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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 and a few important notifications and circulars issued by the Central Board of Direct Taxes.

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International Tax

Case Law 1: Deputy Commissioner of Income-tax Vs. Bombardier Transportation India (P.) Ltd. [2017] 77 taxmann.com 166 (Ahmedabad Trib.)

When certain standard services are provided to the assessee, which may even require use of certain equipment, the consideration paid in respect of these services cannot fall under the ambit of the definition of 'royalty' as the assessee does not really have control over or right to use such equipment.

Further, merely on the basis that the rendering of services to the assessee would result in consequent improvement in the performance of the local employees, the 'make available' clause cannot be invoked, the invoking of which would result in such consideration being categorized as 'fees for included services'.

Ground 1:

Facts:

The assessee is a wholly owned subsidiary of Bombardier Transportation (Holdings) Singapore PTE Ltd., a part of Bombardier Group, and is engaged in the business of manufacturing and supply of rail transportation system. During the course of scrutiny of TDS returns, the assessing officer ('*AO*') noticed that the assessee has made payments, aggregating to INR 91,996,649 to Bombardier Transportation Canada Inc. ('*BTCI*'). These payments were towards information system support services at a group level. A few services which were provided to the assessee are listed as under:

- ERP application for accounting and reporting;
- Common standard human resource platform;
- 3-tier application framework for scientific calculations in the field of engineering;
- Time and attendance system for all employees;
- Server to communicate with employees and stakeholders *(including receiving and sending emails, accessibility to information stored on database)*; &
- Customer claim management tool etc.

These services were charged to the assessee based on costs incurred towards consumption of various service elements by the assessee.

During the course of the assessment proceedings, the AO proceeded to hold that the impugned payments are taxable as royalties, covered by the consideration for 'use or right to use any industrial, commercial or scientific equipment' under section 9(1)(vi) read with Explanation 2(iva) of the Act and as also as per the provisions of Article 12(3)(b) of the Indo-Canada tax treaty. The AO, after a detailed analysis of the payments, was of the view that a major portion of the payment is for the use or right to use industrial, commercial or scientific equipment, while remaining cover the use of various processes for which access had been granted to the assessee company.

The assessee contended that the payments were in the nature of reimbursements and cannot partake the character of income in the hands of the recipient concerned. Further, it contended that there was no transfer of right or any license and therefore the payments were not liable to be taxed under the domestic laws. In the context of the Indo-Canada double tax avoidance agreement ('*DTAA'*), the assessee contended that only such payments as having an element for use of intellectual property rights ('*IPRs*') could be considered as royalties, and in the present scenario, the payments are for standard facilities.

The AO rejected the claim of the assessee and held that the assessee ought to have withheld tax at source @10% from these payments. Accordingly, a demand under section 201(1) read with section 195 of the Act was raised on the assessee.

Aggrieved, the assessee carried the matter in appeal before the Hon'ble commissioner of income tax (appeals) ('*CIT(A)*') who upheld the plea of the assessee and deleted the impugned tax withholding demand.

Aggrieved by the relief so granted by the Hon'ble CIT(A), the AO preferred an appeal before Hon'ble Ahmedabad Tribunal.

Decision of the Hon'ble Tribunal

- The Hon'ble Tribunal, explaining the term 'use or right to use' held that the payments, by no stretch of logic, could be viewed as payments for right to use the equipment. The assessee was entitled to certain services, during rendition of which even if certain equipment were to be used, but that by itself did not result in any use of or right to use the equipment by the assessee. It went on to clarify that the service may involve use of equipment but that does not vest right in the assessee to use the equipment. The Hon'ble Tribunal further stated that even if a part of consideration can be said to be on account of use of equipment by breaking down all the components of economic activity for which consideration is paid, it is neither practicable, nor permissible, to assign monetary value to each of the segment of this economic activity and consider that amount in isolation, for the purpose of deciding character of that amount. The Hon'ble Tribunal held that similarly, even if the payment is to be considered as payment for use of software, as is the settled legal position as of now, unless there is no transfer of copyright, there cannot be any occasion to hold it as royalty.

- The Hon'ble Tribunal further pointed out that in any event, so far as the transaction between the assessee and the BTCI is concerned, it is simply in the nature of reimbursement of expenses incurred by BTCI, on behalf of the assessee, and it had no income element so far as BT Canada is concerned.

The ground was thus dismissed and the matter was decided in favour of the assessee.

Thus, it is trite that for any consideration to be taxed as 'royalties', it has to be first showed that the customer/payer has a 'right to use' the right, information or property and secondly, such right, information or property should be in the nature of IPRs such as patent, formula, secret process, copyright or any other similar property.

Ground 2:

Facts:

The assessee has made payments of INR 68,054,110, on account of administration, marketing and procurement and INR 4,067,408 on account of human resources services to BTCI. The above-mentioned services were in the nature of management support and advisory services.

On these facts, the AO was of the view that these services result in 'passing on suitable knowledge, skill and experience during the course of execution of these services' which itself 'makes available experience and skill of the non-resident to the assessee which in turn gets hit by the mischief of definition of fees for technical services in the DTAA'. The AO was also of the view that 'the service of technical input, advice, expertise etc. rendered by the non-resident company are technical in nature as provided for in the definition in the DTAA and not merely a standard service'.

Accordingly, the assessee was held to have committed a default in not deducting tax at source from these payments, @ 15%, under section 195 of the Act. The resultant demand u/s 201 read with section 195 of the Act was, therefore, raised by the AO. Aggrieved, the assessee filed appeal before the Hon'ble CIT(A) who rendered the decision in favour of the assessee and deleted the impugned demand. Aggrieved by the relief so granted by the Hon'ble CIT(A), the AO preferred an appeal before the Hon'ble Tribunal.

Decision of the Hon'ble Tribunal:

Referring to Article 12 of the Indo-Canada DTAA, the Hon'ble Tribunal stated that in order for a payment to be taxed as 'fees for technical services' under the provisions of the DTAA, such services should 'make available' technical knowledge, experience, skill, knowhow or processes or consist of the development and transfer of a technical plan or technical design. The Hon'ble Tribunal observed that the services provided by BTCI were simply management support or consultancy services which did not involve any transfer of technology.

The Hon'ble Tribunal thus dismissed the ground in favour of the assessee by laying down the following:

"The technical or consultancy service rendered should be of such a nature that it 'makes available' to the recipient technical knowledge, knowhow and the like. The service should be aimed at and result in transmitting technical knowledge, etc., so that the payer of the service could derive an enduring benefit and utilize the knowledge or knowhow on his own in future without the aid of the service provider.

In other words, to fit into the terminology 'making available', the technical knowledge, skill, etc., must remain with the person receiving the services even after the particular contract comes to an end. It is not enough that the services offered are the product of intense technological effort and a lot of technical knowledge and experience of the service provider have gone into it. The technical knowledge or skills of the provider should be imparted to and absorbed by the receiver so that the receiver can deploy similar technology or techniques in the future without depending upon the provider.

Technology will be considered 'made available' when the person acquiring the service is enabled to apply the technology. The fact that the provision of the service that may require technical knowledge, skills, etc., does not mean that technology is made available to the person purchasing the service, within the meaning of paragraph (4)(b). Similarly, the use of a product which embodies technology shall not per se be considered to make the technology available."

Thus, in other words, payment of consideration would be regarded as 'fee for technical/included services' only if the twin test of rendering services and making technical knowledge available at the same time is satisfied.

Case Law 2: Elitecore Technologies Private Limited Vs. Commissioner of Income Tax (ITA No.623/Ahd/2015)

For the purpose of claiming foreign tax credit ('FTC') against the minimum alternate tax ('MAT') liability, actual tax attributable to income to be determined by apportioning the actual tax paid under MAT provisions in the same ratio as double taxed profit to the overall profits.

Facts of the case:

The brief facts of the issue are that the assessee company, Elitecore Technologies Private Limited, is a wholly owned subsidiary of a US company Elitecore Technologies Inc, engaged in the business of software developments and products. During the relevant assessment year, assessee did not have any income taxable under the normal provisions, however, the book profits under section 115JB of the Act were computed and accordingly tax liability under MAT provisions was calculated. The assessee had claimed FTC in respect of taxes withheld abroad i.e. in Singapore and Indonesia on account of certain payments received by the assessee.

The AO however, did not approve the claim so made by the assessee. He was of the view that the tax credit is to be allowed only to the extent corresponding income taxed in India. The extent to which income is taxed in India in respect of these receipts is to be computed by reference to the actual MAT liability being divided in the same ratio as the ratio of corresponding foreign receipts to the overall turnover of the assessee.

The AO thus rejected assessee's FTC claim. On appeal, the Hon'ble CIT(A) upheld the AO's order.

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

Decision of the Hon'ble Bangalore Tribunal:

The Hon'ble Tribunal took a notice of the fact that there are two main aspects to be considered in the assessee's case:
(i) Manner in which the quantum of income was eligible to be treated as taxed in both the countries; &
(ii) Manner in which eligible FTC was to be computed.

In relation to the first aspect, the Hon'ble Tribunal analysed the provisions contained in India-Indonesia DTAA and India-Singapore DTAA and opined that with respect to the quantum of income to be taxed in both the countries, there was no guidance available in the treaties.

However, a perusal of the above clauses of DTAA with Indonesia and Singapore clearly show that the amount of tax payable in respect of profit or income arising in that country and subjected to tax both in India and the other country shall be allowed as a credit against Indian tax payable in respect of such profits or income in such manner that the credit should not exceed the Indian tax which is appropriate to the profit or income arising in the other country. It is vital to note that the term used therein was 'income' and not 'gross receipt'.

The Hon'ble Tribunal also observed that same approach was reflected in the UN Model Convention Commentary as well as OECD Model Convention Commentary. Therefore, it wasn't the right approach to take into account the gross receipts for the purpose of computing admissible tax credit, as was contended by the assessee.

In reference to the transactions under consideration, there was only release of margin money and addition of a separate user and the same did not require any activity on assessee's part. Hon'ble Tribunal therefore opined that those earnings were passive in nature and no part of costs incurred in India could be allocated to earnings from Singapore and Indonesia.

In relation to the second aspect, the Hon'ble Tribunal clarified that FTC for both the jurisdictions would be computed separately, but in a similar manner as per provisions of respective treaties. Per the relevant Articles of India-Indonesia DTAA and India-Singapore DTAA, the Hon'ble Tribunal held that in the tax credit could not exceed the part of the income tax as computed before the deduction is given and therefore income would be computed on a proportionate basis. The Hon'ble Tribunal held that in the absence of any other method for computing the tax credit admissible, the actual tax paid under MAT provisions in the same ratio as doubly taxed profit to the overall profits would be admissible.

In view of the aforesaid reasons, the Hon'ble Tribunal partly allowed the assessee's appeal.

Domestic Tax

Case Law 1: Commissioner of Income Tax, Chennai. Vs. M/s. Chemech Laboratories Ltd. (Tax Case Appeal No.1492 of 2007)

Consideration attributable towards non-compete clause in a composite agreement will be taxed under the head 'profits and gains from business and profession'.

Facts of the case:

The assessee is engaged in the business of manufacture and marketing of pharmaceuticals. The assessee entered into three separate agreements with Solvay Pharma (I) Ltd. *('SPIL')* i.e. for acquisition of brand, consultancy and non-compete for a total consideration of INR 6 crores. The parties had specified terms and conditions for sale and had also incorporated the non-compete agreement vide clause 4 of brand acquisition agreement. During the course of assessment proceedings, the assessee contended that INR 6 crores pertained only to transfer of business under the brand acquisition agreement and no consideration was received towards the non-compete agreement. The AO, however, allocated one installment amounting to INR 4 crores towards non-compete and brought it to tax.

On appeal, the Hon'ble CIT(A) attributed 50% of the consideration i.e. INR 3 crores towards non-compete. The Hon'ble CIT(A) noted that both non-compete and brand acquisition were equally important components in the transfer of an undertaking. On further appeal, the Hon'ble Tribunal reversed orders of the Hon'ble CIT(A) and held that the entire sum of INR 6 crores would constitute a capital receipt and nothing would be attributable to the clause pertaining to non-compete. Aggrieved, the revenue preferred an appeal before Hon'ble Madras High Court.

Arguments before the Hon'ble High Court

Before the Hon'ble High Court, the assessee, in respect of attribution of consideration towards non-compete, submitted that the business transferred by it was highly specialized and exclusive which involved cutting-edge technology wholly inaccessible to it in the absence of the brands transferred.

The assessee also submitted that products it sells constitute hormones utilized for infertility treatment under prescription, close monitoring and in controlled conditions. The assessee therefore argued that said products were manufactured by only three companies worldwide and the third entity which was under exclusive agreement with assessee now stood transferred to SPIL under the brand acquisition agreement. The assessee therefore argued that its re-entry was just wishful thinking and an impossibility and thus no component of the said consideration pertained to the non-compete clause. The assessee however suggested that INR 1 crore might be adopted as a reasonable valuation towards non-compete fee.

Decision of the Hon'ble High Court:

The Hon'ble High Court referred to the agreement for consultancy and observed that it contained various terms and conditions relating to nature and scope of services as well as the remuneration in connection therewith. The Hon'ble High Court also observed that clause 3.6 of the agreement contained that the consideration for all matters has been agreed after taking into account all restrictive covenants.

The Hon'ble High Court noted that the Hon'ble Tribunal's conclusion was based on its observation that dominant purpose of the transaction was not to formulate a restrictive covenant, which was incidental, but to enforce enjoyment of the rights by exploitation of the brands.

The Hon'ble High Court then referred to Proviso (i) to section 28(va)(a) of the Act inserted by the Finance Act, 2002, with effect from April 1, 2002 and observed that legislature itself has made a conscious and clear distinction between the positive right to carry on a business or the activity of manufacture, production or process, consideration for the transfer of which would be chargeable under the head 'capital gains' and a negative right, being a covenant against the carrying on of any activity in relation to a business, the consideration for which would be taxable as business income. The Hon'ble High Court thus opined that after the effective date, consideration received towards a negative covenant would be liable to tax as business profits. The Hon'ble High Court further held that whether activity was incidental or dominant was thus irrelevant.

In line with the above observations, the Hon'ble High Court opined that the three agreements depict a composite transaction in respect of which the amount of INR 6 crores was received and further stated that a certain amount of the consideration would have to be allocated towards the non-compete clause.

With respect to the attribution part, the Hon'ble High Court, noting the assessee's contentions, stated that it has to reconcile this with the apparent intention of the parties to attribute some amount of the total consideration towards non-compete. The Hon'ble High Court thus attributed the sum of INR 1 crore to be proper and to serve the ends of justice.

Thus, consideration received towards an agreement of non-compete will be taxable under the head of business profits, whether or not the agreement was a dominant agreement or an incidental one.

KNAV comments

If a receipt is considered as payment of compensation with source remaining intact, it could be regarded as revenue receipt and thus liable to be taxed under the head 'profits and gains from business and profession'. However, if the receipt results into sterilization of the source of income, the same could be regarded as taxable under the head 'capital gains' subject to the condition that it results into the transfer of a capital asset and there exists a mechanism to compute the capital gains on the said transaction as per the provisions of the Act.

It is important to note that the aforesaid determination of the relevant head for taxability of the consideration received is a purely factual exercise and one that is dependent on the facts and circumstances of each case.

Case Law 2: Trans Corporate Advisory Services (P.) Ltd. Vs. Assistant Commissioner of Income tax (Writ petition no. 42341 of 2016)

Conclusive proof of income escaping assessment is not required at the stage of issuance of a notice under section 147 of the Act.

Summary of the case:

The assessee company was engaged in the business of corporate advisory, commission and real estate. The assessee filed the income tax return and the same was processed under section 143(1) of the Act. Subsequently, the AO noted that the company had issued shares at a huge premium even though the net worth of the company was low. He contended that the amount of share premium was liable to tax under section 68 of the Act and thus initiated reassessment proceedings and issued notice under section 147 of the Act.

The assessee's objections against the initiation of the reopening of assessment were dismissed. Therefore, the assessee filed a writ petition before the Hon'ble High Court.

The assessee's objections were that the AO, without any tangible material on hand, issued notice under section 148 of the Act. Further, he contended that when no assessment order had been passed and the assessment is completed under section 143(1) of the Act, notice for reopening of assessment cannot be issued unless there is reason to believe that the income chargeable to tax had escaped assessment.

In response to the contentions made by the assessee, the AO highlighted that the company had issued securities at a huge premium even though net worth of the company was low. The valuation of shares issued at high premium was prima facie found to be not in order and the source of money which was brought in as share premium required deeper scrutiny. The AO thus contended that this was a reason to believe that the income chargeable to tax had escaped assessment and thus was a reason to reopen assessment proceedings even though there was not conclusive proof of escapement of income.

The Hon'ble High Court agreed with the contentions and view of the AO and therefore, the writ petition filed by the assessee was dismissed and the decision was rendered in favour of the revenue.

Case Law 3: M/s. Shiv Shakti Flour Mills (P) Ltd. Vs. Commissioner of Income tax (ITA No. 6/Gau/2014)

The nature of the transport subsidy received shall be determined on applying the 'purpose test'.

Facts of the case:

The assessee had received a transport subsidy in AY 2001-02. However, his case was taken up for a scrutiny assessment under section 143(2) of the Act. The AO treated the said subsidy as supplementary trade receipt, considering it revenue in nature, and thus added it to the total income of the assessee.

Aggrieved by the order of the AO, the assessee preferred an appeal before the Hon'ble CIT(A), where the Hon'ble CIT(A) noted that the transport subsidy received was under the transport subsidy scheme for the development of north eastern regions of the country.

Therefore, the nature of receipt towards transport subsidy was declared to be capital receipt.

Aggrieved by the order of the Hon'ble CIT(A), the revenue challenged the order before the Hon'ble Tribunal. There were two different views opined by the accounting member and the judicial member of the Hon'ble Tribunal. On account of the differences between the two learned members of the Hon'ble Tribunal, the matter was referred to a 3rd member for his opinion.

Following the jurisdictional High Court decision in the case of CIT Vs. Meghalaya steels, where the transport subsidy received was considered to be revenue in nature, the third member taxed the subsidy and the Hon'ble Tribunal upheld the order passed by the AO. However, an appeal was preferred before the Hon'ble High Court under section 260A of the Act on the substantial question of law on whether the Hon'ble

Tribunal was justified in holding the transport subsidy as revenue in nature.

Decision of the Hon'ble High Court:

The Hon'ble High Court observing the facts of the case and relying on various jurisprudence, concluded that the nature of the transport subsidy received by the assessee has to be determined with respect to the 'purpose' for which the subsidy is given, known as the 'purpose test'. In the case in hand, it was decided that transport subsidy received by the assessee during the AY 2001-02 was intended to stimulate industrial activity in the backward region of the north-eastern states and it was not meant to provide higher profit for the assessee. Hence, the sum received under subsidy cannot be treated as revenue receipt.

Accordingly, the substantial question of law in the appeal is answered in favour of the assessee.

Recent important circulars and notifications issued by the central board of direct taxes ('*CBDT*')

1.Circular No. 41/2016 dated December 21, 2016 – Clarifications on indirect transfer provisions contained in section 9(1)(i) of the Act

The CBDT has clarified herewith by way of the circular that an asset or a capital asset, being any share or interest in a company or entity registered or incorporated outside India, shall be deemed to be and shall always be deemed to have been situated in India, if the share or interest derives, directly or indirectly, its value substantially from the assets located in India. The same shall be applicable only if on the specified date the value of such assets exceeds the amount of INR 10 crore and represents at least 50% of the value of all the assets owned by the company/entity. Small investors holding no right of management or control of such company/entity and holding less than 5% of the total voting power/share capital/interest of the company/entity that directly or indirectly owns the assets situated in India are provided with a carve-out from the applicability of the above explanations. Certain queries about the scope of the indirect transfer provisions have been solved and explained by the Board.

A link for the same is provided herewith:
http://www.incometaxindia.gov.in/communications/circular/circular41_2016.pdf

2.Circular No. 01/2017 dated January 02, 2017 – Deduction of tax at source under section 192 of the Act

The CBDT through this circular have informed about the rates of income tax, surcharge applicable and the broad scheme regarding TDS from salaries. The circular also speaks about the persons responsible for deducting tax and the respective duties of such persons. Further, the circular explains the procedure for computation of income under the head 'Salaries' and many other related issues. The circular has descriptions of various forms and other board notifications.

A link for the same is provided herewith: http://www.incometaxindia.gov.in/communications/circular/tds%202017.pdf

3.Notification No. 124/2016 dated December 29, 2016 – Extension of the date of applicability of the notification of the Ministry of Finance

The notification no. S.O.1902(E) dated May 26, 2016 issued by the Ministry of Finance (Department of Revenue) stated that a person may make a declaration to the designated authority in respect of a tax arrear or specified tax under the Direct Tax Dispute Resolution Scheme, 2016 on or before December 31, 2016. The CBDT through the referred notification have amended the same and extended the applicability of the said notification from December 31, 2016 to January 31, 2017.

A link for the notification issued in May 2016 is provided herewith: http://www.incometaxindia.gov.in/communications/notification/notification34_2016.pdf

A link for the amendment of the same is provided herewith: http://www.incometaxindia.gov.in/Communications/Notification/Notification124_2016.pdf

4.Notification No. 3/2017 dated January 10, 2017 – Agreement for avoidance of double taxation and prevention of fiscal evasion

The CBDT through the said notification notifies that an agreement and a protocol has been entered between Republic of India and Republic of Cyprus on November 18, 2016 to prevent double taxation and prevention of fiscal evasion of taxes on income. This agreement and protocol shall be applicable and enforceable from April 01, 2017.

A link for the same is provided herewith: http://www.incometaxindia.gov.in/communications/notification/notification3_2017.pdf

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