PARTNERS BEYOND BOUNDARIES

India tax newsletter | October, 2017

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 important press releases and notifications issued by the Central Board of Direct Taxes.

Kartik Mehta
Manager, Taxation

Transfer Pricing

Case Law 1: Avenue Asia Advisors (P.) Ltd Vs. DCIT ([2017] 85 taxmann.com 311(Del))

Providing non-binding investment advisory services cannot be termed as providing services as a merchant banker.

Facts of the case:

The assessee was providing non-binding investment advisory services to its Associated Enterprise ('*AE*'). The assessee identified 8 comparable companies in order to comply with the transfer pricing ('*TP*') provisions and concluded a net average margin of 17.48% as against the net margin of the assessee being 21.93%.

The Transfer Pricing Officer ('*TPO*') was not satisfied with the TP study of the assessee. Therefore, the TPO finally chose 10 comparable companies having an average margin of 39.13%, as against the aforementioned margin earned by the assessee. The TPO passed an order under section 92CA(3) of the Income tax Act, 1961 ('*the Act*') recommending an upward adjustment. In agreement with the order by the TPO, the Assessing Officer ('*AO*') passed an order against the assessee.

Also, the Hon'ble Dispute Resolution Panel ('*DRP*') upheld the decision of the AO and the TPO when the objections were filed by the AO against the draft assessment order.

Aggrieved by the assessment order, the assessee preferred an appeal with the Hon'ble Tribunal. The Hon'ble Tribunal analysed the various comparables and remanded the matter to the TPO in respect of a few comparables for further analysis. Further, the Hon'ble Tribunal rejected some of the comparables suggested by TPO but retained some of them. The Hon'ble Tribunal, thus, partly allowed the appeal of the assessee on the issue of comparables.

Aggrieved by the decision of the Hon'ble Tribunal, further appeal was preferred before the Hon'ble High Court Of Delhi.

Decision of the Hon'ble High Court

1. The Hon'ble High Court held that the comparables selected by the TPO were providing advisory services in relation to debt syndication, debt financing, IPO advisory, corporate restructuring, mergers, acquisitions etc;
2. Further, the Hon'ble High Court added the assessee was merely providing non-binding investment advisory services to its AE and therefore, it could not be termed as the services of a merchant banker;
3. The upward adjustment recommended by the TPO was the margin of a merchant banker providing services in relation to debt syndication, debt financing, IPO advisory, corporate restructuring, mergers, acquisitions etc; &
4. The sub-advisory agreement between the assessee and its AE further clarified that the services rendered by the assessee to its AE were not in relation to debt syndication, debt financing, IPO advisory, corporate restructuring, mergers, acquisitions etc. The sub-advisory agreement highlighted the services provided by the assessee to its AE which included advising the AE in preparing reports, making non-binding recommendations etc.

Considering the above facts and circumstances, the Hon'ble High Court deleted the upward adjustment made by the AO on recommendation of the TPO and the decision was ruled in favor of the assessee.

Case Law 2: Allegis Services India (P.) Ltd Vs. DCIT ([2017] 86 taxmann.com 63 (TBang))

Payment on account of software licenses does not fall under definition of royalty and, therefore, assessee is under no obligation to deduct tax at source on payment for software license.

Further, allocation of the indirect cost between the AE and non-AE transactions on the basis of revenue and direct costs on actual basis is proper and justified.

Facts of the case:

During the year under consideration, the assessee had made payment for software licenses. The assessee believed that the payment did not fall under definition of royalty and, therefore, the assessee was under no obligation to deduct tax at source on payment for software license.

The AO, considering the payment to be in the nature of royalty, disallowed the same on account of non-deduction of tax.

Further, the assessee had reported international transactions in two segments i.e., software development services and IT enabled service transactions. While computing its margin, the assessee had allocated indirect cost between AE and non-AE transactions on the basis of revenue. However, direct costs had been allocated on actual basis for both segments.

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

The TPO, while computing the arms length price ('*ALP*') of the transaction, had reallocated the entire cost in the ratio of revenue between the AE and non-AE.

Aggrieved, the assessee preferred an appeal before the Hon'ble Commissioner of Income tax (Appeals) ['*CIT(A)*']. The Hon'ble CIT(A) partly ruled in favour of the assessee.

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

Decision of the Hon'ble Tribunal:

The assessee submitted that prior to the decision of Hon'ble jurisdictional High Court in the case of CIT (International Taxation) Vs. Samsung Electronics Co Ltd ([2010] 320 ITR 209/[2009] 185 Taxman 313 [Kar.]), the assessee was under the *bonafide* belief that the payment on account of software licenses does not fall under the definition of royalty and therefore the assessee was under no obligation to deduct tax at source on the said payment for software license.

Further, the assessee submitted that there were number of judicial precedents on this issue wherein this Tribunal has held that the payment made for purchase of software does not fall under the definition of royalty provided under the provisions of the Act.

Therefore, the assessee submitted that a subsequent amendment or a decision cannot be thrust upon the assessee for deduction of tax in respect of a transaction completed much prior to the said decision. In this regard, the assessee stated that the disallowance made by the AO is not justified when there was no such law or declaration of law at the time of payment made by the assessee to cast the duty on the assessee to deduct tax.

The revenue contended that the decision of Hon'ble High Court in the case of Samsung Electronics Co Ltd though was subsequent to the transaction in question however, the said decision has not brought into statute any new law but it is only a declaration and interpretation of existing law.

The Hon'ble Tribunal had, while deciding on this issue taken note of various decisions in favour of the assessee on the point that the payment for purchase of software does not fall in the definition of royalty.

Therefore, the Hon'ble High Court ruled in favour of the assessee and deleted the disallowance made by the AO.

With regards to the computation of the ALP, the assessee submitted that for the previous AYs the TPO has accepted the allocation of cost made by the assessee and therefore only for the year under consideration, the TPO has disturbed the allocation of cost and reworked out the margins of the assessee in respect of the international transactions.

On the other hand, the revenue contended that when the assessee is providing same services to the AE as well as non-AE then the allocation of cost on the basis of ratio of turnover is proper and justified.

The revenue submitted that since the profit on the transaction with AE is eligible for deduction under section 10A of the Act the assessee is allocating the cost disproportionately to the non-AE transaction to reduce the tax liability.

The Hon'ble Tribunal heard the rival submissions and observed the material on record. The Hon'ble Tribunal noted that the question of allocation of cost arises only in respect of the indirect cost incurred for all the transactions and therefore, the same has to be allocated on the basis of turnover or any other proper basis. In the case of the assessee it is contended that the assessee itself has allocated the indirect cost on turnover basis and the direct cost which relates to a particular transaction has been allocated by the assessee on the actual basis and therefore the TPO was not justified in allocating the direct cost on turnover basis.

Therefore, the Tribunal in-principally agreed with the contention of the assessee that the direct cost has to be allocated on actual basis and not on the basis of turnover.

Therefore, the Hon'ble Tribunal ruled in favour of the assessee stating that the action of the TPO in allocating the direct as well as indirect cost as alleged by the assessee in the ratio of turnover of each segment and transaction was not justified.

Domestic Tax

Case Law 1: CIT Vs. Balbir Singh Maini ([2017] 86 taxmann.com 94 [SC])

In order to qualify as a "transfer'' of a capital asset under section 2(47)(v) of the Act, there must be a "contract" which can be enforced in law under section 53A of the Transfer of Property Act, 1882.

Income tax cannot be levied on hypothetical income. Income accrues when it becomes due but it must also be accompanied by a corresponding liability of the other party to pay the amount. Only then can it be said that for the purposes of taxability the income is not hypothetical and it has really accrued to the assessee.

Facts of the case:

The assessee is a member of the Punjabi Cooperative Housing Building Society Ltd. The society consisted of 95 members and was the owner of 21.2 acres, of which 1500 square yards plots were held by 95 members and the remaining 4 plots of 500 square yards each were being retained by it. The bone of contention in the present appeal is a tripartite Joint Development Agreement ('*JDA*') for development of 21.2 acres of land in the village Kansal. This JDA was entered into between the owner i.e., Punjabi Cooperative Housing Building Society Ltd, Hash Builders ('*HASH*') and Tata Housing Development Company Ltd ('*THDC*'). Under the JDA, it was agreed that HASH and THDC viz., the developers, will undertake to develop 21.2 acres of land owned and registered in the name of the society. The agreed consideration was to be disbursed by THDC through HASH to each individual member of the society, and different amounts and flats were payable and allottable to members having different plot sizes. The developers were to make payments in four instalments, at decided intervals of time effected by different circumstances as mentioned in the JDA. On payment of each installment, certain property would be transferred from the assessee to the developers.

The developers made payments only up to the 2nd instalment, and the same has since suffered payment of capital gains tax for AYs 2007-08 & 2008-09. The problem which arose for the subsequent assessment years was that, due to pending proceedings, the necessary permissions for development were not granted, as a result of which the JDA did not take off the ground.

The AO held that since physical and vacant possession had been handed over under the JDA, the assessee fell within the ambit of "part performance" per section 53A of the Transfer of Property Act, 1882, and thus the same would tantamount to "transfer" within the meaning of sections 2(47)(ii), (v) and (vi) of the Act. He further held that, in the case of an assessee owning a 1000 square yards plot, the full value of consideration would be INR 3.67 crores less cost of acquisition of INR 1,281,724. The long term capital gain was, therefore, stated to be INR 35,468,276.

On further appeal by the assessee, the same was dismissed by both, the Hon'ble CIT(A) and the Hon'ble Tribunal. Aggrieved, the assessee preferred appeal before the Hon'ble High Court, and the decision was rendered in favour of the assessee. Aggrieved, the revenue then preferred appeal before the Hon'ble Supreme Court.

Decision of the Hon'ble Supreme Court:

The Hon'ble Supreme Court noted the following clauses of the JDA:

- The assessee being absolutely seized and possessed of the property, was desirous of assigning its development rights for developing the same;
- The assessee gave express content to THDC to raise financial assistance by mortgaging the property;
- The JDA could be terminated by all the parties, and in the present case it was terminated by the assessee. The consequences of such termination would be that the properties which had already been conveyed, would stand conveyed, while the balance property would still be retained by the assessee; &
- The payment of the 3rd installment was only to be made after the grant of necessary approvals from the Courts. However, since the Courts rejected such approvals, the project had been interdicted.

The Hon'ble Supreme Court then noted that per the amendment effected by the Registration and Other Related Laws (Amendment) Act, 2001, section 17(1A) of the Registration Act, 1908 stated that unless the document containing the contract to transfer for consideration any immovable property *(for the purpose of Section 53A of 1882 Act)* is registered, it shall not have any effect in law.

In short, there is no agreement in the eyes of law which can be enforced under Section 53A of the Transfer of Property Act, 1882.

This being the case, the Hon'ble Supreme Court held that in order to qualify as a "transfer" of a capital asset under section 2(47)(v) of the Act, there must be a "contract" which can be enforced in law under section 53A of the Transfer of Property Act, 1882. Since the JDA in the present case was never registered, no "transfer" can be said to have taken place.

The Hon'ble Supreme Court then viewed the matter from a slightly different angle pertaining to taxation of real and accrued income and held the following:

- Real income must "arise" on the assumption that there is transfer of a capital asset. This income must have been received or have "accrued" under section 48 of the Act as a result of the transfer of the capital asset;
- Income accrues when there arises a corresponding liability of the other party from whom the income becomes due to pay that amount;
- Income from capital gain on a transaction which never materialized is, at best, a hypothetical income. The assessee did not acquire any right to receive income, inasmuch as such alleged right was dependent upon the necessary permissions being obtained; &
- This being the case, in the circumstances, there was no debt owed to the assessee by the developers and therefore, the assessee had not acquired any right to receive income under the JDA.

The Hon'ble Supreme court thus held that no profits or gains "arose" from the transfer of a capital asset so as to attract sections 45 and 48 of the Act.

Thus, the Hon'ble Supreme rendered the decision in favour of the assessee.

Case Law 2: Plastiblends India Ltd Vs. Additional Commissioner of Income tax, Mumbai (2017 86 taxmann.com 137 [SC])

Depreciation has to be reduced for computing the profits eligible for deduction under section 80-IA of the Act.

Facts of the case:

The assessee is engaged in the business of manufacture of master batches and compounds. For this purpose, the assessee had set up manufacturing units. Profits of the business of both the undertakings were eligible for 100% deduction under section 80-IA of the Act. The assessee did not claim depreciation while computing its income under the head "profits and gains of business". Consequently, deduction under Section 80-IA was also claimed on the basis of such profits i.e., without reducing the same by depreciation allowance. However, it is pertinent to note that the assessee did not claim deduction on account of depreciation.

In the previous assessment year, though, this position was not accepted by the AO, the claim of the assessee was upheld by the Hon'ble Tribunal.

In the year under consideration, the AO disregarded the assessee's stand.

Aggrieved by the said assessment order, the assessee preferred appeal before the Hon'ble CIT(A) urging that the AO erred in not considering the Hon'ble Tribunal's decision in the assessee's own case for the previous assessment year. The Hon'ble CIT(A) upheld the assessee's submission that claim for depreciation is optional, based on the Tribunal's order in its own case and hence allowed the appeal.

Aggrieved by the order of the Hon'ble CIT(A), the AO preferred appeal before the Hon'ble Tribunal.

The Hon'ble Tribunal reversed the order of the Hon'ble CIT(A) following the decision of the High Court of Bombay in Scoop Industries P. Ltd Vs. Income Tax Officer [2007] 289 ITR 195.

Aggrieved by the Tribunal's order, the assessee preferred appeal before the Hon'ble High Court.

The Hon'ble High Court upheld the stand of the revenue and stated that whilst computing a deduction under the relevant chapter, it was mandatory to grant deduction by way of depreciation.

Aggrieved, the assessee further preferred an appeal before the Hon'ble Supreme Court.

Decision of the Hon'ble Supreme Court:

The Hon'ble Supreme Court observed that sections 80-IB/80-IA of the Act are the code by themselves as they contain both substantive as well as procedural provisions. Therefore, there was a need to examine what these provisions prescribed for computation of profits of the eligible business.

The present case requires the examination of an eligible business of an industrial undertaking and thereby the source of the profits to manufacture have to be traced.

In this regard, the Hon'ble Supreme Court stated that the devices adopted to reduce or inflate the profits of eligible business are supposed be rejected in view of the overriding provisions of the Act.

The Hon'ble Supreme Court observed that the assessee seeks for 100% deduction, without taking into consideration depreciation, which the assessee wants to utilize in the subsequent years. This would defy the scheme of the provisions of the Act and if the contention of the assessee is accepted, it would allow inflation of the profits-linked incentives provided under section 80-IA of the Act.

Therefore, the Hon'ble Supreme Court ordered that, even assuming that the assessee had an option to disclaim current depreciation in computing the business income, depreciation had to be reduced for computing the profits eligible for deduction under section 80-IA of the Act.

Therefore, on the above grounds, the Hon'ble Supreme Court ruled in favour of the revenue.

Case Law 3: Smt. Meena V Pamnani Vs. Commissioner of Income tax, Mumbai ([2017] 86 taxmann.com 175 [Bom][HC])

Once depreciation has been claimed on an asset forming a part of "block of asset", it continues to be a part of the block even if it is ceased to be used for the purpose of business.

Facts of the case:

The assessee, is an individual, who carried on weaving work on job basis. She owned three concerns each of which had multiple looms. The operations of the looms were from 2 industrial galas. Of the 2 galas, the assessee sold one of the galas, which resulted into a capital gain. The assessee treated this gain as long-term capital gain and claimed deduction under section 48(2) of the Act. The AO noted that the assessee had not only claimed depreciation on the above gala for almost the entire holding period but also claimed deduction under section 80(J) of the Act for certain AYs in the holding period.

The assessee contended that section 50 of the Act is not applicable in the present case as the asset is not forming a part of block of assets. The assessee further stated that the concept of block of assets was incorporated in the Act and came into effect after she bought the galas and therefore the same shall not be applicable.

It was further pointed out that machinery and looms were shifted from the gala being sold to the other gala and the gala being sold was lying vacant since the past couple of years. No depreciation was claimed thereon and the asset was sold as personal asset.

The AO set aside the assessee's claim by holding that once depreciation had been allowed, the asset would remain a business asset and the profit earned on sale of that asset would be taxed under section 50 of the Act. According to the AO, stoppage of the claim of depreciation will not alter the nature of assets.

On the above grounds, the AO concluded that the gain arising on the sale of industrial gala was not long-term capital gain as claimed by the assessee, but short-term capital gain under section 50 of the Act and the AO accordingly taxed the amount.

The Hon'ble CIT(A) and the Hon'ble Tribunal concurred with the view of the AO. Aggrieved, the assessee preferred an appeal before the Hon'ble High Court.

Decision of the Hon'ble High Court:

The assessee contended that per the provisions of the Act, the gala was incapable of being termed as depreciable asset. It could not be deemed to be a part of the block of assets. Further, the asset was incapable of being treated as depreciable asset as this asset was not 'used' for the purpose of assessee's business. Per the assessee's claim, it was a settled law that for availing depreciation under the Act, it is imperative that two criteria are satisfied - first is the ownership and second is the use for the purpose of business or profession.

In the assessee's case, the user criteria was not satisfied, and therefore the AO was not justified in terming this asset as part of block of assets.

The revenue contended that once an asset had been treated as block of asset, then, irrespective of its disposal and in the manner done by the assessee, it would continue to be treated as block of asset. Once it is treated on its initial introduction in the block as block of asset, then, that treatment shall continue.

Keeping in mind the above submissions, the Hon'ble High Court was of the view that the revenue, Hon'ble CIT(A) and the Hon'ble Tribunal correctly interpreted the meaning of block of asset. The Hon'ble High Court stated that an asset cannot move out of the block of assets once depreciation had been claimed. Even though the assets were not used for the business of the assessee, they continued to be part of block of assets on which depreciation was claimed by the assessee.

Therefore, on the above grounds, the Hon'ble High Court ruled in favour of the revenue.

Case Law 4: ATC Telecom Tower (P.) Ltd Vs. Principal Commissioner of Income Tax [2017] 86 taxmann.com 97 (TMum)

Revision order can by passed u/s 263 of the Act even though the same things were observed during the reassessment proceedings if proper enquiries were not made.

Summary of the case:

The assessee company was engaged in the business of setting up of Telecom Towers and Infrastructure services. During the relevant AY, it filed a loss return. the case was selected for scrutiny assessment and a Nil order was passed by the AO u/s 143(3) of the Act.

However, post culmination of the assessment proceedings by the AO, the officer was in receipt of a confidential report which revealed the assessee company's name in the list of the companies reported in the 2G scam. On further investigation, the AO was also informed that the assessee had paid INR 700 crores in prior AYs to Loop Telecom Limited which was refunded to the assessee in the relevant AY. Also, the assessee had increased the share capital from INR 100,000 to INR 1,92,096,800.

In regards to all the aforementioned reasons, the AO reopened the assessment proceedings u/s 147 of the Act.

During the reopening assessment proceedings, the AO had asked for details for the transactions of INR 700 crores. In response to which the assessee provided details and informed that the amount of INR 700 crores was advanced to Loop Telecom Limited in order to secure a business deal for providing passive Infrastructure facility and maintenance services. Also, the assessee informed that the amount of INR 700 crores was received by the Mauritius Holding company by way of share application money and therefore, no interest was payable to the holding company against the share application money received. The AO also verified these facts from the Mauritius Revenue Authorities through the Foreign Tax and Tax Research. Since the occurrence of events of receiving funds from the holding company and payment to Loop Telecom Limited was on succession days, the AO observed that the shares were issued to holding company only for this purpose. Since, the amount was refunded by Loop Telecom Ltd after 2 months, the AO calculated interest at 20% and made the additions accordingly.

After the culmination of reassessment proceedings, the Commissioner of Income Tax ('*CIT*') went through the file of the AO and concluded that the reassessment order passed by the AO was erroneous and prejudicial to the interest of the revenue. Thus, the CIT vide Show Cause Notice called upon the assessee to explain as to why the same may not be revised u/s 263 of the Act.

The CIT recorded following reasons so as to conclude that the order passed by the AO was erroneous and prejudicial to the interest on revenue since in his opinion, the AO did not verify the facts and documents received before passing the assessment order. Further, CIT concluded that the AO had no sufficient and relevant material on record to conclude that the amount received as share application money was from an explained source. Thus, the CIT had initiated revisionary proceedings u/s 263 of the Act.

In the backdrop of the aforementioned facts and aforesaid conviction of the Principal CIT, the Principal CIT set aside the reassessment order passed by the AO and directed the AO to pass a fresh order, as per law, after making necessary enquiries and investigations and affording reasonable opportunity of being heard to the assessee.

Aggrieved by the order of the CIT, the assessee preferred an appeal before the Hon'ble Tribunal.

The assessee stated that it was beyond comprehension that now when the concluded assessment was reopened for verifying the nature, mode and source of the share application money received by the assessee.

Against this, the Department representative stated that the assessment was reopened on account of receipt of new data from Delhi regarding the 2G scam and such information and documents were not verified by the AO before passing the reassessment order.

Therefore, the Hon'ble tribunal upheld the order of the Principal CIT and dismissed the appeal by the assessee.

The decision was rendered in favour of the revenue and the Hon'ble Tribunal upheld the order passed by the Principal CIT u/s 263 of the Act.

Recent important press releases and notifications issued by the central board of direct taxes (‘*CBDT*’)

1. Press release dated September 19, 2017 – Voluntary reporting of estimated current income and advance tax liability

Vide this notification, the CBDT has proposed to create a mechanism for self-reporting of estimates of current income, tax payments and advance tax liabilities by certain taxpayers *(companies and tax audit cases)*. The proposed reporting mechanism is sought to be created by way of inserting a new Rule 39A and Form No. 28AA in the Income tax Rules, 1962 (‘*the Rules*’).

The link to visit the press release is provided hereunder:

http://www.incometaxindia.gov.in/Lists/Press%20Releases/Attachments/658/Press-Release-Voluntary-reporting-estimated-current-income-advance-tax-liability.pdf

2. Press release dated October 06, 2017 – Framing of rules in respect of country-by-country reporting and furnishing of master file – comments and suggestions thereof

Subsequent to the introduction of section 286 of the Act, and amendment to section 92D of the Act, CDBT proposes to insert Rules 10DA, 10DB and Form nos. 3CEBA to 3CEBE in the Rules, to lay down the guidelines for maintaining and furnishing of TP documentation in the Master File and Country-by-Country report.

In this regard, draft notification providing for the insertion of rules 10DA & 10DB and form nos. 3CEBA to 3CEBE has been framed and uploaded.

The link to visit the press release is provided hereunder:

http://www.incometaxindia.gov.in/Lists/Press%20Releases/Attachments/659/Press-Release-6-10-2017.pdf

The link to visit the notification is provided hereunder:

http://www.incometaxindia.gov.in/communications/notification/framing-rules-respect-country-by-country-reporting-furnishing-master-file-6-10-2017.pdf

3. Press release dated October 18, 2017 – Draft Notification of amendment of Rule 17A and Form 10A of the Income tax Rules, 1962 – comments and suggestions thereof.

Vide Finance Act, 2017, a new clause (ab) was inserted in section 12A(1) of the Act to the effect that where a trust or an institution, which has been granted registration under sections 12A or 12AA of the Act has subsequently adopted or undertaken modification of the objects and such modification does not conform to the conditions of such registration, then such trust or institution shall be required to obtain registration again by making an application within a period of thirty days from the date of such adoption or modification of the objects. In accordance with the same, draft notification providing for the amendment of Rule 17A and Form 10A has been framed for comments from stakeholders and general public. The comments and suggestions on the draft Rules may be sent by October 27, 2017 electronically at the email address, dirtpl1@nic.in.

The link to the press release is provided as under:

http://www.incometaxindia.gov.in/Lists/Press%20Releases/Attachments/662/Press-Release-Draft-Notification-amendment-Rule-17A-Form-10A-18-10-2017.pdf

The link to the notification is provided hereunder:

http://www.incometaxindia.gov.in/news/draft-notification-amendment-rule-17a-form-10a-income-tax-rules-1962-18-10-2017.pdf

For expert assistance, please contact Vaibhav Manek at : vaibhav.manek@knavcpa.com or +91 98676 70620

Visit us at: www.knavcpa.com