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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 along with the important circulars and notifications issued by the Central Board of Direct Taxes.

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Transfer Pricing

Case law 1: ACIT Vs. Gates India (P.) Ltd ([2017] 84 taxmann.com 42 [Tdel])

Unless there is a high degree of comparability between the controlled transactions and uncontrolled transactions, comparable uncontrolled price ('CUP') cannot be applied as the most appropriate method.

Facts of the case:

The assessee, a private limited company, is a wholly owned subsidiary of a US company. The assessee was engaged in manufacture and trading of hose pipes. In the year under consideration, the assessee had reported multiple international transactions with its associated enterprises (*'AE's'*). The assessee applied different methods as most appropriate method for benchmarking its each international transaction. The transfer pricing officer ('*TPO*') rejected the methods adopted by the assessee and applied transactional net margin method ('*TNMM')* - as the most appropriate method for determining the arm's length price (*'ALP'*) in respect of the international transactions of import of raw material and import of other goods from AE. The TPO had also applied internal CUP for determining the ALP in respect of export of goods by the assessee and thereby proposed an adjustment u/s 92CA of the Income Tax Act, 1961 ('*the Act*').

The assessee challenged the action of the TPO before the Hon'ble Commissioner of Income tax (Appeals) ['CIT(A)'']. The Hon'ble CIT(A) accepted the contention of the assessee.

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

Decision of the Hon'ble Tribunal:

The revenue contended that when an internal CUP is available, then, there is no scope for adopting any other method as most appropriate method. In the case of the assessee, there being sale of the same goods to the unrelated party, the sale price of export to the AE has to be tested with the CUP method.

On the other hand, the assessee contended that the domestic sale price cannot be applied as CUP in respect of export made by the assessee to its AE because of different geography as well as the incentives in respect of the export which were not available in respect of domestic sales. Further, the TPO had selected only those transactions of export which were found less than the domestic sales price, thereby disregarding several transactions which are more than the ALP being domestic sale price. Also, as the TPO had already tested the composite transactions with the AE under TNMM, further computation of ALP in respect of the export by applying CUP was a futile exercise.

After hearing the rival contentions, the Hon'ble Tribunal was of the view that as the transactions are multiple and inter-related, a particular transaction out of the composite transactions cannot be tested under CUP. It is not appropriate to apply separate methods for determining the ALP for each of the transaction, particularly, when the international transactions are closely linked and inter-dependent having direct bearing on the price of each other.

Therefore, Hon'ble Tribunal ruled in favour of the assessee, stating that given the facts and circumstances of the case, the TNMM method would be the most appropriate method for determining the ALP of the international transactions entered into by the assessee.

Case Law 2: M/s Parexel International Clinical Research Pvt Ltd Vs. DCIT [IT(TP)A Nos. 254/Bang/2016 & 292/Bang/2017]

Location savings is a relevant factor for conducting a proper enquiry while determining ALP but cannot be the sole basis for ALP determination.

Facts of the case:

The assessee, a subsidiary of Netherlands company is engaged in providing clinical research services in India. The group company and parent company of assessee are also clinical research organizations based in USA & UK respectively. They are assigned the work of conducting clinical trials by sponsoring pharmaceutical companies which have in turn been outsourced to the assessee at cost plus 15% mark-up charges.

During the year under consideration, the TPO observed that conducting trial in India through the assessee resulted in location saving for the AE. This location savings was on account of the substantially lower regulatory, compliance and investigatory costs in India as compared to developed countries. As the assessee had done the benchmarking against local comparables, it did not consider the benefit of location savings.

Therefore, the TPO proposed to apply the profit split method at 50:50 on account of location saving, and split the profit between the assessee and the AE, thereby making an addition to the assessee's income.

The assessee raised objections before the Hon'ble Dispute Resolution Panel ('*DRP*'). The Hon'ble DRP concurred with the view of the TPO and concluded that the location saving exists in the current business model of the assessee and therefore the order was upheld.

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

Decision of the Hon'ble Tribunal:

The decision of the Hon'ble Tribunal can be summarized under the following points:

- Location savings include benefit in respect of low cost labour, low cost of raw-material, low fuel cost as well as location advantage and is available to all parties irrespective of whether related party or unrelated party;
- Though location savings is relevant factor for conducting a proper enquiry while determining ALP, it is universally accepted in cross border trade so far since the transactions are not entered into solely for the purpose of avoiding tax and with motive to shift income to no tax or very low tax jurisdiction;
- The Hon'ble Tribunal on examining the facts of the case, stated that though the low cost of regulatory and other compliances are relevant factors adding to the location saving, such savings and conditions are available to all parties irrespective whether the transaction is between related party or unrelated party;
- Thus, Hon'ble Tribunal, therefore, stated that location savings and advantages are relevant in the cross border transaction but for limited purpose of carrying out an exercise of examination and investigation of the transaction and not as a basis for determining the ALP and consequently adjustment. Accordingly, Hon'ble Tribunal opined that if the CUP is available then the location saving or condition cannot be itself the basis for determination of ALP and consequential adjustment; &
- Further, noting that the functional comparability of the companies selected by the assessee was not examined by TPO and no steps were taken to find out other comparables, the Hon'ble Tribunal opined that issue of determination of ALP and consequential adjustment shall be examined afresh at the level of TPO.

Therefore, the Hon'ble Tribunal set aside the matter to the file of TPO for fresh adjudication.

International Taxation

Case Law 1: CIT(IT) Vs. JSH (Mauritius) Ltd ([2017] 84 taxmann.com 37 [Bom])

Tax residency certificate issued by a competent authority is sufficient to prove the residency of an assessee making it entitled to the benefits of the double tax avoidance agreement ('DTAA').

Facts of the case:

The assessee, a company incorporated in Mauritius, transferred shares held by it in Tata Industries Limited *('TIL') (an Indian company)* to Tata Sons Limited. The revenue claimed that such company incorporated in Mauritius was a shell and fly-by-night company, and was only incorporated for the purpose of taking advantage of the tax treaty between India and Mauritius. Thus, the revenue claimed that the capital gains arising on the transfer of shares are taxable in India. On the other hand, the assessee claimed that it is a tax resident of Mauritius and is rightfully entitled to the benefits as laid down in the India-Mauritius DTAA. The Hon'ble Authority for Advance Rulings (Income Tax) *('AAR')* ruled in favour of the assessee.

Aggrieved thereby, the revenue filed a writ petition before the Hon'ble High Court.

Arguments before the Hon'ble High Court:

- The revenue argued the assessee has only been interposed to avoid tax. Thus, it submits that this is a fit case of abuse of tax treaty and it amounts to treaty shopping. Such treaty shopping is undesirable since it frustrates the spirit of the treaty. It places reliance in the case of Vodafone International Holdings Vs. Union of India (2012) (341 ITR 1);
- The assessee submits that it has been incorporated and is a resident of Mauritius since April 04, 1996. It is engaged in business of investment and financing activities. It holds a Category 1 Global Business Company License issued by the Financial Services Authority of Mauritius. The Mauritius Revenue Authority have issued a tax residency certificate ('*TRC*') to the assessee evidencing that it is a tax resident in Mauritius. Further, it has filed its advance return in Mauritius offering its income to tax and also paid taxes in Mauritius. It is a resident of Mauritius under Article 4(1) of DTAA and is eligible to claim the benefits under the treaty;
- The assessee further submits that it had made investment in shares of TIL in June 1996 after obtaining Government approval including approval in May 1996 from Department of Industrial Policy & Promotion. The investment in shares of TIL was made with an intention of long term investment. The shares were held for a period of 13 years and were transferred only in June 2009. It claims that as per the provisions of Article 13(4) of the DTAA, the long term capital gains arising on such transfer is not taxable in India; &
- It also placed reliance in the case of Union of India and Anr. Vs. Azadi Bachao Andolan & Anr. (263 ITR 706) (SC) and submits that in the said judgment the Hon'ble Apex Court held that once the Certificate of Residence is granted, that would be conclusive evidence for determining the status of residence under the DTAA.

Decision of the Hon'ble High Court:

The Hon'ble High Court takes the following points into consideration:

- Section 90(2) of the Act specifically provides that where the Government of India had entered into a DTAA with the Government of any other country for granting relief of tax or any avoidance of double taxation, then in relation to the assessee to whom said agreement applies, the provisions of tax treaty shall apply to the extent they are more beneficial to the assese;
- The shares were purchased by the assessee in the year 1996 and were held for long period of 13 years and were sold in the year 2009. This goes to suggest the bona fide of the applicant. The said shares were again invested in another company of the same group in India and the same were being held by the assese;
- The Apex Court in the case of Azadi Bachao Andolan & Anr. (*supra*) observed that the whole purpose of the DTAA is to ensure that the provisions thereunder are available even if they are inconsistent with the provisions of the Act; &
- It is clear from the DTAA that the capital gains arising to a resident of Mauritius from alienation of the shares situated in India could only be taxed in Mauritius and not in India.

Taking into consideration the facts of the case and the jurisprudence on the issue, the Hon'ble High Court held that the Hon'ble AAR has considered all the relevant aspects of the matter and has arrived at the just conclusion. The DTAA has also been rightly considered. Thus, the Hon'ble High Court ruled in favour of the assessee.

Case Law 2: Shanghai Electric Group Co. Ltd Vs. DCIT(IT) ([2017] 84 taxmann.com 44 [Tdel])

In view of the fact that supervision activities in respect of erection and commissioning of equipment was carried out in India through assessee's supervisory permanent establishment ('PE'), a part of profit earned from transaction of offshore sales attributable to operations performed by PE in India was to be brought to tax in India.

Summary of the case:

The assessee is a foreign company, incorporated under the laws of People's Republic of China, and is engaged in the business of supply of Boiler, Turbine and Generator ('*BTG*') equipment. The assessee filed its return of income and offered to tax income from onshore services.

The assessee stated that no portions of income arising from offshore supplies were offered to tax since the sale of BTG equipment was concluded outside India. The assessing officer ('*AO*') did not agree and brought the same under the tax net by contending that part of profit of offshore supplies was attributable to the supervisory PE of the assessee in India.

The judgement of the Hon'ble Tribunal revolves around existence of business connection and supervisory PE in India in respect of the offshore sales of the assessee. The same has been briefly stated below:

a. <u>Existence of a business connection in India</u>

The assessee is a non-resident and thus, as per provision of section 9 of the Act, all income accruing or arising whether directly or indirectly through or from any business connection in India shall be deemed to accrue or arise in India thereby liable to tax in India. The Hon'ble Tribunal relied on various judicial precedents and observed that:

The assessee is supplying BTG equipment to customers in India and is wholly responsible for erection/installation/successful commissioning of equipment. The contracts are negotiated and concluded in India by a team consisting of persons from PE in India and assessee in China. The expatriates from Shanghai, China come to India to provide technical support services to PE in India. All these activities go on to establish that the assessee has business connection in India within the meaning of section 9(1)(i) of the Act. The assessee is doing business activities in India which are not isolated instances rather these represent real and intimate relationship between activities of assessee done outside India and those done within India. The business operations being done in India are revenue generating as these operations are required to earn the contract and to meet with contractual obligations. Therefore, all the parameters of business connection are satisfied.

b. <u>Existence of supervisory PE in India</u>

Article 5(1) of the India-China DTAA provides a general requirement for the purpose of existence of the PE which states that the term PE means a fixed place of business through which the business of an enterprise is wholly or partly carried on; whereas para 2 provides specific instances of the PE. The assessee argued that in order to establish PE in India in terms of Article 5(2), conditions of Article 5(1) must also be satisfied. This argument was rejected on the ground that:

Article 5(2) of DTAA provides the circumstances under which PE arises in a Contracting State. Para 2 provides for specific instances over and above the general provisions contained in para 1. It is a well accepted principle that specific provisions prevail over the general provisions.

Therefore, if the conditions provided in para 2 of Article 5 are satisfied, it will amount to a PE, irrespective of the fact whether the general provisions of Article 5(1) cover such a situation or not.

Further, Article 5(2)(j) of the DTAA encompasses a building site, a construction, assembly or installation project or supervisory activities in connection therewith, only if such site, project or activities last more than six months *(183 days)*.

It was thus held that the supervisory PE of assessee existed in India from the time Indian clients contracted with assessee to carry out the work of supply, supervision, erection, installation and successful commissioning of plants. Further, on account of existence of business connection in India, a part of the profit attributable to the PE was liable to be taxed in India.

Case Law 3: Mc Kinsey Knowledge Centre India Pvt Ltd Vs. ITO TDS (IT) (ITA No. 407/Del/2013)

Payment made by assessee to foreign company for database access and for downloading readily available information falls outside the purview of the definition of royalty under Article 12 of the Indo-Singapore DTAA; it merely amounts to use of 'copyrighted material' and not use of copyright.

Facts of the case:

The assessee was engaged in the export of computer software *(including data processing)*, rendering support services and acting as a back-office to its parent entity. For the purpose of its business, the assessee was required to access certain database, maintained by Thomson Asia Pvt. Ltd, Singapore ('*Thomson*') which provides general information on share price, market etc. This database was publicly available and could be accessed by anyone, who was willing to subscribe to it. The assessee filed an application u/s 195(2) of the Act requesting the AO to issue an order of nil deduction of tax, in respect of payment of USD 39,427.50 to Thomson, as consideration for the database access.

The AO rejected such request and treated the payments as royalty. The assessee contended that payments to Thomson were not in nature of royalty per section 9(1)(vi) of the Act as payments were merely for accessing database and assessee did not have any license for commercial exploitation of copyright.

The AO rejected assessee's submissions and treated payments as royalty u/s 195(2) of the Act, thereby directing assessee to withhold tax at source. On appeal, the Hon'ble CIT(A) dismissed the assessee's appeals. Aggrieved, the assessee preferred appeal before the Hon'ble Tribunal.

Decision of the Hon'ble Tribunal:

On perusal of the agreement, the Hon'ble Tribunal observed that the database provided by Thomson to the assessee was a compilation of general information, relating to share market which is neither relating to Thomson's own experience nor is it secret or divulged information and the payments made were for merely accessing the database. Further, the Hon'ble Tribunal noted that with this access, the assessee has not received any knowledge as to how the databases are maintained nor does it have any license for commercial exploitation of the copyright with regard to the database maintained by Thomson.

Accordingly, the Hon'ble Tribunal observed that assessee had claimed a limited right to use the information which was no doubt the 'copyrighted information' solely belonging to Thomson under the agreement.

The Hon'ble Tribunal stated that in order to qualify payment made to Thomson as royalty payment, it is necessary to establish that there is a transfer of all or any rights in respect of copyright of literary work. In relation to the same, it observed that the assessee was not allowed to exploit the database commercially under the agreement. The Hon'ble Tribunal observed that the payment made by the assessee was for the use of 'copyrighted material' only, and not for the use of the copyright.

Hence, the Hon'ble Tribunal ruled in favour of the assessee by holding that as the assessee has only received access of copyrighted material, there was no dispute about the payment falling within the ambit of definition of royalty.

Case Law 4: Ballarpur Industries Ltd Vs. CIT ([2017] 84 taxmann.com 61 [Bom])

Differential amount arising on account of exchange fluctuation shall be considered as an income which shall be subject to tax in the year of receipt even though the original/base income is exempt from tax.

Facts of the case:

The assessee is a public limited company and derived its income from business along with income by way of royalty and interest from a joint venture company in Malaysia. Per the then India-Malaysia DTAA, any income accrued or received by way of royalty or interest from Malaysian entity, was exempt from tax in India. Accordingly, the assessee recorded the said income as exempt income.

In the relevant AY, the assessee had received the royalty and interest which were accounted in the earlier years on accrual basis. The Malaysian company remitted the same in foreign currency and as a result of difference in the exchange rates, the assessee earned an exchange gain. There was no change in the income in terms of Malaysian currency.

As the income by way of royalty and interest from a Malaysian company was exempt from tax in view of India-Malaysia DTAA, using the same analogy, the assessee took a stand that the differential amount arising on account of exchange fluctuation of remittance of royalty and interest pertaining to the earlier years should also be exempt from tax.

However, the AO did not accept this claim and treated the same as income of the assessee in the year of receipt stating that it is said in law that income arising on account of exchange fluctuation in respect of foreign currency held abroad on revenue account is a trading receipt and is liable to tax. It cannot be said that this trading receipt retains the character of royalty and interest.

Aggrieved by the decision of the AO, the assessee preferred an appeal with the Hon'ble CIT(A). The Hon'ble CIT(A) upheld the order of the AO relying on the decision rendered by the supreme court in case of CIT Vs. Sutlej Cotton Mills Ltd (116 ITR 1) (SC) wherein it was held that the profit arising to the taxpayer on account of appreciation in the value of foreign currency held by it has to be treated as trading profit.

On further appeal, the Hon'ble Tribunal also upheld the stand taken by the AO and Hon'ble CIT(A). The Hon'ble Tribunal held that the DTAA does not cover the income on account of fluctuations in foreign currencies and therefore, the same shall be taxable in the hands of the assessee.

Aggrieved by the decision, the assessee preferred an appeal with the Hon'ble High court.

Decision of the Hon'ble High Court:

The Hon'ble High Court stated that the gain on account of foreign exchange variation cannot be attributed to royalty and interest earned in Malaysia, but it is a benefit/income arising from subsequent transaction not related to interest and royalty which has accrued earlier and was taxable in an earlier year.

It further added that exchange differences arising on foreign currency transactions should be recognized as income or as expense in the period in which they arise. Further, it relied on the decision rendered by the Apex Court in the case of Woodward Governor India (P) Ltd. (312 ITR 254) (SC) wherein the Hon'ble Supreme Court approved the applicability of AS 11 in order to determine the taxability on account of foreign exchange fluctuation.

Thus it was held that income arising due to foreign currency fluctuation shall be taxable irrespective of the fact that base income is exempt on account of operation of the DTAA.

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

1. Circular No. 24/2017 dated July 25, 2017 – FAQs on computation of book profits u/s 115JB for Indian Accounting Standards

The CBDT has clarified herewith by way of the circular, various issues arising on account of computation of book profit for the purposes of levy of Minimum Alternate Tax ('*MAT*') u/s 115JB of the Act for Indian Accounting Standards ('*Ind AS*') compliant companies.

A link for the same is provided herewith:

http://www.incometaxindia.gov.in/communications/circular/circular_24_%202017.pdf

2. Circular No. 23/2017 dated July 19, 2017 – TDS on the Goods and Service Tax ('*GST*') component

The CBDT has clarified herewith by way of circular that no tax shall be liable to be deducted ('*TDS*') on the amount of GST charged in the invoice separately.

The rationale of excluding the service tax component from the purview of TDS remains valid. In cases where the component of 'GST on services' payable to a resident is indicated separately, tax shall be deducted at source under Chapter XVII-B of the Act on the amount paid or payable without including such 'GST on services' component.

A link for the same is provided herewith:

http://www.incometaxindia.gov.in/communications/circular/circular_23_2017.pdf

3. Notification No. 79 dated August 3, 2017 – Capital gain exemption u/s 54EC of the Act

The CBDT has notified herewith by way of notification, a new bond for the purpose of claiming exemption u/s 54EC of the Act. Alongwith bonds issued by Rural Electrification Corporation and National Highway Authorities of India, bonds issued by the Indian Railway Finance Corporation Limited shall also be entitled to the benefit provided to the taxpayer u/s 54EC of the Act.

A link for the same is provided herewith:

http://www.incometaxindia.gov.in/communications/notification/notification79_2017.pdf

4. Notification No. 75 dated July 28, 2017 – Annexures of Multilateral Competent Authority Agreement on the Exchange of Country-by-Country Reports

The CBDT has issued herewith by way of notification the Multilateral agreement.

A link for the same is provided herewith:

http://www.incometaxindia.gov.in/communications/notification/notification75_2017.pdf

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