable uncontrolled transaction or a number of such transactions is computed having regard to the same base".** It was further noted that for the purpose of computing the ALP under internal TNMM, ***so long as the net profits earned from the controlled transactions are the same or higher than the net profits earned on uncontrolled transactions, no ALP adjustments are warranted.*** It is not at all necessary that such a computation should be based on segmental accounts in the books of accounts regularly maintained by the assessee and subjected to audit. Further, the basis of allocation of expenses was clearly mentioned by the assessee and the TPO has not pointed out any specific defects in them. Thus, the Hon'ble Tribunal has deleted the entire adjustment.

2. Stay / recovery of outstanding demand

a. Case law - Deloitte Consulting India Pvt. Ltd. Vs. Asst. CIT

Rejection of stay application by ITAT on the ground that "the financial position of the assessee is very sound" and "government also needs liquid funds to manage its day to day affairs" & without discussing prima facie case is in disregard of law laid down in KEC International 251 ITR 158 (Bom)

Facts of the case:

The Petitioner is engaged in the business of export of computer software and providing information technology enabled services. In Form 3CEB, the Petitioner had inter-alia declared an amount of Rs. 5.86 Crores as marketing expenses paid to its AE. In the meantime, the TPO vide order dated 10 February 2005, for the AY 2002-03, disallowed the expenditure on account of marketing expenses paid. The Petitioner filed revised return of income and didn't claim deduction of the marketing expenses. The same was also added back to its income before claiming deduction under Section 10-A of the Act on its income under the head 'profit and gains of business'.

The AO denied the benefit of exemption claimed u/s 10A of the Act to the extent of Rs. 5.86 Crores on the ground that the revised return, adding the amount of Rs. 5.86 Crores already claimed as expenditure, was filed with a view to get over Section 92C(4) of the Act and the proviso thereto. The addition made by the AO has been upheld by the ITAT as well against which the Petitioner is in appeal before the High Court.

Thereafter, the AO passed order imposing penalty u/s 271(1)(c) of the Act. Aggrieved, the Petitioner filed stay before the AO as well as the CIT, however, both were rejected. The Petitioner had filed a Writ Petition before the High Court where this Court had granted stay against recovery of penalty subject to the condition that the Petitioner deposits an amount of Rs. 50.00 lakhs by 31 March 2013. The said amount was duly paid off by the Petitioner.

Thereafter, the CIT(A) dismissed the appeal of the Petitioner against which the Petitioner filed appeal before the ITAT. The Petitioner had also filed a stay application before the ITAT.

Disposing the stay application by the Mumbai Tribunal:

The ITAT directed the petitioner to deposit a further amount of Rs. 50 lakhs for staying the outstanding demand of Rs.1.55 crores by way of penalty under Section 271(1)(c) of the Act for the assessment year 2004- 05.

Arguments before the High Court:

The Petitioner argued that the Tribunal has not at all dealt with its

arguments on the prima facie case and therefore, no deposit / payment of penalty was called for. Further, the Petitioner has paid full tax amount for the A.Y.2004-05. The assessee's quantum appeals under Section 260A of the Act are still pending before this Court.

The DR argued that even if the Rs. 50 lakh installment, as directed by the ITAT, is paid, even then the Petitioner would have paid only 50% of the demand.

Decision by the Bombay High Court:

The High Court held that the Tribunal's order has been passed in **total disregard of the principles laid down in KEC International Ltd. Vs. B. R. Balakrishnan and others (251 ITR 158) (Bom)** wherein a Division Bench of this Court laid down following parameters to be observed by the Authorities while considering and disposing off the stay application:

a) While considering the stay application, the authority concerned will at least briefly set out the case of the assessee

b) In cases where the assessed income under the impugned order far exceeds returned income, the authority will consider whether the assessee has made out a case for unconditional stay. If not, whether looking to the questions involved in appeal, a part of the amount should be ordered to be deposited for which purpose, some short prima facie reasons could be given by the authority in its order;

c) In cases where the assessee relies upon financial difficulties, the authority concerned can briefly indicate whether the assessee is financially sould and viable to deposit the amount if the authority wants the assessee to so deposit;

d) The authority concerned will also examine whether the time to prefer an appeal has expired. Generally, coercive measures may not be adopted during the period provided by the statue to go in appeal. However, if the authority concerned comes to the conclusion that the assessee is like to defeat the demand, it may take recourse to coercive action for which brief reasons may be indicated in the order; and

e) We clarify that if the authority concerned complies with the above parameters while passing orders on the stay application, then the authorities on the administrative side of the Department like respondent no.2 herein need not once again give reasoned order.

Lastly, the High Court held that the Petitioner does have a **strong *prima facie* case** on merits and considering the fact that the Petitioner had already paid 25% of the penalty amount, the Tribunal erred in directing

the Petitioner to deposit a further sum of Rs. 50 lakhs and ignoring the directions laid down by KEC (*supra*) as also the observations made by the High Court in the earlier Writ Petition filed by the Petitioner.

3. Section 14A

a. Case law - Garware Wall Ropes Limited Vs. Addl. CIT

No S. 14A/ Rule 8D disallowance if the investment is a strategic to hold controlling stake in group concern and not to earn tax-free income

Facts of the case:

During the year, the assessee earned exempt dividend income of Rs. 36,90,456/-. The assessee had *suo-moto* disallowed an amount of Rs. 1,03,915/-. Further, since no borrowed funds was used for making investments and the interest expenditure was on the bank term loans, therefore, in absence of nexus between the interest expenditure and the investment in shares, there was no disallowance made on account of interest expense. The AO didn't accept this contention and disallowed the administrative expenses by applying Rule 8D and worked out the disallowance at Rs. 8,83,569/-. On appeal, CIT(A) has confirmed the disallowance made by the AO.

Arguments before the Mumbai Tribunal:

Arguments of the AR:

a) no expenditure incurred in respect of the investment and dividend income in question;

b) investments are in the group concerns of the assessee and therefore are passive investments made for the purpose of holding controlling stake in the group concern and not for the purpose of earning any dividend or active investment;

c) shares were held in DMAT account and the dividend was received directly in the account. Therefore, there was no direct or indirect expenditure incurred for earning exempt income in question.

Arguments of the DR:

Issue was covered against the assessee by the decision of the Tribunal in the assessee's own case in assessment year 2008-09.

Held by the Mumbai Tribunal:

- As regards the new plea raised, i.e. during the year under consideration,

no expenditure had been incurred by the assessee for earning the exempt income or for the investments in question, we find merit and substance in the contention of the assessee on this point since the investments have been made in the group concerns and not in the shares of any unrelated party. Therefore, the **primary object** of investment is **holding controlling stake** in the group concerns and not earning any income out of investment. Further the said investments were made long back and not in the year under consideration.

- Where no expenditure has been incurred in relation to the exempt income, then principle of apportionment embedded in section 14A has no application.

- For attracting the provisions of section 14A, there should be proximate cause for disallowance which has relationship with the tax exempt income as held by the Hon'ble Supreme Court in case of **CIT Vs. Walfort Share and Stock Brokers P. Ltd. (326 ITR 1)** which was absent in the instant case.

Accordingly, the Hon'ble Mumbai Tribunal deleted the addition / disallowance made by AO u/s 14A r.w. Rule 8D of the Act.

b. Circular no. 5 of 2014 dated 11th February 2014

Clarification regarding disallowance of expenses under section 14A of the Income-tax Act in cases where corresponding exempt income has not been earned during the FY.

The Central Board of Direct Taxes ("CBDT") has issued this Circular to put at rest the controversy which has arisen in certain cases as to whether disallowance can be made by invoking section 14A of the Act even in those cases where no income has been earned by an assessee which has been claimed as exempt during the financial-year.

The CBDT has drawn reference to its **Circular no. 14 of 2001** which provided the intention for introduction of section 14A with retrospective effect from 01.04.1962 (i.e. from inception). In the referred Circular, the CBDT had mentioned that no deduction for expenses, which have been incurred for earning exempt income, can be allowed from the taxable income. The basic principle of taxation is to tax the net income, i.e. gross income minus the expenditure. Drawing the same analogy, exemption can be allowed on net income only.

The CBDT proceeded to state that expenses, which are relatable to earning of exempt income have to be considered for disallowance irrespective of the fact whether such income has been earned during the financial year or not.

The CBDT has clarified that usage of the term '*includible*' in the Heading of section 14A and Rule 8D indicates that it is not necessary that exempt income should necessarily be included in a particular year's income, for disallowance to be triggered. Also, section 14A of the Act doesn't use the word 'income of the year' but income under the Act' which indicates that for invoking disallowance u/s 14A, it is not material that assessee should have earned such exempt income during the year under consideration. Further, the CBDT has also drawn attention to the words used in Rule 8D.

Thus, the CBDT, in exercise of its powers u/s 119 of the Act has clarified that section 14A r.w. Rule 8D, provides for disallowance of the expenditure even where taxpayer in a particular year has not earned any exempt income.

Our comments:

Circulars issued by the CBDT are binding only on the revenue authorities and not on the assessee. This is merely a clarificatory Circular, since in substance, the Assessing Officers were already disallowing expenses even in cases where the assessees were not earning any exempt income during the year.

4. Other Circulars

The CBDT, vide its **Circular no. 6/2014 dated February 11, 2014**, has clarified regarding the scope of additional income tax on distributed income u/s 115R of the Act. The said Circular has clarified that "**redemptions of units or repurchase of units would not attract levy of tax under sub-section (2) to Section 115R of the act as such income is not of the nature of income distributed to the unit holders and hence lies outside the purview of this section.**"

The need for this clarification has arisen because the field officials were of the view that redemption or repurchase and issue of bonus units in a mutual fund is a distribution of income (similar to dividend payment) to investors, and hence the proceeds should be taxed.

There were various arguments raised by the taxpayers that redemptions are not in the nature of distribution of income and any move to tax redemptions would amount to double taxation since the redemption proceeds are anyways taxed under capital gains.

Our comments:

In the time where tax uncertainty is at its peak, issuing this Circular which brings tax certainty is certainly welcome and is

surely expected to bring substantial relief to the investors.