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

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Transfer Pricing

Case Law 1: RTA Alesa AG Vs. DCIT(IT) (ITA No. 1659/Del/2017)

International transactions meeting common portfolio must be aggregated for the purpose of benchmarking the transactions when using the Transactional Net Margin Method ('TNMM').

Summary of the case:

The assessee is a foreign company, incorporated in Switzerland and is a subsidiary of Rio Tinto Plc. The assessee is engaged in provision of various goods and services including turnkey projects. The assessee was awarded a EPC contract and accordingly a project office was set up in India. The project consisted of supply of equipments, commissioning spares and provision of erection, inland transportation, on-site installation and commissioning services. Both the transactions were benchmarked separately by the assessee using the TNMM method.

The approach of segregation of transactions by the assessee was rejected by the Transfer Pricing Officer ('*TPO')* on the contention that transactions ought to be bundled for the purpose of benchmarking in case the transactions are interlinked or closely connected. Objections were raised before the Hon'ble Dispute Resolution Panel ('*DRP*') wherein the contention of the TPO was upheld. The assessee preferred an appeal with the Hon'ble Tribunal.

The judgement of the Hon'ble Tribunal has been briefly stated below:

The Hon'ble Tribunal relying on the decision of Hon'ble High Court laid down in case of Sony Ericsson Mobile Communication India Private Limited Vs. CIT, ([2015] 55taxmann.com 240 [Delhi]) held that, the expressions "class of transaction", "functions performed by the party" under section 92C(1) of the Income Tax Act, 1961 ('*the Act*'), illustrate the word "transaction" to include bundle or a group of connected transactions.

Further it was observed that there was a single contract agreement for the execution of both the components. Mere breaking down of the price into components of the contract, cannot make the transactions separable from each other. The execution of the turnkey project required material and service side by side for erection and commissioning and installation of the plant.

Thus, since the activity of supplying of equipment, spare parts and commissioning of the plant was a complex web of activities, inextricably linked and inseparable from each other, there cannot be a doubt in the aggregation approach followed by the TPO.

Thus, for the purpose of application of the TNMM method, transactions that are inextricably linked or closely connected ought to be aggregated for the purpose of benchmarking.

Case Law 2: Dimension Data India Private Limited Vs. DCIT ([2017] 84 taxmann.com 318 [Tmum])

When only certain services are availed out of a bunch of services mentioned in the agreement, a Transfer Pricing ('TP') adjustment cannot be made, especially when the revenue authorities are of the opinion that price of the services availed is at arms length.

Facts of the case:

The assesse, a private limited company in India, is a subsidiary company of a global group. It was engaged in the dealership of networking products. As per the agreement entered into between the assessee and its Associated Enterprise ('*AE*'), the AE was supposed to render services to the assessee under ten different heads.

However, during the year under consideration, the assessee had not availed services under certain heads. Though as per the agreement, the assessee was entitled to avail all the services. On account of these services, the assessee paid management fee to its AE.

The TPO had held that payments made by the assessee under the heads for which the services were received were at arms length. However, with regards to the heads under which services were not received in the year under consideration, the TPO suggested an adjustment on the ground that the assessee had not provided details called for, and further not explained as to how the services were charged.

Aggrieved by the TPO's order, the assessee filed an appeal before the Hon'ble DRP. The Hon'ble DRP remanded the evidences to the TPO for verification and comments. Before the Hon'ble DRP, the assessee argued that the TPO had not apportioned the total management fee into different categories correctly and further, the assessee had received different types of services from the AE for which management fee had been paid.

The Hon'ble DRP partially allowed the assessee's claim. Aggrieved, the assesse filed an appeal before the Hon'ble Tribunal.

Decision of the Hon'ble Tribunal:

The Hon'ble Tribunal was of the view that, while deciding the Arms Length Price ('*ALP*') of an umbrella of services, the right of assessee to avail those services has to be considered. It is not correct to reject the entire TP study on the ground that the assesse did not avail all or the majority of services out of the bouquet of services as mentioned in the agreement.

Therefore, TP adjustment cannot be made if an assessee avails only certain services out of the bunch of services mentioned in an agreement particularly when the ALP of availed services is not a matter of dispute.

Case Law 3: Virginia Transformer India P. Ltd Vs. ITO (ITA No. 1001/DEL/2014)

Foreign exchange gain earned on receivables on account of export/rendering of services is to be included in computing operating revenue of the assessee; Costs incurred but not reimbursed to the company, per the decision of the company, may not be considered as abnormal costs since the company was not forced by any exceptional circumstances or other compulsion to incur the same; the costs should thus be included in the company's operating cost.

Summary of the case:

The assessee is a wholly owned subsidiary of VTC Virginia, USA and is engaged in designing transformer components etc. under the projects provided by its AE. The assessee is working as a captive service provider in respect of work outsourced by its AE and is remunerated on the basis of 250% of the remuneration of service engineers who are assigned to work on the AE's project.

Foreign exchange gain:

For the AY 2009-10, assessee had claimed foreign exchange gain earned on AE receivables on account of export/rendering of services, as it was a part and parcel of revenue earned by assessee. The TPO/Hon'ble DRP contended that the definition of operating cost and operating revenue is neither given in the TP provisions nor under rule 10B of the Income-tax Rules, 1962 *('the Rules)*, and therefore there was a necessity to adopt the definition of the terms "operating cost" and "operating revenue" under rule 10A of the Rules wherein the loss or income arising on account of foreign currency fluctuation have been specifically excluded from the operating expenses or operating revenue. Thus, the revenue excluded the forex gain while computing assessee's margin. Aggrieved, the assessee preferred an appeal before the Hon'ble Tribunal.

The Hon'ble Tribunal upheld the assessee's argument and held that foreign exchange gain on account of receivables becomes part and parcel of the revenue receivable by the assessee. It further held that there is no quarrel on the point that in case an exchange loss or gain is considered as part of the operating cost or revenue of the assessee then on the principle of parity the same has to be considered as part of the operating cost/operating revenue in case of comparable companies.

Thus, the Hon'ble Tribunal ruled in favour of the assessee.

Capacity utilization adjustment:

The assessee submitted that during the AY, it had set up an office in Delhi and had hired trainee engineers. However, though the assessee incurred lease rentals as well as remuneration costs of trainee engineers from April 2008, the same was reimbursed by AE only from October 2008. Accordingly, the assessee claimed that the expenditure incurred by the assessee in respect of remuneration of trainee engineers as well as on account of lease rentals from April 2008 to September 2008 was abnormal cost and should be excluded from assessee's operating cost for the purpose of computing margin.

The revenue, on the other hand, referred to the agreement between assessee and its AE whereby AE was supposed to bear the cost of engineers employed by the assessee for the purpose of carrying out the business activity as a captive service provider to the AE. The revenue thus argued that the employment of the engineers was not an exceptional activity but a normal business activity to carry out the manufacturing, marketing and services to be rendered to AE. It was further argued that since assessee was not forced by any exceptional circumstances or other compulsion to keep the facility idle, its claim of abnormal costs could not be accepted.

The Hon'ble Tribunal referred to various clauses of the agreement and observed that the sole purpose of incorporation of the assessee as a wholly owned subsidiary of the AE was to render the services as captive service provider to it. The Hon'ble Tribunal also observed that the manpower and personnel designated by the assessee to execute the contracts of the AE were to be screened by AE. Therefore, it noted that the entire work process of the assessee was under the supervision of and as per the specifications provided by the AE. Thereafter, the Hon'ble Tribunal observed that there was another agreement between the parties to cater to AE's requirement on an availability basis .The Hon'ble Tribunal also noted that any loss on account of the secondment of the personnel was to be reimbursed by the AE to assessee.

Thus, considering all of the above, the Hon'ble Tribunal rejected the assessee's claim and held that there was no substance in the claim of the assessee.

Case Law 4: M/s.Elder Exim Pvt Ltd Vs. DCIT (ITA No.5385/Mum/2014, ITA No.2744/Mum/2014, ITA No.5386/Mum/2014)

Transaction entered into with the US branch of an Indian company does not constitute an international transaction; &

Mere allegation of two parties to be AE's without adequate evidence to substantiate the claim, cannot regard two companies to be AE's.

Facts of the case:

The assessee was engaged in the business of manufacturing of spliced decorative veneer in flitch form. During the concerned AY, the assessee had entered into transactions of purchase/import of raw-materials & sale of finished products with 2 concerns, General Woods and Durian. The AO treated the transactions with the 2 AE's as 'international transactions' within the meaning of section 92B of the Act. Thereafter, the AO determined a TP adjustment of INR 1.44 CR. The Hon'ble Commissioner of Income Tax (Appeals) ('CIT[A]') confirmed the AO's order.

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

Decision of the Hon'ble Tribunal

1. Durian Industries Ltd, USA

Before the Hon'ble Tribunal, the assessee contended that Durian was an Indian company, registered under the Companies Act, 1956 and was a tax-resident of India and therefore, the transactions with such a concern did not fall within the meaning of 'international transactions' for the purposes of section 92B of the Act. The Hon'ble Tribunal noted that the assessee had purchased raw material from the USA branch of Durian and had also sold its finished products to the said concern. The Hon'ble Tribunal considered the assessee's submission that Durian was a tax-resident of India, and thus was assessed in India on its worldwide income.

Thereafter, the Hon'ble Tribunal noted that section 92B(1) of the Act provides that an "international transaction" is a transaction between two or more associated enterprises, "either or both of whom are non-residents". In the present case, the Hon'ble Tribunal opined that there was no denying the fact that Durian was an Indian tax-resident. It states that as the assessee was also an Indian tax-resident, therefore, neither the assessee nor Durian is non-resident so as to include the transactions between them as 'international transaction' for the purposes of section 92B(1) of the Act.

Thus, the Hon'ble Tribunal concluded that the transactions with Durian do not fall within the meaning of international transactions.

2. General Woods Limited, Canada *('General Woods')*

The assessee contended that the transaction entered with General Woods cannot be subjected to the provisions of chapter X of the Act since it was not an AE. The Hon'ble Tribunal noted that the AO had proceeded on the premise of the following points:

- Mr. Satish Chawla *(major shareholder in assessee)* was also a director and major shareholder of General Woods. He was also actively involved in fixing the prices of the transactions carried out between the assessee and General Woods;
- Mr. Stevan Elefant *(shareholder in assessee through Tanika International)* was a director of General Woods; and
- The total purchases made by the assessee from Durian and General Woods *(on a combined basis)* were in excess of 95.44% of the total purchases.

Accordingly, the AO concluded that General Woods was an AE under clause (h), (i) & (j) of section 92A(2) of the Act. The above stand was also affirmed by the Hon'ble CIT(A).

The Hon'ble Tribunal noted that no material had been brought out by the revenue to justify the assertion of the AO that Mr. Satish Chawla and Mr. Stevan Elefant were the shareholders and directors in General Woods. Further, it observed that the assessee had also furnished an Affidavit of Mr. Satish Chawla averring that he was neither a shareholder nor a director of General Woods. In view of the above facts, the Hon'ble Tribunal decided to proceed further on the basis that neither Mr. Satish Chawla nor Mr. Stevan Elefant were shareholders/directors of General Woods.

With regard to the determination of whether General Woods was an AE of the assessee under clause (h), (i) & (j) of section 92A(2) of the Act, the Hon'ble Tribunal held the following:

Application of section 92A(2)(h) of the Act: The Hon'ble Tribunal noted that purchases from General Woods were approximately 38% of the total purchases. It noted that the revenue contended that combined, the purchases from Durian and General Woods exceeded 90% of the total purchases. However, noting that section 92A(2)(h) does not permit aggregation of purchases from different parties for the purpose of testing the limit of 90% prescribed, the Hon'ble Tribunal opined that clause (h) of section 92A(2) of the Act was not attracted in the present case.

Application of section 92A(2)(i) of the Act: The Hon'ble Tribunal noted that no material was brought on record by AO to establish that the purchase and selling prices for and on behalf of General Woods were determined by Mr. Satish Chawla and Mr. Stevan Elefant. Referring to the earlier conclusion that neither Mr. Satish Chawla nor Mr. Stevan Elefant was a director of General Woods, the Hon'ble Tribunal held that in the absence of any substantiation by the AO, it could not be said that the test provided in clause (i) of section 92A(2) of the Act was satisfied.

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Application of section 92A(2)(j) of the Act: The Hon'ble Tribunal noted that section 92A(2)(j) of the Act provides that an enterprise will be an AE where one enterprise is controlled by an individual, the other enterprise is also controlled by such individual or his relative or jointly by such individual and relative of such individual. In this regard, the Hon'ble Tribunal opined that no material was provided by the revenue to show that the prescribed test was satisfied.

Therefore, the Hon'ble Tribunal held that General Woods was not an AE of the assessee within the meaning of section 92A of the Act.

Case Law 5: CIT Vs. Sanmina SCI India Pvt Ltd (Tax Case [Appeal] No.567 of 2016) (MAD)

Inclusion of additions/disallowance/variations in the final order of assessment that do not form part of the order of draft assessment shall amount to violation of the provisions of the Act.

Facts of the case:

The assessee entered into international transactions with its AE during the year under consideration. The TPO proposed the following adjustments on assessee's international transactions for the relevant assessment year:
(i) An adjustment to the ALP in accordance with the TPO's order; &
(ii) An adjustment to the computation of relief u/s 10A of the Act.

Aggrieved, the assessee raised objections before the Hon'ble DRP. The Hon'ble DRP issued directions on both the above issues. As a consequence of the Hon'ble DRP's direction, the AO passed order of final assessment and made an additional disallowance in respect of section 10A, which was not contemplated in the order of draft assessment. The additional disallowance pertained to the aggregation of income/loss from various sources under the same head of income prior to allowance of relief u/s 10A of the Act. Since the aggregation resulted in a loss and there was no profit, the AO concluded that the relief u/s 10A was not liable to be allowed.

Aggrieved, the assessee appealed before the Hon'ble Tribunal. The Hon'ble Tribunal upheld the assessee's contention that variation relating to reduction of losses was illegal, in so far as it neither emanated from the order of draft assessment nor from the directions of the DRP. Thus, it was not in line with the statutory mandate with the provisions of the Act.

Aggrieved, the revenue filed an appeal before the Hon'ble High Court.

Decision of the Hon'ble High Court:

The Hon'ble High Court analysed the provisions of the Act and observed that the draft assessment order sets out the proposed variations and the same is forwarded to the assessee for response. Further, the AO is required to complete the assessment on the basis of the draft order.

The provisions of the Act do not provide the assessee with an opportunity of being heard prior to passing of the final assessment order giving effect to directions of the Hon'ble DRP. The Hon'ble High Court, therefore settled that the AO is not expected to, and shall not venture to, raise any issue except the variations specified by him in the order of draft assessment or any issue raised by the Hon'ble DRP by way of enhancement. The scheme of the provisions of the Act would thus be wholly violated if the AO includes in the order of final assessment such additions/disallowance/ variations that do not form part of the order of draft assessment.

Accordingly, the Hon'ble High Court concluded that the variation in the order of final assessment relating to the priority of set-off of losses was purely misconceived and an excess of jurisdiction by the AO.

Therefore, the Hon'ble High Court ruled in favour of the assessee.

Domestic Tax

Case Law 1: Principle Commissioner of Income tax Vs. Delhi State Industrial Infrastructure Development Corp. Ltd 85 ([2017] taxmann.com 24) (DEL)

The depiction of the receipt in the accounts of the assessee may not be conclusive of the nature of the receipt for the purposes of the income tax.

Facts of the case:

The assessee was awarded projects by Delhi Government for relocation of industries, common effluent treatment plants and development works of the Narela Industrial Complex Scheme. During the relevant AY, the assessee received/collected ground rent and maintenance charges from the allottees of the plot. The assessee has not offered the said receipt for tax but had held it on behalf of the government. Even the interest earned on the said receipt was not credited to the Profit and Loss account. The department argued that although the receipt was not accounted in the Profit and Loss account, even the entries in the books of accounts are not conclusive to depict the nature of receipt for tax purpose.

The AO held that both the ground rent and maintenance charges collected by the assessee formed part of its income and added the same to the income of the assessee.

On appeal with the Hon'ble CIT(A) by the assessee, the Hon'ble CIT(A) deleted the additions made by the AO on the basis of the orders passed by the tribunal in respect of the similar issue in the assessee's own case for prior AY.

Since, there was no change in the facts of the matter for the relevant assessment year, the Hon'ble Tribunal also upheld the view taken by the Hon'ble CIT(A).

Aggrieved by the decision of the lower appellant authorities, the revenue preferred an appeal with the Hon'ble High Court of Delhi.

Decision of the Hon'ble High Court:

When the matter was escalated to the High Court, it was understood that the order which the Hon'ble CIT(A) and the Hon'ble Tribunal were referring to, in the assessee's case for prior assessment year, had been further escalated to the High Court for that AY by the department. In the prior AY, the Hon'ble High Court had decided the matter in favour of the revenue.

Therefore, maintenance charges received by the assessee for the AY was taxed in the hands of assessee. The order passed by the Hon'ble High Court was not taken into consideration by the lower appellant authorities while passing their judgements.

Based on the decision rendered by the Hon'ble High Court in the assessee's own case in the prior AY, the Hon'ble High Court distinguished the decision of the Hon'ble Tribunal in the relevant AY and taxed the maintenance charges received by the assessee. However, there was no judgement passed on the taxability of ground rent. Therefore, the matter was restored to the AO since the taxability of ground rent was never considered by the lower authorities.

Thus, in view of the above discussion as well as in the facts and circumstances of the case, the Hon'ble High Court held the matter partially in favour of the revenue.

Case Law 2: CIT Vs. Mrs. Tara Sinha [2017] 85 taxmann.com 9 (TDelhi)

Compensation received in lieu of a non-compete agreement that incorporates a covenant stating that assessee, who enjoyed a position in advertising industry, shall not be involved in any advertising business in India, is capital in nature thereby, not liable to be taxed.

Facts of the case:

The assessee was working as a president of TSME. She also held 51% shares of the said company and MEW held 40% of the shares of TSME. Upon her retirement, she received payments in lieu of entering into a non-compete agreement with MEW. The payment was declared as a capital receipt and accordingly, was not offered for taxation in India. However, the AO taxed the same as a revenue receipt. On appeal to the Hon'ble CIT(A), the addition made by the AO was deleted and the contention of the assessee was upheld.

The AO stated that amount in question was nothing but a terminal benefit, which was couched as a non-compete fee in order to escape the payment of tax and preferred an appeal with the Hon'ble Tribunal.

Decision of the Hon'ble Tribunal:

Upon a careful perusal of the agreement, it was held that:

- The assessee was an acknowledged personality in the advertising field in India. Further, TSME was a brainchild of the assessee. The non-compete fees were paid by MEW to the assessee since MEW was apprehensive about her retirement and the effect it could have on their business:
- The non-compete agreement was entered into since the assessee did have the potential and stature to take away a substantial number, if not all, of the clients and the employees of TSME;
- The 'real nature of the transaction' is that it is a non Compete Agreement wherein the assessee agreed not to be involved in any business in India of advertisement, sale, promotion, public relations etc., which was competitive with MEW or solicit any client of MEW or hire any employee of MEW; &
- The non-compete fee paid to her cannot, therefore, be termed as a camouflage or a well- orchestrated plan to avoid payment of tax.

Thus, any payment made which represents compensation for the loss of the source of income would be capital in nature and accordingly, shall not be liable to be taxed.

Case Law 3: ACIT Vs. Shahrukh Khan [2017] 84 taxmann.com 209 (TMum)

Immovable property received shall be treated as a gift and not a professional receipt in absence of a direct link between services provided and property received.

Facts of the case:

The assessee received a Villa as a gift executed by a Dubai based public joint stock company which was under exclusive domain and control of the assessee's friend, a Sultan.

Over the years, the assessee had made visits to the sales office of the company and had also delivered a speech in its annual day event, images of which were on the Company's official website and other electronic & print media.

In the year under consideration, non-monetary gifts were not taxable under section 56(2) of the Act, and thus value of said Villa could not be brought to tax under the gift tax provisions.

The AO rejected the assessee's contention that the said Villa was a gift and stated that this was in fact a *quid pro quo* arrangement or a barter for using the assessee's brand image for endorsing the company's projects. Accordingly, this must be brought to tax as assessee's 'professional income' as per section 28(iv) of the Act.

Further, the AO stated that the ownership of the Villa vested with the Company which was a distinct legal entity separate from its Directors and lacked emotions like natural love and affection.

The assessee challenged the action of the AO before the Hon'ble CIT(A). The Hon'ble CIT(A) accepted the contention of the AO. Aggrieved, the assessee preferred an appeal before the Hon'ble Tribunal.

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Decision of the Hon'ble Tribunal:

The assessee contended that his presence at the Company's annual day event was out of a personal courtesy, without consideration and at the request of the Sultan. The assessee merely addressed the employees of the company and did not undertake any stage performance which would tantamount to brand endorsement or advertisement for the Company.

On the other hand, the revenue contended that the assessee's frequent visit to the Company's sales centre and appearance at the Company's event, strongly points that the alleged gift is a professional receipt for using the assessee's image and brand potential for publicity. Revenue further contended that this element of consideration and the absence of human sentiments/emotions in the Company show that the transaction in reality was not a gift.

After hearing the rival contentions, the Hon'ble Tribunal was of the view that the said Villa was received in gift by the assessee. Assessee's presence at the Company's event was a mere goodwill gesture. It further stated that companies are competent to make gifts and there is no requirement of any natural love or affection.

The revenue placed reliance merely on photographs and news items, which is not sufficient to state that it amounted to any kind of promotion for the Company. The onus of proving that the said Villa was not a gift and in fact a professional receipt was on the revenue, which it failed to discharge.

Therefore, Hon'ble Tribunal ruled in favour of the assessee, stating that given the facts and circumstances of the case, the said Villa could not be brought to tax as professional income and was a simple case of receipt of gift.

Recent important Notifications issued by the central board of direct taxes ('*CBDT*')

1. **Notification No. 80/2017 dated August 18, 2017 – Amendments to Form No. 29B i.e. MAT audit report to be provided under section 115JB of the Act.**

Vide this notification, the CBDT has provided the taxpayers with amended Form 29B. The amendments to Form No. 29B pertain to Ind-AS related adjustments where financial statements of company are drawn up as per Ind-AS.

The link to visit the notification is provided hereunder:

http://www.incometaxindia.gov.in/communications/notification/notification80_2017.pdf

2. **Notification No. 82/2017 dated August 30, 2017 – Notification providing protocol to amend the DTAA between India and Vietnam.**

The DTAA between India and Vietnam stands amended in order to:

a. Replace Article 27 – Exchange of information

Such an amendment paves way for having a strong mechanism in place for the purpose of exchange of information between two contracting states. One of the clauses of the Article, inter alia, state that any information received by a Contracting State shall be treated as secret in the same manner as information obtained under the domestic laws of the State.

b. Introduction of Article 27A – Assistance in collection of taxes

Introduction of this Article provides various mechanisms in order to enable both the contracting states to raise a revenue claim and also to resolve various issues mentioned thereunder.

The link to visit the notification is provided hereunder:

http://www.incometaxindia.gov.in/communications/notification/notification82_2017.pdf