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 circular and notification issued by the Central Board of Direct Tax.

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Transfer Pricing

Case Law 1: M/s Akzo Nobel India Limited Vs. DCIT (ITA No. 531/Kol/2014)

Services rendered by the associated enterprise ('AE') cannot be considered as stewardship services if such services add economical/commercial value to enhance the position of the assessee.

Facts:

The assessee is a member company of Akzo Nobel group company, engaged in business of manufacturing and marketing of paints. The assessee operates through subsidiaries in various countries.

The assessee entered into a service level agreement *('SLA')* with another Akzo group company, Akzo Nobel Paints Pte Ltd. ('*ANPAP*'), which was an AE of the assessee. As per the SLA, ANPAP agreed to render services to the assessee relating to advice/support in the area of human resources to attain functional excellence, advice and assistance on operation relating to plant, advice and support on strategies to optimise cost structures, provide a range of market support services, provide a range of services in information technology; advice and assistance on reporting/accounting, financial control and planning activities; and other ancillary services in support of assessee's business.

The consideration payable for such services was determined at actual cost plus a margin of 5%. However, the transfer pricing officer ('*TPO*') proceeded on the basis that the nature of services rendered were in the nature of stewardship activity and therefore no charges ought to have been paid by the assessee. Accordingly, the TPO made adjustments determining the transaction at nil. The assessee filed objections before the Dispute Resolution Panel ('*DRP*') but the same were dismissed. Aggrieved, the assessee filed an appeal before the Hon'ble Tribunal.

Decision of the Hon'ble Tribunal:

The Hon'ble Tribunal observed that there is no specific mention of allocation of common cost in Indian Transfer Pricing ('*TP*') provisions. The Hon'ble Tribunal further held that the commercial expediency cannot be questioned by the tax authorities. The Hon'ble Tribunal identified 6 aspects that would require consideration in order to identify it as intra-group services requiring arm's length remuneration.

On further analysing the matter, Hon'ble Tribunal noted that ANPAP had developed expertise in the field of HR, operations and purchasing, IT, marketing, finance and planning areas with a view to enable the Akzo group companies to have full access to this extensive knowledge and expertise. On accessing to such services, the assessee had also benefited from substantial savings in total cost.

The Hon'ble Tribunal concluded that the benefits generated by the said services during the relevant financial year have undeniably added economic/commercial value to enhance the commercial position of the assessee and such services were received by the assessee on a continuous basis across its operational area.

Therefore, such services ought not to be considered as stewardship services and therefore the charges paid by the assessee were held to be justified.

Case Law 2: Hyundai Motor India Ltd Vs. Deputy Commissioner of Income tax, Chennai [2017] 81 taxmann.com 5 (TChe)

The accretion of brand value, as a result of use of the brand name of foreign AE under technology use agreement does not result in a separate international transaction to be benchmarked.

Facts of the case

The assessee was a fully owned subsidiary of South Korean automobile giant Hyundai Motor Company *('HMC')* and was engaged in the business of manufacturing cars in India. The assessee entered into a number of international transactions with its AEs abroad. During the course of scrutiny of determination of ALPs for these transactions, the TPO noted, so far as the AY 2009-10 was concerned, that the assessee was manufacturing cars under the brand name 'Hyundai', which was legally owned by HMC and that the assessee was to mandatorily, as per the agreement, "use the badge with trademark Hyundai in every vehicle manufactured by it".

The TPO was of the view that:

- By doing so, the assessee had contributed to the development of Hyundai brand in Indian market;
- HMC Korea is benefited due to brand promotion activity carried out by the assessee company;
- The mandatory requirement has not given any benefit to the assessee but has deprived the assessee of developing its own brand name and logo, thus being doubly jeopardized; &
- The brand name 'Hyundai' is getting popularized

which has led to HMC having bigger share in the automobile market globally whereas the assessee has no identity and has to wear the mask of holding company even though the cost spent and efforts taken in promoting the brand name are attributed to the assessee.

The TPO noted that the assessee had not shown any compensation received from the holding company *(i.e. legal owner of the Hyundai brand)* for developing the brand. The TPO thus made a calculated addition based on the assumption that on the basis of the agreement, it could easily be inferred that there was an international transaction, without any consideration, between the assessee and HMC for promotion of brand name and logo.

The assessee filed objections before the Hon'ble DRP who rejected the objections of the assessee and confirmed, in principle, the stand of the TPO. Aggrieved, the assessee preferred appeal before the Hon'ble Chennai Tribunal.

Decision of the Hon'ble Tribunal

The Hon'ble Tribunal noted that the question that needed to be decided was whether the benefit accruing to the HMC, as a result of increased brand value due to sale of Hyundai cars in India by the assessee, constituted an international transaction or not.

The Hon'ble Tribunal observed as under:

- The percentage of AMP expenses as a proportion of net sales was not an unreasonable high figure and that the arguments of the assessee that 'there was no excess over and above a market benchmark average in the financial year' had been accepted by the TPO;
- The emphasis of the TPO was all along on the benefit accruing to the HMC, on account of increased brand valuation, as a result of cars being sold by the assessee in India, and not as a result of conscious brand promotion by the assessee; &
- The short case of the revenue was that simply because the cars are sold by the assessee, the brand gets more visibility, and this visibility results in greater brand value of the Hyundai Korea.

Relying on the decision in case of Maruti Suzuki India Ltd Vs. ADIT (2010) (328 ITR 510) (Del), the Hon'ble High Court opined that unless the expenses incurred by the assessee on its AMP are excessive vis à vis what similarly placed comparables would have incurred then, to that extent, the foreign AE had an obligation to compensate the assessee company for the AMP expenses.

The Hon'ble Tribunal further went on to evaluate that there were two basic aspects of the arrangement to be considered as an international transaction:

- First, what was the true nature, and proximate cause, of the arrangement about the use of foreign brand name - was it a case of using foreign brand name to promote the brand name, or to benefit the assessee from the reputation of the established brand name?; &
- Second, what was the scope of definition of 'international transaction' under the Indian TP legislation, and whether this arrangement could fall under the same?

With regard to the first question, the Hon'ble Tribunal opined that when the assessee used the established and valuable brand name in the name of the models of vehicles manufactured by it, it did indeed amount to an advantage to the assessee. In that sense, the use of brand name owned by the foreign AE was a privilege, a marketing compulsion and of direct and substantial benefits to the assessee. The Hon'ble Tribunal thus went on to hold that the obligation of the assessee to use the brand name owned by the assessee was, therefore, not solely and proximately driven by the benefits to the AE, owning the brand name.

However, having held so, the Hon'ble Tribunal also recognized the fact that the use of brand name did amount to a benefit to the AE, an incidental benefit though, in the sense that increased visibility to the trade name does contribute to increase in brand valuation of the brand name.

The Hon'ble Tribunal thus went on to establish whether such an accretion in brand value can be treated as an international transaction under the Indian TP legislation.

Thus, with regard to the second question to be considered, the Hon'ble Tribunal held as under:

- So far as intangibles were concerned, the relevant transaction, covered by the definition of international transactions, were only transactions of purchase, sale or lease of intangible properties and there was no purchase, sale or lease of intangibles in this case at all;
- Section 92B(i)(b) of the Income tax Act, 1961 ('*the Act*') did add that the expression 'international transaction' would include "the purchase, sale, transfer, lease or use of intangible property, including the transfer of ownership or the provision of use of rights regarding land use, copyrights, patents, trademarks, licences, franchises, customer list, marketing channel, brand, commercial secret, knowhow, industrial property right, exterior design or new design or any other business or commercial rights of similar nature" but even under this extended definition, the accretion to the value of intangibles was not covered;
- Undoubtedly, 'provision for services' is included in the definition of 'international transaction' under section 92B of the Act, but then accretion in brand value due to use of foreign AE's brand name in the name of assessee's products could not be treated as service either; &
- Finally, the residual definition of international transaction in the nature of any other transaction having a bearing on the profits, income, losses or assets of such enterprises also does not apply to the present case. The accretion in brand value of the AE's brand name is not on account of costs incurred by the assessee, or even by its conscious efforts.

In view of these discussions, as also bearing in mind the entirety of the case, the Hon'ble Tribunal held that the accretion of brand value, as a result of use of the brand name of foreign AE under the technology use agreement, which had been accepted to be an arrangement at an ALP, did not result in a separate international transaction which required to be benchmarked. The grievance of the assessee, with respect to ALP adjustments on account of accretion in the brand value of the AE due to its use by the assessee, was thus upheld by the Hon'ble Tribunal.

International Tax

Case Law 1: Commissioner of Income tax Vs. Hero Motocorp Ltd [2017] 81 taxmann.com 162 (Del)

Payment of export commission by assessee to AE under export agreement, where assessee had not been transferred or permitted to use any patent, invention, model, design or secret formula and further, the AE had not rendered any managerial, technical or consultancy services is neither considered as royalty nor fee for technical services.

Facts:

The assessee was engaged in the business of manufacture and sale of motorcycles using technology licensed by its AE, Honda Motor Co Ltd, Japan *('HMCL')*. The assessee entered into various agreements over the years with HMCL, listed as under:

- Technical Collaboration Contract (1984 – 1994): assessee manufactures models of motorcycles by using knowhow of HMCL;
- License and Technical Assistance Agreement ('LTAA') (1995 – 2014): HMCL (*'licensor'*) granted to the assessee (*'licensee'*) an "indivisible, non-transferable and exclusive right and license, without the right to grant sublicenses, to manufacture, assemble, sell and distribute the products and parts within the Territory *(India)*"; &
- Export Agreement ('*EA*') (2004): HMCL accorded consent to the Appellant to export specific models of two wheelers to certain countries on payment of export commission @ 5% of the FOB value of such exports.

During the course of assessment proceedings, the AO treated the export commission as an international transaction entailing a TP adjustment. The TPO further held the said payment was unnecessary; that it was detrimental to the assessee and was made only with a view to benefitting the AE's units/subsidiaries in those countries to which the assessee was permitted to export the vehicles. The TPO proceeded to hold that the ALP of the said transaction i.e., the payment of export commission was nil. The Hon'ble DRP concurred with the TPO, and the AO passed the assessment order accordingly.

Aggrieved, the assessee preferred an appeal before the Hon'ble Tribunal, which ruled in its favour. The Hon'ble Tribunal noted that the assessee had in fact benefited from the transaction in as much as it had earned a profit of INR 13.05 crores through exports.

Aggrieved, the revenue preferred an appeal before the Hon'ble High Court and pleaded that either:

- the said payment be treated as an international transaction and thereby entail a TP adjustment; or
- the said payment be construed as royalty, which in turn would require tax deduction at source. The failure to do so would lead to its disallowance u/s 40(a)(i) of the Act.

Arguments before the Hon'ble High Court

The revenue submitted that it might not be able to contest the finding as far as treating the payment of export commission as an international transaction entailing a TP adjustment was concerned.

However, it pleaded that the same be considered as royalty payment from the assessee to its AE. It contended that *Explanation* 2 of section 9(1)(vi) of the Act defines 'royalty' as consideration for the purposes specified thereunder in subclauses (i) to (vi). The word 'consideration' as defined in section 2 of the Indian Contract Act, 1872 would include a payment to do or abstain from doing a particular thing. It pointed out that under the LTAA, there was a specific bar *(in the form of a negative covenant)* that prevented the assessee from using the knowhow to manufacture vehicles for export outside India. Within a few days on June 21, 2004, a separate EA was entered into permitting export of the vehicles so manufactured to certain countries. The revenue claimed the EA to be nothing but an extension of the LTAA itself. It was submitted that the consideration for the negative covenant under the LTAA i.e., abstaining from exporting the product outside India was monetised in the EA in the form of the export commission and was therefore a payment of royalty.

The revenue further submitted that in the absence of any principal-agent relationship between HMCL and the assessee in terms of the EA, the payment of export commission thereunder was without consideration. It submitted that the EA was nothing but a device to enable the AE to avoid paying taxes on the income earned as a result of the use by the assessee of the knowhow.

Decision of the Hon'ble High Court:

The Hon'ble High Court noted the following:

- When the entire history of the collaboration between the assessee and HMCL is viewed, then it becomes clear that the agreements of technical knowhow being licensed to the assessee and the EA were two distinct agreements and therefore cannot be said to be contemporaneous;
- The payment of the export commission was not without consideration. It permitted the assessee to export specified two wheelers manufactured under the Hero Honda brand to the specified countries;
- The assessee did not have to pay for using the

existing distribution and sales networks in those territories;
- To view the transaction as only benefitting the AE is to overlook the fact that not only has the assessee benefitted in various ways as noted before, but it has also earned during the AY in question profits of INR 13.05 crores from exports; &
- Consequently, there was no question of there having to be a principal-agent relationship to justify the payment of the export commission. The amount spent on that score by the assessee was for the benefit of its business and in fact resulted in a benefit.

Thus, the Hon'ble High Court concurred with the findings of the Hon'ble Tribunal that by export agreement, the assessee has not been transferred or permitted to use any patent, invention, model, design or secret formula. Similarly, HMCL, by way of export agreement, has not rendered any managerial, technical or consultancy services. Thus, the Hon'ble High Court concludes that the payment of export commission was not in the nature of payment of royalty or fee for technical services attracting disallowance u/s 40(a)(i) of the Act.

Domestic Tax

Case Law 1: Palam Gas Service Vs. Commissioner of Income tax [2017] 81 taxmann.com 43 (SC)

For payments made to contractors/subcontractors, tax is required to be deducted in both the contingencies, namely, when the amount is credited to the account of the contractor or when the payment is actually made.

Facts:

The assessee, is engaged in the business of purchase and sale of LPG cylinders. In order to carry out the business, the assessee entered into contracts with three individuals for transportation of the LPG. The assessee while making freight payments to the three individuals, did not deduct tax at source. The AO observed that the assessee had entered into a subcontract with the three individuals within the meaning of section 194C of the Act and, therefore, he was liable to deduct tax at source from the payment made. As per the provisions of section 40(a)(ia) of the Act, any amount 'payable' to a resident contractor/sub-contractor on which tax is deductible at source and such tax has not been deducted shall be disallowed while computing profits and gains from business and profession. The assessee contended that, the provisions of the said section shall not apply in a case where the amount is not payable to a contractor/sub-contractor on which tax is deductible at source and such tax has not been deducted. The assessee also contended that, the provisions of the said section shall not apply in a case where the amount is not payable to a contractor/sub-contractor but has been actually paid.

The AO disregarded the assessee's contention and disallowed the freight expenses.

Against the order of the AO, the assessee preferred an appeal before the CIT(A), who upheld the order of the AO. The assessee preferred an appeal before the Hon'ble Tribunal. The Hon'ble Tribunal decided the matter against the assessee.

Aggrieved, the assessee filed an appeal before the Hon'ble High Court, where again the outcome remained unchanged. The Hon'ble High Court dismissed the appeal affirming the order of the Hon'ble Tribunal.

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

Decision of the Hon'ble Supreme Court

The question in the instant case before the Hon'ble Apex Court was whether the word 'payable' used in section 40(a)(ia) of the Act would cover only those contingencies where the amount is due and still payable or it would also cover the situations where the amount is already paid but no tax has been deducted thereupon.

The Hon'ble Apex court observed that as per section 194C of the Act, it is the statutory obligation of a person making payment to the subcontractor, to deduct tax at source at the rates specified therein. The plain language of the section suggests that such a tax at source is to be deducted at the time of credit of such sum to the account of the contract or at the time of payment thereof, whichever is earlier. Thus, tax has to be deducted in both the contingencies, namely, when the amount is credited to the account of the contractor or when the payment is actually made.

Further, section 200 of the Act imposes further obligation on the person deducting tax at source, to deposit the same with the Central Government or as the Board directs, within the prescribed time. The Hon'ble Apex Court was of the view that a conjoint reading of these two sections of the Act suggests that not only a person, who is paying to the contractor, is supposed to deduct tax at source on the said payment whether credited in the account or actual payment made, but also deposit that amount to the credit of the Central Government within the stipulated time.

In view of the above discussions, the Hon'ble Supreme Court approved the view of the Hon'ble High Court and dismissed the assessee's appeal.

Case Law 2: Jitendra V Faria Vs. Income tax Officer [2017] 81 taxmann.com 16 (TMum)

Exemption u/s 54 of the Act shall be granted to the assessee if the cost of the new property purchased is paid by the assessee entirely even though the new property purchased is jointly held along with the assessee.

Facts:

The assessee carried a business in hardware and aluminium sections. During the AY in appeal, he sold a residential house property ('*RHP*')which he jointly

owned with his wife. He computed the capital gains as per the provisions of the Act and calculated 50% of such gains as his share. Also, he purchased another RHP of an amount almost equivalent to the gains and claimed exemptions u/s 54 of the Act. The new property was purchased by the assessee along with his brother, however all the cost of the new house including the registration charges and stamp duty were incurred by the assessee only. His brother's name was included in the agreement only for the sake of convenience.

The AO disallowed the exemption claimed by the assessee to the extent of 50% since the new property was purchased jointly by the assessee and his brother. Aggrieved by the order of the AO, the assessee filed an appeal before the Hon'ble CIT(A). The Hon'ble CIT(A) disregarded the appeal of the assessee and also directed the AO to tax the entire proceeds from the sale of the old house in the hands of the assessee.

Aggrieved by the decision of the Hon'ble CIT(A), the assessee filed an appeal before the Hon'ble Tribunal.

Decision of the Hon'ble Tribunal

The Hon'ble Tribunal distinguished the decision of the Hon'ble CIT(A) and held that there was no justification in the order of the Hon'ble CIT(A). Also, the balance 50% of the proceeds from the sale of the RHP was offered for tax by his wife in her income tax return.

In case of the view taken by the AO in disallowing the exemption claimed u/s 54 of the Act by the assessee just because the new RHP was held jointly by his brother, the Hon'ble Mumbai Tribunal relied on the decisions rendered by the Hon'ble Delhi High Court in the case of CIT Vs. Ravinder Kumar Arora [2012] (342 ITR 38) (Del) which in turn had relied on the decision rendered by the Hon'ble Supreme Court in case of CIT Vs. Podar Cement P Ltd [1997] (226 ITR 625) (SC). In both these decisions, the respective Courts have accepted the theory of constructive notice i.e., even if the new RHP was purchased jointly by two or more persons, if the assessee has incurred/paid all the costs of new property, then he/she will be eligible to claim the exemptions u/s 54 as well as 54F, as may be applicable. Also, purposive construction is to be preferred as against the literal construction. More so, even the purposive construction does not imply that the house should be purchased in the name of the assessee only.

Thus, in view of the above discussion as well as in the facts and circumstances of the case, the Hon'ble Tribunal held that the views taken by the AO and the Hon'ble CIT(A) were hyper technical and required a modification.

Recent important circulars and press release issued by the Central Board of Direct Taxes ('*CBDT*')

1. Circular No. 16/2017 dated April 25, 2017 – Taxability of Lease rent from letting out building/ developed space along with other amenities in an industrial park/SEZ

The CBDT has clarified herewith by way of a circular that lease rent from letting out building/developed space along with other amenities in an industrial park/SEZ is to be treated as business income on fulfilment of certain conditions.

A link for the same is provided herewith:

http://www.incometaxindia.gov.in/communications/circular/circular16_2017.pdf

2. Notification no. 32/2017 dated April 21, 2017 – Valuation of assets for the purposes of section 115TD(2) of the Act

The CBDT has notified the method of valuations for trust and institution for the purpose of section 115TD(2) of the Act.

A link for the same is provided herewith:

http://www.incometaxindia.gov.in/communications/notification/notification32_2017.pdf

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