PARTNERS BEYOND BOUNDARIES

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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.

Kartik Mehta
Manager, Taxation

Transfer pricing

Case Law 1: Agilisys IT Services India (P.) Ltd. Vs Income Tax Officer 9(2)(3), Mumbai [2016] 76 taxmann.com 134 (Mumbai Trib.)

On factoring in the notional interest calculated with respect to overdue receivables from the associated enterprises ('AE'), addition cannot be made if the margin of assessee was more than average margin of comparable selected.

Facts of the case:

The assessee is a company, engaged in the business of software development services. The assessee rendered software development services to its AE at cost + mark-up of 15% and earned revenue constituting 90% of its total revenue. The transaction was bench marked using Transactional Net Margin Method ('*TNMM*') at entity level.

Aggrieved by the order passed, the assessee filed appeal before the Hon'ble CIT(A). The Hon'ble CIT(A) partly allowed the assessee's appeal by scaling down the rate of interest by applying the rate of LIBOR + 200 basis points as against the assessee's claim for a complete deletion of the adjustment made.

Aggrieved by the decision, cross appeal was filed by the assessee and the revenue.

Decision of the Hon'ble Tribunal:

The Hon'ble Tribunal without going into the controversy as to whether the overdue receivables from the AE constitute an 'international transaction' within the meaning of section 92B of the Income Tax Act ('*Act')* or not, held that if on calculating the notional interest with respect to the overdue receivables from the AE, the reduced margin of assessee was more than the average margin of the comparables selected thereby showing that no further adjustment is required to be made to the stated transactions.

Thus, since in the assesee's case, the margin of assessee was much higher than the comparable concerned, the transaction can be said to be at arm's length and no separate adjustment is required to be made on it.

Addition is not required to be made if the margin of assessee was much higher than the average margin of the comparables selected.

Domestic taxation

Case Law 1: Bajaj International (P.) Ltd Vs DCIT [2016] 76 taxmann.com 202 (Mumbai Trib.)

*If it is proved that the impugned commission payments were illicit, it could not be concluded that same were not made for purpose of assessee's business***.**

Facts of the case:

- The assessee was engaged in the business of trading in export of electrical goods and appliances;
- The assessee had exported goods to Iraq under the UNO 'Oil for Food Scheme' and in this connection, had paid commission to its agent for providing services to them and realization of export proceeds;
- The assessing officer ('*AO*') citing Volcker Committee Report, reported that illicit kickbacks and surcharges were paid to the Iraqi government in pursuance of the 'Oil for Food Programme', in various nomenclatures like inland transportation fee, loading fee, commission, etc.;
- In view of the above, the commission paid by the assessee to its agent were actually nothing but illicit payments made to the Iraqi Government and thus shall be disallowed u/s 37 of the Act;
- However, it was found that the commission payments made by the assessee to its agent, were for services that have been rendered by its agent to the assessee in consideration of the same;
- Further, nothing has been brought on record by revenue to show that the transactions relating to the payment of commission by the assessee are either nongenuine or are excessive or unreasonable;
- Thus, from a casual perusal of the details on record and in the orders of the authorities below it has not been proved that the assessee company was involved in illicit payments of commission to the Iraqi Government;
- Therefore, it cannot be concluded that commission payments were not made for the purpose of assessee's business and thus section 37(1) cannot be invoked merely on the basis of an unestablished doubt that expenditure incurred could be for infraction of law.

Thus, the commission paid to agent cannot be disallowed u/s 37(1) of the Act, unless proved illicit in nature.

Head office: 303, OIA House, 470 Cardinal Gracious Road, Andheri (East), Mumbai - 400 099, India
Other offices: Amsterdam | Atlanta | Bengaluru | Delhi | Dubai | Geneva | Hyderabad | London | Lyon | Singapore | Toronto

Case Law 2: Siemens Pub. Communication Network Pvt Ltd Vs CIT Bangalore & ANR (ITA No. 59/2007)

While analysing whether a subvention is a capital or revenue receipt, unless the grant-in-aid received is utilized for acquisition of an asset, the same must be understood to be in the nature of a revenue receipt.

Facts of the case:

The assessee is an Indian company and has its parent company in Germany. The assessee had been making losses, and subsequently, it received a subvention from its parent company in Germany. The above subvention was treated as a revenue receipt by the AO. Though the Hon'ble CIT(A) and the Hon'ble Tribunal had reversed the said finding, the Hon'ble High Court had restored the view taken by the AO. Aggrieved, the assessee has filed the present appeal before the Hon'ble Supreme Court of India.

Decision of the Hon'ble Supreme Court:

The Hon'ble Supreme Court considered the arguments put before the Hon'ble High Court. The Hon'ble High Court made a reference to two decisions namely Sahney Steel & Press Works Ltd, Hyderabad Vs CIT, A.P.-I, Hyderabad and CIT, Madras Vs Ponni Sugars and Chemicals Limited. The Hon'ble High court had held it to be a principle of law applicable to all situations, that unless the grant-in-aid received by an assessee is utilized for acquisition of an asset, the same must be understood to be in the nature of a revenue receipt. However, the above view tends to overlook the fact that in both the above cases preferred to by the Hon'ble High Court, the subsidies received were in the nature of grant-in-aid from public funds and not by way of voluntary contribution by the parent company as against in the present scenario. However, in the present case, the voluntary payments made by the parent company to its loss making Indian company can also be understood to be payments made to protect the capital investment of the assessee. Keeping the above view in mind, and referring to the pronouncement in CIT Vs Handicrafts and Handlooms Export Corporation of India Ltd., the Hon'ble Supreme Court held that the payments made to the assessee by the parent company for assessment years ('*AY*') in question cannot be held to be revenue receipts.

In view of the aforesaid reasons, the Hon'ble Supreme Court allowed the present appeal by setting aside the order of the High Court and affirming that the subvention received is not revenue in nature, as it can be understood that the payments were being made to protect the capital investment of the assessee company.

Case Law 3: M/s Andrew Telecommunications India Pvt. Ltd. Vs PCIT, ACIT, JCIT, The Union of India

In a case where the outstanding demand is disputed before Hon'ble CIT(A), the AO shall grant stay of demand till disposal of first appeal on payment of 15% of the disputed demand unless the case falls under certain categories as mentioned in para B of office memorandum dated February 29, 2016 ('OM').

Facts of the case:

The assessee is engaged in the business of manufacturing base station antennas, microwave antennas, R. F. cables, jumpers and connectors and trading in related products. For the AY 2012-13, the assessee filed a return declaring a loss of INR 10.23 crore. The assessee's case was selected for scrutiny. The scrutiny was concluded and the assessee was served with a demand notice for INR 16.90 crore.

The assessee preferred an appeal before the Hon'ble CIT(A), which was pending disposal. The assessee further applied for stay of demand, and claimed stay of demand till the appeal was decided by Hon'ble CIT(A). However, the same was not considered. Instead, the revenue ordered to adjust the refund of INR 12.25 crore which was due to the assessee in respect of the AYs 2006-07 and 2007-08 against the said demand. Further, the assessee's personal request for a hearing was not acceded to.

Aggrieved, the assessee filed a writ petition before the Hon'ble Bombay High Court.

Before the Hon'ble High Court the assessee submitted that in accordance with the instructions laid down in the OM, the AO was obliged to grant stay of the demand on payment of 15% of the disputed amount in a case where the outstanding demand is disputed before the Hon'ble CIT(A). The assessee thus argued that only 15% of the amount, and not the full amount could be adjusted against any pending refund.

Decision of the Hon'ble High Court:

The Hon'ble High Court observed the facts of the case and noted that assessee's case was fit for granting a stay till the disposal of the first appeal on payment of 15% of the disputed demand in accordance with the provisions of the OM.

The Hon'ble High Court further stated that the OM contemplated for some additional conditions which might be imposed by AO while granting stay which also included a right to adjust the refund to the extent of demand subject to section 245 of the Act.

The Hon'ble High Court thus noticed that the dispute was about the extent of such adjustment. The Hon'ble High Court, observing the facts of the case and the provisions of the OM, held that the demand could be stayed subject to 15% of the total demand which could be adjusted towards the refund due for AYs 2006-07 and 2007-08.

The Hon'ble High Court thus ordered interim stay of said order on condition that 15% of amount would be adjusted against refund due for the AYs 2006-07 and 2007-08.

Case Law 4: Virage Logic International Vs DDIT (ITA No. 1108/2007)

Transfer of computer software from the Indian branch to the head office is entitled to claim benefit under section 10A of the Act.

Facts of the case:

The assessee is engaged in the business of software development and had been approved by the Reserve Bank of India ('RBI') to establish a branch office in India for the purpose of development of software for export. It also received approval for setting up of 100% Export Oriented Unit ('EOU') under the Software Technology Park ('STP') Scheme. The software so developed under the Scheme by it was electronically transferred to its head office abroad. The head office paid 15% mark up on all direct and indirect costs incurred by the assessee as per the terms of the agreement. Lastly, the assessee reported a profit from this transfer and filed a return seeking exemption under section 10A of the Act.

Based on the above facts, the learned AO rejected the assessee's claim holding that the transaction did not qualify as an export transaction as the assessee had sold the software to its head office and the head office and the branch were part of the same entity. Also, benefits of section 10A were introduced to encourage foreign exchange. However, in the present case, the AO observed that the assessee remitted back its profit to the head office defeating the purpose of introducing the said section. The AO further relied on definition of export as given in *Explanation 2* to section 80HHC of the Act which provides that only when the goods which are transferred to head office situated outside India are sold to a third party by the head office, such transfer shall be deemed to be export for the branch.

However, the assessee stated that the condition as laid down in the *Explanation 2* to section 80HHC of the Act *(i.e. considering the transaction as export only if the product is sold after being exported to the head office)* is absent in the provisions of section 10A of the Act. The assessee thus stated that this would imply that the intent of the government is to consider such a transaction between the branch and the head office without fulfilment of the condition mentioned above as an export transaction, and thus, be included in the ambit of section 10A of the Act.

On carrying the matter before the Hon'ble CIT(A), the Hon'ble CIT(A) upheld the decision of the AO observing that:

1. The computer software was transferred to the head office and the head office and the branch were one entity; &
2. Since there is no further sale by the head office, there is no export sale by the assessee.

On further appeal before the Hon'ble Tribunal, the Hon'ble Tribunal held in favour of the AO and upheld the decision.

Aggrieved by the decision, appeal was preferred before the Hon'ble High Court.

Decision of the Hon'ble High Court:

The Hon'ble High Court reversed the decision of the Hon'ble Tribunal on the grounds that in absence of a deemed export provision in section 10A similar to one in section 80HHC does not logically challenge the meaning of the expression export as defined in section 10A(7).

For the above reason, the Hon'ble High Court was of the opinion that the law framed is in favour of the assessee and accordingly the appeals were dismissed granting the exemption to the assessee.

Thus, transfer of computer software from the Indian branch to the head office is entitled to claim benefit under section 10A of the Act in absence of the deemed export provision.

Case Law 5: Hardik Jigishbhai Desai Vs DCIT (ITA No. 1084/Ahd/2013)

Provision of expense is disallowed on account of non-deduction of TDS under section 40(a)(ia).

Summary of the case:

The assessee followed mercantile system of accounting. It was the assessee's normal practice to provide for the expenses on the year-ending date and reverse the same on the 1st day of the next financial year since the names of payees were unknown on the year-ending date. The actual expenses were booked by the assessee when the bills were received along with actual names of payee. Therefore, the assessee contended that the TDS provisions under section 194H of the Act were not applicable on such provision of expenses where the liability on the year-ending date was not ascertainable.

Based on the above facts, the AO observed that tax should be deducted on expenses credited or likely to be credited as per the provisions of section 194H of the Act. The AO also opined that the current accounting practice of the assessee resulted in diversion of the assessee's income to the next FY, which should be taxed in the current year. Thus, the AO invoked the provisions of section 40(a)(ia) of the Act for disallowing the provisions for expense.

On carrying the matter before the Hon'ble CIT(A), the Hon'ble CIT(A) upheld the decision of the AO observing that no tax had been deducted at source on provision of commission payable. Further, he observed that the liability to deduct tax at source would arise in the hands of the assessee at the time of making the provision. Therefore, the amount of provision of expense was not allowed as deduction during the year.

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

Decision of the Hon'ble Tribunal:

The Hon'ble Tribunal upheld the decision of Hon'ble CIT(A) stating that the provision for payment of commission claimed by the assessee is unascertainable, uncrystallised and fanciful. It doesn't assume the character of ascertained mercantile liability.

Therefore, the provision of expense was fully disallowed and the assessee's appeal was dismissed.

Case Law 6: Sanyo BPL Private Limited Vs Deputy Commissioner of Income Tax (2016) 75 taxmann.com 253 (Bangalore Trib.)

Ingredients essential for invoking Explanation 3 to section 43(1) of the Act in order to determine the actual cost of asset evaluated.

Facts of the case:

The assessee company is engaged in the business of manufacture and trade of colour television and accessories. The assessee is a 50:50 joint venture of M/s BPL Ltd and M/s Sanyo Electric Co, Japan. The colour TV business of BPL Ltd was transferred on slump sale basis to the assessee company. Fixed assets were transferred to the assessee and the difference between the closing WDV of the transferor and the opening WDV of the assessee company as per valuation was INR 58.08 crores.

The AO noted that the assessee company has undervalued the value of land substantially and increased the value of other fixed assets eligible for depreciation which became clear from the fact that the value of depreciable items was substantially increased from INR 15.75 crores to INR 73.83 crores *(difference being INR 58.08 crores)*. Thus, the AO increased the value of closing WDV of the transferor by only 25% and disallowed the depreciation claimed on the value of assets, over and above 25% of the closing WDV of the transferor by invoking *Explanation 3* to section 43(1) of the Act. The assessee appealed with the Hon'ble CIT(A) wherein the Hon'ble CIT(A) upheld the order of the AO and thus, the assessee preferred an appeal with the Hon'ble Bangalore Tribunal.

Decision of the Hon'ble Bangalore Tribunal:

The prerequisite condition necessary for invoking the said *Explanation 3* to section 43(1) are only *(1)* that the asset at any time was used by any other person for the purpose of business and *(2)* the main purpose of transfer of such assets directly or indirectly to the assessee company was for reduction of liability to income tax.

In the present case, transaction of acquisition of business as a going concern is between two related parties and the seller had a substantial interest by holding 50% share.

Also, the assets were already depreciated in the hands of the transferor, higher values were assigned by the assessee company in order to avoid tax liability.

Thus, ingredients which are necessary for invoking *Explanation 3* to section 43(1) are satisfied and the AO is justified in his action in restricting the allowance of depreciation on WDV at higher than 25% of the closing stock.