KNAV
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 along with important notifications, circular and press releases issued by the Central Board of Direct Taxes.

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Transfer Pricing

Case Law 1: Aster Private Limited Vs. DCIT ([2017] 81 taxmann.com 297 [Hyderabad - Trib.])

In respect of loan given in foreign currency, LIBOR rate should be the basis for calculation of interest rate;
No arms' length price ('ALP') adjustments can be made to the reimbursement expenditure which is not charged to profit and loss account of the assessee.

Summary of the case:

The important aspects in the instant case have been presented issue wise.

a. In respect of loan given in foreign currency

The assessee gave a loan to its subsidiary in Afghanistan and charged interest at the rate of 8% on the loan given. The transfer pricing officer ('*TPO*') proposed an addition by charging the interest at 12.25%. The Hon'ble Dispute Resolution Panel ('*DRP*') restricted the interest to 8.25%.

On appeal to the Hon'ble Tribunal, it was held that the loan was taken in foreign currency outside India and thus, LIBOR rate should be taken as the basis for calculating the interest. The assessee had charged 8% on the loan, which is higher than the LIBOR rate and accordingly no ALP adjustment is required to be made.

b. In respect of reimbursement of expenditure

The assessee received reimbursement of expenditure on cost-to-cost basis, which was neither part of profit and loss account nor operating expenditure. The TPO made an adjustment by charging a mark-up of 10% on the said reimbursement, as fees on the transaction. The Hon'ble DRP restricted the fees for reimbursement at 5%.

On appeal to the Hon'ble Tribunal, it was noted that the reimbursement of expenditure was made on cost to cost basis and it does not form part of profit and loss account of assessee, therefore no adjustment is warranted. Further, the said transaction was not a revenue generating transaction and the expenditure was purely traveling expenditure which was reimbursed and not part of operating expenditure. It was thus held that, no ALP adjustments can be made to the reimbursement expenditure, which is only reimbursement of traveling and other miscellaneous expenditures and is not charged to profit and loss account.

Case Law 2: Schneider Electric India Private Limited Vs. DCIT (ITA No. 209/Ahd/2015)

Just because the services are worthless in the eyes of the revenue authorities, the ALP of these services cannot be held to be nil.

Facts of the case:

The assessee was engaged in the business of manufacturing and sale of switches, outlets and other electrical products. During the year, the assessee had made payment of INR 1.51 crores under a cost sharing arrangement to its parent associated enterprise ('*AE*') towards management services and filed the Central Cost Allocation Agreement with the TPO which set out the details of these services.

The TPO considered the ALP for management fees as nil and disallowed the same by contending that assessee had failed to justify the payment on the basis of receipt and benefit test. Against this, the assessee preferred an appeal with the Hon'ble Commissioner of Income Tax ('*CIT[A]')* who upheld the order of the assessing officer *('AO') (passed in accordance with directions of the TPO)* by holding that merely filing a copy of central cost allocation agreement did not prove as an evidence that services were actually rendered. Aggrieved by the decision of the Hon'ble CIT(A), the assessee preferred an appeal with the Hon'ble Tribunal.

Decision of the Hon'ble Tribunal:

The Hon'ble Tribunal distinguished the decision of the Hon'ble CIT(A) on the following reasons:

- Just because the services are worthless in the eyes of the revenue authorities, the ALP of these services cannot be held to be nil;
- Relying on the decision rendered in the case of Merck Limited (TS 143 ITAT 2016) (Mum) wherein it was decided that when evaluating the ALP of a service, it was wholly irrelevant as to whether the assessee benefits from it or not;
- The real question which was to be determined in such cases was whether the price of this service was what an independent enterprise would have paid for the same;

- The cost allocation agreement and detailed documentation support placed on record by assessee proved actual rendition of services;
- It was not for TPO to bother about business expediency of these services but determine the ALP on the basis of a permissible method and therefore, it cannot question business expediency of assessee.

The Hon'ble Tribunal stated that the TPO cannot question the business expediency of the assessee and cannot reject the method adopted for the transaction entered by the assessee just because the services are worthless in the eyes of the officer.

Therefore, the decision was held in favour of the assessee.

Case Law 3: Shipnet Software Solutions India Private Limited Vs. DCIT ([2017] 81 taxmann.com 301 [Chennai - Trib.])

Turnover and brand value are not the criteria for selection of a comparable.
Further, a comparable company cannot be rejected merely because it is engaged in government projects, unless there is any functional dissimilarity.
Also, persistent loss-making companies should not be selected as a comparable.

Facts of the case:

The assesse company was engaged in rendering services in relation to design and development of software to its AE. The assessee had, in its transfer pricing report, shortlisted comparable companies after applying certain filters.

The TPO rejected the contentions of the assessee, and made certain additions and deletions to the list of comparables chosen by the assesse for the purpose of benchmarking the international transaction.

Against the said adjustments to the list of comparables, the assesse raised objections with the DRP and further, being aggrieved by the directions given by the Hon'ble DRP to the TPO, the assessee preferred an appeal before the Hon'ble Tribunal.

Summary of the decision rendered by the Hon'ble Tribunal:

The decision of the Hon'ble Tribunal in respect of the key issues can be summarized as under:

- It was observed by the Hon'ble Tribunal that the turnover of 3 comparable companies was substantially more than the assessee's turnover. The Hon'ble Tribunal noted that as per Rule 10B, turnover and brand value were not the criteria for selection of comparables. Noting that the assessee had neither demonstrated impact of high turnover on margin in the service sector under Transactional Net Margin Method ('*TNMM*'), nor brought forward fresh evidence in respect of functional differences to controvert the findings of the TPO/DRP, the Hon'ble Tribunal retained the comparables;
- The Hon'ble Tribunal rejected a comparable company engaged primarily in engineering design services on the ground that it is functionally dissimilar;
- In relation to another comparable, the assessee submitted that it had high margins as it was mainly engaged in government projects, and it also followed different revenue recognition method. The Hon'ble Tribunal held that a company cannot be excluded merely because it was engaged in government projects, and thereby rejected assessee's argument regarding high margins in government projects. It stated that the assessee did not bring forward any functional dissimilarity, differences in assets deployed and the impact on margins as per the revenue recognition note, and therefore, the said company was also included as a comparable; &
- Inclusion of a company as a comparable holding that loss is normal incidence of business unless any peculiarity or any abnormal situation of uncontrolled transaction was brought on record. The Hon'ble Tribunal noted that a comparable company was making persistent losses and further, the assessee itself had initially excluded this company citing persistent losses and therefore, rejected assessee's plea for inclusion.

Case Law 4: M/s Logix Microsystems Ltd Vs. DCIT (IT[TP]A No.280/Bang/2014) (IT[TP]A No.243/Bang/2014)

Normally, subscription to the shares of subsidiary company and allotment of such shares within a reasonable period of time, is not considered as an international transaction u/s 92B of the Act. However, when the shares have not been allotted for an unusually long period of time, and the money is available for utilization with the subsidiary, it loses the character of share application money, and therefore, such transaction will be covered u/s 92B of the Act as capital financing/advance to the AE.

General facts of the company:

The assessee is an Indian company, engaged in business activities segmented as business solutions, automotive solutions and enterprise product. The automotive solution segments are operated in the US market by its AEs whereas the other segments predominantly operated in domestic markets.

Ground 6 to 9: Selection of comparables

The assessee rendered software development and consultancy services to its AEs. To benchmark the same the assessee selected 11 comparable companies and adopted TNMM as the most appropriate method. However, during the scrutiny assessment procedures, TPO was not satisfied with the assessee's study report, and included a few other companies, resulting in a TP adjustment of INR 4.50 crores. The assessee sought exclusion of 3 companies from the set of comparables, on which Hon'ble Tribunal ruled as under:

Name and conclusion of the Hon'ble Tribunal	Observation of the Hon'ble Tribunal
Bodhtree Consulting Ltd – Excluded, relying on Marlabs Software Pvt. Ltd. (IT[TP]ANo.72/Bang/2014)	The company used a revenue recognition method which caused drastic fluctuations in profit margins on a yearly basis. Hence, excluded on the basis of drastic variations in profit margins.
KALS Information Systems Ltd – Excluded, relying on 3DPLMSoftware Solutions Ltd (42 Taxmann.com 333)	The company was engaged in development of software products in addition to being a software service provider. Hence, excluded on the ground of functional dissimilarity.
Sasken Communication Technology Ltd. *(Seg)* – Excluded	Turnover of the company was INR 479 crores, in comparison with assessee's turnover amounting to INR 25.44 crores. Hence, excluded on the basis of application of 10 times turnover filter.

Grounds 10 & 11: Foreign exchange gain or loss

The assessee has considered the foreign exchange fluctuation gain/loss as operating in nature as it had arisen from sale proceeds, per the consistent view taken by the Hon'ble Tribunal. The assessee was thus of the opinion that the same should be a part of the operating margins as well as comparables. The AO however was of the view that only foreign exchange fluctuation gain/loss in respect of the sale proceeds of the current year can be considered as operating in nature and not that arising on account of realization of sale of earlier year. The same had been contended by both the parties before the Hon'ble Tribunal.

Finding substance in revenue's argument, the Hon'ble Tribunal stated that gain or loss arising on account of realization of sale of earlier year cannot be considered as operating profit/cost of the year and thus, set aside the issue to the record of the AO/TPO for re-computing the margins.

Grounds 12 to 14: Treatment of share application money

The assessee had disclosed in its 3CEB Report and transfer pricing ('*TP*') documentation, an additional investment of INR 32.98 crores towards subscription in equity share capital of a subsidiary namely Logix America Inc. However, the shares were pending for allotment as on March 31, 2009. The TPO held that the fund remitted to the subsidiary for subscription of equity shares constituted an international transaction u/s 92B of the Act because such funds were in the nature of debt. Accordingly, the AO/TPO proposed a TP adjustment of INR 4.20 crores. The Hon'ble DRP upheld the proposed additions.

Aggrieved, the assessee preferred appeal before the Hon'ble Tribunal. The assessee submitted that subscription of equity shares was not a transaction of purchase/sale of shares.

Decision of the Hon'ble Tribunal:

The Hon'ble Tribunal explained that in the ordinary circumstances share application money remitted to AE cannot be considered as loan or advance to constitute international transaction u/s 92B of the Act, if the shares are allotted within a reasonable period of time. However, the Hon'ble Tribunal pointed out that share application money did not belong to the allotting company till the shares were actually allotted against the said remittance. Thus, till the allotment of shares, the allotting company cannot have any right to use the share application money, pursuant to which it has to be kept in a separate bank account maintained for that purpose.

Noting that the assessee had remitted the amount during the year and no shares were allotted till the end of the financial year, the Hon'ble Tribunal opined that when this money was available with the AE of the assessee for utilization, then it loses the character of share application money. It further stated that the rule as laid down by the various decisions of the same Tribunal relied upon by assessee would not be applicable in a case where the money was available to the AE and there was an extraordinary delay in allotment of shares.

The Hon'ble Tribunal thus held that the transaction would constitute an international transaction as per the provisions of section 92B of the Act having a direct bearing on the profit and loss as well as the assets of the enterprise. Further, the Hon'ble Tribunal also held that as per the Explanation to section 92B(1) of the Act, the said money will constitute as capital financing/advance to AE till the date of allotment of shares.

However, the Hon'ble Tribunal concurred with the assessee's alternative plea to apply LIBOR rate for determining the arm's length interest as the remittance was made in foreign currency.

Accordingly, the Hon'ble Tribunal directed the AO/TPO to recompute the arm's length interest in respect of the transaction by taking into consideration LIBOR for the period from the date of remittance till Match 31, 2009.

The Hon'ble Tribunal had also ruled on various other domestic issues in this order.

International Tax

Case Law 1: Oncology Services India Private Limited Vs. ADIT (IT) (ITA No. 2990/Ahd/2013)

Consideration paid to foreign company for sharing of standard operating procedures ('SOPs'), and allied activities such as access to database, email server, hardware and software, is taxable as royalty, notwithstanding the fact that said foreign company does not have any permanent establishment ('PE') in India.

Facts of the case:

During the relevant previous year, the assessee made payments, aggregating to Euros 45,000, to German based entity, Oncology Services Europe S.a.r.l ('*OSE*'), without any tax deduction at source. The AO was of the view that the payments were made for using the name, goodwill and market reputation of OSE and, therefore, were taxable in India as royalties u/s 9(1)(vi) of the Income Tax Act, 1961 ('*the Act*').

The assessee claimed that OSE did not have PE in India, and that since the payments made to OSE were only for the purpose of sharing SOPs and access to database, email server, hardware and software, these payments, in the absence of the PE of OSE in India, were not taxable in India.

The arguments were rejected by the AO and he proceeded to raise the impugned demand u/s 201 r.w.s. 195 of the Act. Aggrieved, assessee carried the matter in appeal before the Hon'ble CIT(A) but without any success. The assessee then preferred appeal before the Hon'ble Tribunal.

Decision of the Hon'ble Tribunal

The Hon'ble Tribunal noted that under the agreement, OSE specifically agreed to permit the assessee to use its name, brand, logo and website without any costs or financial liability. It therefore concluded that no part of Euros 45,000 was paid for the purpose of use of name, brand or logo etc.

The Hon'ble Tribunal highlighted that the true consideration for the Euros 45,000 were the SOPs and the access to database, email server and hardware or software. The question was whether the consideration for use of SOPs developed by the OSE, and incidental activities, could be brought to tax as royalty payment u/s 9(1)(vi) of the Act and under the Indo-German DTAA.

The Hon'ble Tribunal then noted that the sharing of SOPs does amount to sharing 'information concerning industrial, commercial or scientific experience' which is included in the definition of royalty as laid down in Article 13(3) of the Indo-German DTAA and was thus taxable under the same. It opined that the access to database, and allied activities like harmonization of software systems, policy and process, were only incidental to the main object of sharing the SOPs and could not thus be viewed in isolation.

As for the argument of the assessee that OSE does not have a permanent establishment in India, the Hon'ble Tribunal commented that it is only elementary that existence of PE is *sine qua non* only for taxation of business profits but that the foreign entity not having a PE in India does not come in the way of taxation of royalties.

Thus, the Hon'ble Tribunal held that the consideration for sharing of the SOPs was indeed taxable as 'royalties' under the Indo-German tax treaty.

Domestic Tax

Case Law 1: Balgopal Trust Vs. ACIT ([2017] 81 taxmann.com 367 [Mumbai - Trib.])

A private non-discretionary trust formed for individual beneficiary is eligible to obtain deduction u/s 54F of the Act.

Facts of the case:

The assessee, a private non-discretionary trust, earned capital gains on sale of unquoted equity shares. The assessee sought to claim exemption u/s 54F of the Act. However, the AO held that deduction under section 54F was allowable only to individual or hindu undivided family ('*HUF*') and not to any other person. The assessee being a specific trust, the AO held that it was not eligible for deduction under section 54F and disallowed the same.

On appeal, Hon'ble CIT(A) confirmed the order of the AO.

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

Decision of the Hon'ble Mumbai Tribunal:

Relying on the decision of Hon'ble Jurisdiction High Court in case of Mrs Amy F Cama Vs. CIT [1994] 237 ITR 82 (Bom.), it was held that:

- Section 161 of the Act makes a representative assessee subject to the same duties, responsibilities and liabilities as if the income was received by him beneficially;
- As per the mandate of section 161 of the Act, the Act doesn't intend to charge tax upon persons other than the beneficial owner of the income and thus, whatever benefits the beneficiary will get in a particular assessment must be made available to the trustee while assessing him; &
- Thus, whatever benefits the beneficiary is entitled to receive in his individual status shall also be available to the trust, in whose hands the income of beneficiary is taxed.

Hence, the trust was principally entitled to deduction under section 54F of the Act and it cannot be said that since it is an Association Of Persons and not an individual or HUF the said exemption should be denied.

KNAV comments:

Though the issue pertaining to section 54F of the Act is squarely settled, the ratio laid down by the aforesaid ruling as well as the decision of Hon'ble Bombay High Court (supra) could be extended in respect of other deductions/exemptions as well which are specifically meant for individuals/HUF's.

Case Law 2: Raj Dadarkar & Associates Vs. ACIT ([2017] 81 taxmann.com 193 [SC])

Lack of substantial arguments proving that the income from sub-letting premises is to be considered as income from business and profession may render the decision against the assessee; merely referring to the object clause of the agreement is not sufficient to characterize the income as income from business and profession.

Facts of the case:

The assessee acquired a part of a bare structure in an auction and spent substantial amount on additions/alterations of the entire premises. The assessee constructed various shops and stalls of different carpet areas on the premises. The assessee then collected the receipt from the sub-licensees in form of leave & license fees and service charges for providing various services, including security charges, utilities etc.

The assessee filed the return wherein income from the aforesaid shops and stalls sub-licensed by it was offered to tax under the head 'Profits and gains of business or profession'.

However, the AO computed the income from the shops and the stalls under head 'Income from House Property'. The reasons given for so computing the income under the head 'Income from House Property' were:

- By virtue of section 27(iiib) of the Act, the appellant was 'deemed owner' of the premises as it had acquired leasehold right in the land for more than 12 years;
- In agreements for sub-licensing the words 'lease compensation' were used instead of 'license fees' and deposits were referred as 'sub-lease deposits'; &
- Property tax had been levied on the assessee.

Aggrieved, the assessee preferred appeal before the Hon'ble CIT(A) who reversed the order of the AO. However, on further appeal by the revenue, the Hon'ble Tribunal rendered the decision in favour of the revenue. The Hon'ble High Court also confirmed the order of the Hon'ble Tribunal. Aggrieved, the assessee preferred appeal before the Hon'ble Supreme Court.

Decision of the Hon'ble Supreme Court:

- The Hon'ble Supreme Court noted that the submission of the assessee was that even if the assessee was a deemed owner of the premises in question, since the letting out of the place and earning rents therefrom was the main business activity of the assessee, then the income generated from sub-licensing the market area should have been treated as income from business and not income from the house property. The assessee's submission was that the dominant test has to be applied and once it is found that dominant intention behind the activity was that of a business, the rental income would be business income;
- The Hon'ble Supreme Court recognized that the question to be considered is whether the income would be chargeable under the head 'income from the house property' or under the head 'Profits and gains from business or profession';
- The Hon'ble Supreme Court also particularly mentioned that merely because there is an entry in the object clause of the business showing a particular object, would not be the determinative factor to arrive at a conclusion that the income is to be treated as income from business. Such a question would depend upon the circumstances of each case;
- The Hon'ble Supreme Court noted that in the present case, reading of the object clause would bring out two discernible facts, which are as follows:
  1. The assessee which is a partnership firm is to take the premises on rent and to sub-let those premises. Thus, the business activity is of taking the premises on rent and sub-letting them. In the instant case, by legal fiction contained in section 27(iiib) of the Act, the assessee is treated as 'deemed owner'.
  2. The aforesaid clause also mentioned that the partnership firm may take any other business as may be mutually agreed upon by the partners;
- However, the Hon'ble Supreme Court also noted that apart from relying upon the aforesaid clause in the partnership deed to show its objective the assessee did not produce or refer to any other material; &
- The Hon'ble Supreme Court opined that it was for the assessee to produce sufficient material on record to show that its entire income or substantial income was from letting out of the property which was the principal business activity of the appellant and noted that no such effort was made.

Thus, for the aforesaid reasons, the Hon'ble Supreme Court held that the instant appeal lacked merit and, accordingly, dismissed the same.

KNAV comments:

In order to support the contention that income from letting out of property is to be considered as 'income from Business and Profession', reliance may be placed on the judgments of the Hon'ble Supreme Court in Chennai Properties & Investments Ltd. ([2015] 231 Taxman 336 [SC]) and Rayala Corporation (P) Ltd ([2016] 243 Taxman 360 [SC]). In Chennai Properties & Investments Ltd. it was found that the main object of assessee was to acquire properties and earn income by letting out same. Also, entire income of the appellant was through letting out of the properties it owned and there was no other income of the assessee. Thus, income was characterized as an income from Business and Profession.

Recent important notifications, circular and press releases issued by the central board of direct taxes *('CBDT')*

1. **Press Release dated May 26, 2017 - CBDT issues clarification on furnishing statement of financial transaction ('*SFT*') & SFT Preliminary Response**

Section 285BA of the Act requires furnishing of the SFT for transactions prescribed under Rule 114E of the Income-tax Rules, 1962. The said press release clarified the operational aspects and clarified that registration of reporting person is mandatory only when at least one of the transaction types is reportable.

A link for the same is provided herewith:
http://www.incometaxindia.gov.in/Lists/Press%20Releases/Attachments/627/CBDT-Clarification-furnishing-SFT-Preliminary-Response-26-5-2017.pdf

2. Circular No. 18/2017 dated May 29, 2017 – Clarification on eligibility for exemption from TDS in case of entities whose income is exempt under section 10 of the Act

The CBDT has modified herewith by way of circular the eligibility criteria for entities to claim exemption from TDS and list of additional entities that are eligible for such exemption.

A link for the same is provided herewith:
http://www.incometaxindia.gov.in/communications/circular/circular_18_2017.pdf

3. Notification No. 5/ 2017 dated May 29, 2017 – Clarification regarding the income of minor in case both the parents of the minor are dead

The CBDT clarified by way of notification that the income of the minor shall not be clubbed in the hands of the grandparents in case both the parents of the minor are dead. The minor shall file an income tax return through his/her guardian.

A link for the same is provided herewith:
http://www.incometaxindia.gov.in/communications/notification/notification_5_2017_tds.pdf

4. Press release dated May 31, 2017 - CBDT extends the due date for furnishing Statement of Financial Transaction

In order to remove inconvenience and to facilitate ease of compliance, the CBDT has extended the due date for furnishing of the SFT for FY 2016-17, from May 31, 2017 to June 30, 2017.

A link for the same is provided herewith:
http://www.incometaxindia.gov.in/Lists/Press%20Releases/Attachments/629/PressRelease31-5-2017.pdf

5. Notification No. 44/2017 dated June 5, 2017 – Specifies the Cost inflation Index numbers considering FY 2001-02 as base year

The CBDT has published herewith by way of notification the cost inflation index numbers taking FY 2001-02 as the base year. The said notification shall come into force from April 01, 2018 and shall accordingly apply to AY 2018-19 and subsequent years.

A link for the same is provided herewith:
http://www.incometaxindia.gov.in/communications/notification/notification44_2017.pdf

6. Draft Notification dated June 15, 2017– Exception, modification and adaptation in respect of foreign company said to be resident in India under section 115JH of the Act – comments and suggestions-reg

The Finance Act, 2016, introduced special provisions in respect of foreign company said to be resident in India on account of Place of Effective Management ('*PoEM*') by way of insertion of a new Chapter XII-BC consisting of section 115JH in the Act with effect from April 01, 2017.

The said draft notification lists down the exception, modification and adaptation subject to which, provisions of the Act relating to computation of total income, treatment of unabsorbed depreciation, set off or carry forward and set off of losses, collection and recovery and special provisions relating to avoidance of tax shall apply in a case where a foreign company is said to be resident in India due to its PoEM being in India for the first time and the said company has never been resident in India before.

A link for the same is provided herewith:
http://www.incometaxindia.gov.in/news/draft-notification-exception-15-6-2017.pdf

7. Notification No. 52/2017 dated June 15, 2017– Computation of interest income pursuant to secondary adjustments

Finance Act, 2017 inserted Section 92CE in the Act to provide for secondary adjustment by attributing income to the excess money lying in the hands of the associated enterprise. The said Rule prescribes the time limit of repatriation of excess money and the rate at which the interest income shall be computed in the case of failure to repatriate the excess money within the prescribed time limit.

A link for the same is provided herewith:
http://www.incometaxindia.gov.in/communications/notification/notification52_2017.pdf