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India Spectrum

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In this issue

Editorial

We are delighted to present yet another issue of India Spectrum.

Growth and Reform once again top our agenda. The Confederation of Indian Industry (CII) President has forecasted India's economic growth to be 6 to 6.4% in the financial year 2014. The CII President has suggested a long list of reforms, such as raising the cap on foreign direct investment (FDI) in insurance and banking, implementation of taxation reforms by introducing Goods and Services Tax and the introduction of the Direct Taxes Code in order to achieve the set target.

On the Indian economic front, inflation based on the wholesale price index was estimated at 5.96% at the end of March 2013 as against 6.84% in the previous month, and 7.69% in March last year. The decline in the price of vegetables pulled down inflation to a three-year low in March 2013. The industrial output growth also slowed to 0.6% in February 2013.

On the global front, the UK General Anti-Abuse Rules (GAAR) were released, clarifying that taxation was "not to be treated as a game in which taxpayers could indulge in any ingenious scheme in order to reduce their tax burden". Effectively, the UK Parliament has "imposed an overriding statutory limit" on the extent to which taxpayers can go in trying to reduce their tax bill. The GAAR have thus severely circumscribed the applicability of the Duke of Westminster ruling.

On the regulatory front, the Reserve Bank of India (RBI) has clarified that core investment companies (CIC) desiring to enter into the business of insurance do not have a ceiling stipulated for their investment in an insurance joint venture. However, a CIC cannot undertake insurance agency business.

Ketan Dalal

Shyamal Mukherjee

On the judicial front, the Delhi High Court, in the case of Goodyear Tyre and Rubber Company, held that the transfer of shares of an Indian company between two non-residents in the form of a gift was not taxable in India. No consideration could be said to have accrued or arisen to the Indian company by the transfer of the shares, since no profit or gain was derived by it from the gift. In another ruling, the Mumbai Bench of the Tribunal in the case of Adani Enterprises Ltd held that an assessee could not be considered as an 'assessee-in-default' on its failure to withhold tax in respect of interest paid on foreign currency convertible bonds, where monies were actually deployed outside India and interest was specifically exempt under section 9(v)(b) of the Act. See page no. 6 and 9 for a detailed analysis of these rulings.

We hope you enjoy this issue. As always, we look forward to hearing from you.

Ketan Dalal and Shyamal Mukherjee
Joint Leaders, Tax and Regulatory Services

Analysing tax issues
Corporate tax

Indirect transfer

Transfer of shares of an Indian company, without consideration, between two non-residents not taxable in India

The assessee is a resident of the USA having 74% shareholding in G Ltd, an Indian company. As a part of its global corporate strategy, it proposed to voluntarily transfer, without any consideration, its entire shareholding in G Ltd to S Ltd, a tax resident of Singapore and a wholly-owned subsidiary of the assessee.

The assessee sought an advance ruling on the taxability of the share transfer transaction and contended the following:

- The shares in G Ltd, being capital assets of the assessee, on transfer would be liable to capital gains tax. However, the full value of consideration for such shares was nil. Hence, the capital gains tax computation provision under section 48 of the Income-tax Act, 1961 (the Act) was not applicable.
- The shares transferred were in the form of a 'gift'. Hence, this would be excluded from the scope of "transfer" under section 45 by virtue of section 47(iii) of the Act.

The AAR, after examining the various provisions of the Act, held that there would be no tax liability on either the assessee or on S Ltd.

Aggrieved, the revenue filed a writ petition before the HC and contended that:

- The shares of G Ltd were transferred to create a better business environment, which was the consideration for transfer. Hence, the transaction could not be termed as a 'gift'.
- The share transfer transaction was a case of 'treaty shopping' for avoidance of capital gains at a future date i.e. if the shareholding remained with the USA company and was subsequently transferred to some third entity, the income would be taxable under the Act as well as under the India-USA Double Taxation Avoidance Agreement (the tax treaty). However, if the shares were transferred by the Singaporean company to a third entity, such a transaction would not be taxable under the Act and the India-Singapore tax treaty.

The HC held that the AAR had rightly observed that the possibility of the assessee making better returns in the future by virtue of the reorganisation cannot be regarded as a 'consideration' in the absence of any right to receive a definite or an unascertainable amount or benefit from the transferee.

Therefore, no consideration can be said to have accrued or arisen to the assessee by transfer of the shares since no profit or gain was derived by the assessee from the transaction.

It is a well settled law that section 45 must be read with section 48 of the Act. Therefore, if the computation provision under section 48 cannot be given effect to, for any reason, the charging provision under section 45 also fails.

The AAR further observed that G Ltd was a company in which the public were substantially interested, and its shares were listed on the Bombay Stock Exchange. Therefore, any income arising from the transfer of long-term capital asset, being equity shares in a company with the transaction liable to securities transaction tax, would be exempt under section 10(38) of the Act.

Therefore, even if consideration had been charged for transfer of the shares, the income arising

would be exempt by virtue of the provisions of section 10(38) of the Act.

Accordingly, the HC upheld the AAR ruling stating that in view of the transaction being exempt under section 10(38) of the Act, the revenue's argument that the transaction was designed for the purpose of treaty shopping was also irrelevant.

DIT(IT) *v* Goodyear Tire and Rubber Company [2013] 30 taxmann.com 400 (Delhi)

Fees for technical services

Receipts from referral fees not taxable as FTS

The assessee company, a tax resident of Hong Kong, was engaged in the business of referring international clients to Indian stock brokers. During the year, it referred institutional clients to C, an Indian stock broking company. C paid referral fees to the assessee. The assessee did not offer the income on the basis that the referral fees were not in the nature of fees for technical services (FTS) under section 9(1)(vii) of the Act.

The tax officer (TO) held that the referral fees received were in the nature of FTS under section 9(1)(vii) of the Act chargeable to tax in India and not in the nature of commission.

On appeal, the Commissioner of Income-tax (Appeals) (CIT(A)) upheld the TO's order and held that the 'source' of the referral fees was in India as the transactions were executed in that country. Hence, the right to receive the income had arisen in India. Furthermore, it was held that the services were in the nature of marketing and sales promotion, covered under 'managerial' and 'consultancy' services in terms of FTS under section 9(1)(vii) of the Act. Accordingly, it held that the income was chargeable to tax in India.

The Income-tax Appellate Tribunal (the Tribunal) held that the assessee had only referred the international clients to the Indian stock brokers and after the payment for referral fees, there were no activities conducted by the assessee outside India. It was also held that no expertise or know-how was made available by the assessee to treat the services to be in the nature of managerial, technical or consultancy services covered as FTS in terms of explanation 2 to section 9(1)(vii) of the Act. In this regard, reliance was also placed on the decision in the case of Cushman and Wakefield (S) Pte Ltd, In re [2008] 305 ITR 208 (AAR).

Therefore, it was held that the 'referral fees' were not in the nature of FTS under section 9(1)(vii) of the Act.

CLSA Ltd *v* ITO [2013] 31 taxmann.com 5 (Mum)

Payment for transfer of exclusive technology along with intellectual property rights is taxable as FTS or royalty

The assessee company was engaged in the manufacturing of two- and- three-wheelers. It had entered into an agreement with X Ltd, a UK tax resident to develop and import inkjet printers and inks based on the assessee's specification. It made an application to the TO under section 195(2) of the Act for making payment to X Ltd for the purchase of printers without withholding tax, on the basis that the purchase transaction was not taxable in India.

The TO held that since the technical design, drawing and plans in relation to printers were made available by X Ltd, the payment was in the nature of FTS taxable in India in terms of Article 13(2) of the tax treaty between India and the UK.

On appeal, the CIT(A) held that the assessee had utilised the technical services of X Ltd for development of a technical

plan or design of the printer and inks. The payment was made for the transfer of intellectual property over the design developed and made available to the assessee. Hence, it was in the nature of royalty or FTS in terms of section 9(1)(vi) read with explanation 2(i), (ii) & (vi) to section 9(1)(vi) of the Act and Article 13(4)(c) of the India-UK tax treaty.

On further appeal, the assessee contended that the payment could not be treated as FTS since it was for purchasing printers and no technology was 'made available' to it. Furthermore, since X Ltd had no PE in India, the payment was not taxable even as business profits.

The Tribunal observed that under the agreement between the parties, the intellectual property (IP) was exclusively developed for the assessee. The assessee had whole and irrevocable rights to file a patent or design application for the IP rights. X Ltd could make the IP available to third parties only if permitted by the assessee. Therefore, the assessee was not a mere user of the IP but it had rights over the IP.

Accordingly, the Tribunal held that the agreement was not only for purchase of the printers but was also towards transfer of specific technology which was exclusively 'made available' to the assessee. Consequently, entire payment including the payment for printer made to X Ltd was taxable as FTS in India.

Bajaj Holdings and Investments Ltd *v* ADIT [2013] 30 taxmann.com 176 (Mum-Trib)

Tour handling services rendered outside India without any independent decision making not FTS

The assessee, an individual, is a proprietor of two concerns, Gemini International (GI) and Gemini Tours and Travels (GT), engaged in the business of tour operations. For the relevant year, GI made a payment to a non-resident (MPL) towards commission fees for weighing the goods, customs clearance in the Maldives and their delivery to the purchasers, and GT made payment to H, a non-resident, towards tourist handling charges. No tax was withheld on the payments made to non-residents.

During the course of assessment proceedings, the TO disallowed the expenditure of commission and tourist handling charges under section 40(a)(i) of the Act on the basis of failure to withhold tax on the payments made to the non-resident payees. The TO treated the payments in the nature of FTS in terms of the provisions of section 9(1)(vii) read with Explanation to section 9(2) of the Act. The CIT(A) upheld the order of the TO.

The Tribunal noted that MPL was engaged as an agent for weighing the goods, and clearance from the customs in the Maldives to facilitate the delivery of goods to the customers. Similarly H was responsible for receiving the clients and leaving them in resorts or hotels i.e. to facilitate the movement of the tourists.

The Tribunal noted that the activity required only certain skill and knowledge of the equipment in weighing and delivering the goods and did not require any application of mind or independent decision making. Hence, the receipts from services rendered were not in the nature of FTS, but would be taxable as business income in India.

However, reliance was placed on the decision in case of CIT *v* Eon Technology Pvt Ltd [2011] 343 ITR 366 (Del), where it was held that the business income earned by a non-resident cannot be deemed to accrue or arise in India in the absence of a PE or any business connection in India. Therefore, it was held that since the non-residents did not have a PE in India, no income was chargeable to tax

in the country. Accordingly, disallowance under section 40(a)(ia) of the Act was deleted.

Subbaraman Subramanian *v* ACIT [2013] 30 taxmann.com 236 (Bang-Trib)

Withholding tax

An assessee cannot be considered an 'assessee in default' for not withholding tax in respect of interest paid on foreign currency convertible bonds

The assessee had remitted interest payable on foreign currency convertible bonds (FCCB) without withholding of tax on the basis that the money from the FCCB was primarily invested in a foreign subsidiary and balance in time deposits outside India.

The TO passed an order under section 201(1) of the Act treating the assessee as an assessee-in-default for not withholding tax on remittance of interest on bonds as provided under section 196C of the Act.

On appeal, the CIT(A) held that the assessee is not liable to withhold tax on the interest under section 196C read with section 115AC of the Act on the following grounds:

- Almost all of the money from the FCCB was deployed outside India.
- Interest was covered by the second limb of the exception to section 9(1)(v)(b) of the Act and consequently, it fell outside the ambit of deemed income arising or accruing in India.

On further appeal, the Tribunal held that once income is specifically excluded under the deeming provisions of section 9(1)(v)(b) of the Act, it cannot be taxed again as income accruing or arising under section 5(2)(b) as both the provisions are mutually exclusive. Hence, no tax was required to be withheld on the interest paid on FCCB.

ADIT (IT) *v* Adani Enterprises Limited [2013] 29 taxmann.com 99 (Ahd-Trib)

Taxability of services in country

Services liable to tax in the contracting state cannot be made taxable in India, even if no tax was actually payable in the contracting state

The assessee had made payment to K Ltd, a tax resident of the UAE and a sole proprietorship of V, an individual, for providing certain professional services. The assessee contended that the services provided were "independent personal services" under Article 14 of the India-UAE tax treaty. Since V was not in India for more than 183 days, the payment towards the independent personal services would not be liable to withholding tax in India.

The TO observed that V, a resident of the UAE, was not paying any tax in the Emirates. Therefore, he was not a 'resident of a contracting state' within the meaning of Article 4(1) of the tax treaty. Furthermore, since income had accrued or arisen in India, it was chargeable to tax in that country. Hence, the assessee was required to withhold tax on the professional fees paid to K Ltd. Accordingly, it disallowed the payment made by the assessee to K Ltd under section 40(a)(i) of the Act. The CIT(A) confirmed the order of the TO.

The Tribunal held that under Article 4(1) of the tax treaty with the UAE, the expression "resident of a contracting state" means any person who is 'liable' to tax in the UAE by reason of his domicile, resident, place of management, place of incorporation or any other criteria of a similar nature. Therefore, the expression 'liable to tax' does not necessarily imply that the person should actually pay tax in the contracting state and that a mere right to tax such person is sufficient.

Therefore, since V was not in India for more than 183 days, nor had any fixed base in India, such payment was not taxable in that country. It was taxable in the UAE.

In the case of ACIT *v* Green Emirates Shipping Travel [2006] 100 ITD 203 (Mum) it was held that a tax treaty not only prevents 'current' but also 'potential' double taxation. Therefore, once the right to tax UAE residents in specified circumstances vests with the government of UAE, that right, whether exercised or not, continues to remain the exclusive right of the government of UAE. Therefore, merely because no tax was actually paid by K Ltd in UAE, the payment cannot be brought to tax in India. Consequently, the payment made by the assessee to K Ltd towards professional services cannot be disallowed under section 40(a)(i) of the Act.

KPMG *v* JCIT [TS-91-ITAT-2013 (Mum)]

Business expenditure

Interest paid on loan borrowed from group companies for purchase of shares deductible under section 36(1)(iii) of the Act

The assessee is registered as a non-banking financial company with the RBI and is in the business of investing in shares. The assessee had taken loans from its group companies at the beginning of the year and repaid them back to the respective companies at the end of the year. This was done on a year-on-year basis, thereby assuming the characteristic of a continuing loan. A part of the loan was utilised for purchasing shares of another group company.

The assessee, in its tax return for assessment year (AY) 2003-04, claimed deduction in respect of interest paid under section 36(1)(iii) of the Act.

The TO was of the view that considering that the entire loan amount was not utilised for earning business income, part of the funds were kept idle to reduce incidence of tax. The TO rejected the assessee's claim and disallowed the interest to the extent the loan was not utilised for business.

On appeal, the CIT(A) held that since the assessee has declared the income from sale of shares as 'long-term capital gains', the assessee was not engaged in the business of sale and purchase of shares. Furthermore, the shares were considered as 'investments' in the balance sheet and not 'stock-in-trade', and the TO disallowed the deduction of interest on the loan borrowed for purchase of shares.

On further appeal, the Tribunal held that the income earned from investment in shares is to be treated as 'business income' and allowed the deduction of the entire interest under section 36(1)(iii) of the Act relying on the memorandum of association, wherein the main object among other things was to carry out the business of investment in shares. The HC upheld the order of the Tribunal.

CIT *v* Peninsular Investment Ltd [2013] 29 taxmann.com 422 (AP)

Loan to subsidiary

No interest disallowance on interest-free loans provided to subsidiary

The assessee is engaged in hotel business. It provided interest-free loans to its subsidiary.

To justify its claim for deduction of interest cost, the assessee contended that the amount provided to subsidiary was in the course of the business and also relied on the principle of commercial expediency and stated

that the amounts were provided from interest-free funds. The TO rejected the assessee's contentions and disallowed proportionate interest paid on borrowed funds. The CIT(A) also confirmed the disallowance.

On further appeal, the Tribunal held that the impugned disallowance was unsustainable, as the interest-free funds available with the assessee were far more than interest-free advances made to the subsidiary companies. For this reason there was no room for the disallowance of the interest paid on borrowed funds. Reliance was placed on the Bombay HC's decision in the case of CIT *v* Reliance Utilities and Power Ltd [2009] 313 ITR 340 (Bom).

S P Jaiswal Estates Pvt Ltd *v* ACIT [2013] 140 ITD 19 (Kol)(TM)

Personal taxes
Assessing personal tax

Notification

The government of India signed a tax treaty with the government of Malaysia on 9 May 2012. The agreement came into force on 26 December 2012.

Notification no. 7/2013 (F.NO. 506/123/84-FTD-II)

Case laws

Salary/perquisite

Brought forward speculation losses can be given preference over current year business loss for setting off against current year speculation profits

The assessee filed his tax return on 31 October 2000 and claimed set off of brought forward loss from speculation business of INR 1.44 million and INR 7.53 million for the AY 1999-2000 and 1998-1999 respectively against the current year speculation profit of INR 14.65 million.

The TO adjusted the current year's losses from all the businesses of the assessee against the current year's profit from speculation business and then adjusted the brought forward speculation losses against the remaining speculation profit. This method of adjustment was disadvantageous to the assessee as, under section 73(2) of the Act, the brought forward losses from speculation business can be set off against speculation profit only. Moreover, the speculation loss could not be carried forward for more than eight AYs.

Aggrieved by the order, the assessee filed an application under section 154 of the Act seeking rectification of the order. On appeal, the CIT(A), noted that in the judgement relied upon by the assessee, Circular no. 23D of 1960 of the CBDT was applied. According to the Circular, speculation loss carried forward from previous years may be first set off against the speculation profits before being set off against any other current year profits, if that procedure is more beneficial to the assessee. The CIT(A) also noted that the courts have also recognised that though the Circular was issued in the context of section 24 of the Income-tax Act,1922, it has not been withdrawn and therefore, it remains applicable even under section 73 of the Act. In the light of this, the CIT(A) upheld the assessee's method of first setting off the brought forward speculation losses against such speculation profits.

The revenue appealed before the Tribunal. The appeal was dismissed on the basis that the beneficial Circular issued by the CBDT was still binding as it was not withdrawn. Even though it was issued under the Income-tax Act, 1922, it was still valid.

CIT *v* Ashok Mittal [2013] 31 taxmann.com 240 (Delhi)

Multiple units can constitute as one residential house for claiming exemption under section 54 of the Act

The assessee, an individual, was the owner of a property comprising basement, ground, first and second floor. In 2006, the assessee entered into a development agreement where the builder was to demolish the property and construct a new building comprising three floors. In consideration, the assessee received INR 40 million cash grant along with two floors and one of the floors was retained by the builder. While submitting its tax return, the assessee declared the cash grant and computed long-term capital gains, after applying indexation of the purchase cost.

While completing the assessment proceedings, the TO held that the entire cost of construction incurred by the builder i.e. INR 34.3 million had to be added to INR 40 million received by the assessee. The assessee claimed that if this was to be added to the sale consideration, as it was fully invested in the residential house, exemption should be allowed under section 54 the Act.

However, the TO rejected the claim, partially on the basis that the units on the said floor were independent and self-contained, and could not be considered one residential unit. Therefore, exemption could be claimed for only one unit.

The Tribunal, upheld the order the CIT(A)'s order allowing the exemption. The Tribunal observed that the intention of the legislation was not to allow exemption for a single residential house. It expressed that the view that the words "a residential house" appearing in sections 54/54F of the Act cannot be construed to mean a single residential house, since, under section 13(2) of the General Clauses Act, 1897, the singular included the plural.

It relied on the HC's decision in CIT *v* Smt K G Rukminiamma [2011] 196 Taxman 87 (Kar.)

On the revenue's appeal, the HC observed that the expression used is "a residential house" and not "a residential unit". Furthermore, sections 54/54F of the Act requires the assessee to acquire a "residential house". As long as the assessee acquired a building, which may be constructed, for the sake of convenience, in such a manner as to consist of several units which could, if the need arose, be conveniently used as independent residences, the requirement of the section should be taken to have been satisfied. There was nothing in this section which required the residential house to be constructed in a particular manner. Thus, the assessee was entitled to exemption under section 54-F of the Act.

CIT *v* Gita Duggal [2013] 30 taxmann.com 230 (Delhi)

Tax equalisation gross-up to be restricted to incremental tax liability

The assessee, an individual, was an employee of American Express Bank Ltd and received salary both in India as well as in his home country (the US). The assessee had submitted his tax return in India for AY 1996-97. During the course of detailed scrutiny assessment, the TO observed that the assessee was entitled to tax equalisation, and thus the Indian tax liability was borne by the employer. The TO further observed that as the entire tax liability was borne by the employer, the full amount had to be considered for multiple grossing up and no deduction for 'hypo' taxes could be allowed.

On the assessee's appeal the CIT(A) relied upon the rulings of Jaidev H Raja [ITA. No. 2021/Mum/1998] and Nicco Corporation Ltd *v* CIT [2003] 129 Taxman 875 (Cal). The CIT(A) directed the TO to consider the perquisite only to the extent of tax paid by the employer after reducing the hypothetical tax paid by the employee.

Aggrieved by the order, the assessee appealed to the Tribunal. The Tribunal held that gross-up shall be only for incremental tax liability borne by the employer.

DCIT *v* Bikram Sen [TS-59-ITAT-2013 (Mum)]

Structuring for companies
Mergers and acquisitions

Case laws

No disallowance under section 14A of the Act on ad hoc basis

For AY 2006-07, the assessee company had exempt income comprising of tax-free interest on bonds and dividend income. The TO made *ad hoc* disallowance of 1% of interest and finance expenses under section 14A of the Act.

The assessee submitted that out of total exempt income, some amount was earned from a project which was still under construction in respect of which no expenditure was claimed. With respect to balance exempt income, the investments were made out of huge interest-free funds available in the form of share capital and free reserves. No administrative expenses were incurred for earning such income.

The CIT(A) enhanced the disallowance made by the TO by following the method prescribed under Rule 8D of the Rules.

The Tribunal observed that the TO had not given a specific finding on the use of interest-bearing funds for making the investment. Relying on the Delhi HC decision in the case of Maxopp Investments Ltd *v* CIT [2011] 64 DTR 122 (Del), the Tribunal noted that "expenditure incurred" in section 14A of the Act referred to actual expenditure and not some imagined expenditure. Since the TO had not pinpointed any expenditure incurred for earning exempt income, the Tribunal ordered deletion of the ITO's disallowance.

Furthermore, the Tribunal held that since Rule 8D of the Rules was applicable from AY 2007-08 and the case pertained to AY 2006-07, no disallowance could be made under Rule 8D of the Rules.

A similar view was taken by the Delhi Tribunal in the case of Interarch Building Products Pvt Ltd *v* ACIT [2012] 34 CCH 81 (Del) where the Tribunal held that disallowance under section 14A of the Act could be increased by the TO only if he or she recorded a finding that he or she was not satisfied with the assessee's method.

Torrent Power Ltd *v* ACIT [2012] 34 CCH 241 (Ahd)

Assessment of a dissolved company is invalid

NJ Steels Pvt Ltd. (the assessee) amalgamated with Life Time Buildcon Pvt Ltd and stood dissolved on 28 September 2010 under such amalgamation. The TO passed an assessment order on 31 December 2010.

The assessee contended that on the date of amalgamation, the assessee company stood dissolved. Thus, the assessment of a company that was dissolved or amalgamated under section 391 and 394 of the Companies Act was invalid.

On appeal, the CIT(A), relying on various rulings, held that the assessment order passed on the assessee company was invalid. Furthermore, the CIT(A) observed that there was no provision in the Act to assess an amalgamating or transferor or dissolved company, even if it participated in the assessment proceedings.

On appeal by the revenue, the Tribunal observed that a company incorporated under the Companies Act was a juristic person. It took its birth and got life with incorporation and it died with the dissolution under the provisions of the Companies Act. On amalgamation, the company ceases to exist in the eyes of the law.

The Tribunal relied on the ruling of the Delhi Tribunal in the case of ACIT *v* Micron Steels Pvt Ltd [ITA no 160 order dated 21 September 2012] and held that the assessment of a dissolved company was impermissible.

ACIT *v* NJ Steels Pvt Ltd [TS-65-ITAT-2013(DEL)]

Benefit under section 80-I of the Act available on amalgamation

On 1 April 1994, an industrial undertaking which was being run in the name and style of AA Alloys Ltd was amalgamated with the assessee company.

The assessee company, in its tax return for the AY 1995-96, claimed the benefit of of section 80-I of the Act on the premise that this was the profit earned by the industrial undertaking which was hitherto being run by the amalgamating company and such activity had been carried on by the assessee company on and after 1 April 1994.

The TO held that the assessee company was not eligible for deduction under section 80-I of the Act in view of the restriction imposed under clause-(ii) of sub-section (2), which stated that for claiming deduction, the undertaking should not have been formed by transfer to a new business of machinery or plant previously used for any purpose.

The Tribunal held that amalgamation of a company did not come within the scope of sub-section 47(2) of the Act defining "transfer" and therefore, allowed the deduction under section 80-I of the Act.

The HC upheld the order of the Tribunal and accordingly dismissed the appeal of the revenue.

CIT *v* Bhuwalka Steel Industries Ltd [2013] 255 CTR 516 (Kar)

Pricing appropriately
Transfer pricing

Prelude

Last year, the Prime Minister constituted a committee consisting of experts from the revenue department to review taxation of development centres and the IT sector. Based on the recommendations of the Rangachary Committee, the Central Board of Direct Taxes (CBDT) issued circulars on research and development (R&D) centres, introducing guidelines for the Indian revenue department and its taxpayers. The proactive introduction of guidelines and clarifications is a welcome move on the part of the CBDT, who are of the view that these circulars will help in providing certainty and guidance to the taxpayers on issues relating to transfer pricing of development centres. This puts an additional onus on the taxpayers to have robust documentation to establish the functional profile of the Indian R&D centre. A summary of these circulars is included below.

In addition, the Finance Act, 2011 had proposed to come up with an allowable variation for different business activities and types of transactions. Since then, the taxpayers had been keenly awaiting the government's notification in this regard for financial year (FY) 2012-13. Recently, the CBDT issued the notification, specifying the tolerance band of 1% for whole sale traders and 3% for other taxpayers. A summary of the notification is provided.

We have also summarised the observations of the various tax courts across the country on the various transfer pricing cases.

Circulars on application of profit split method (PSM) and conditions to identify the development centres as contract R&D service providers assuming insignificant risks

Two recent circulars dealt with the application of the PSM based on the recommendations of the Rangachary Committee, and with the identification of contract R&D providers assuming significant risks. The key aspects emanating from the circulars are as follows:

Circular on application of the PSM (circular no. 2/2013):

- There is no correlation between cost incurred on R&D activities and return on an intangible developed through R&D activities. The use of transfer pricing methods such as the transactional net margin method (TNMM) to estimate the value of intangibles based on cost of intangible development is generally discouraged
- The PSM is primarily chosen when the international transaction with associated enterprises (AEs) involves intangibles
- If the transfer pricing officer (TPO) is of the view that the PSM cannot be applied in an international transaction involving intangibles, he or she must record the reasons for non-applicability of the PSM before considering the TNMM or the comparable uncontrolled price (CUP) method as the most appropriate method (MAM)
- If the assessee is not able to meet the documentation requirements laid down under section 92D of the Income-tax Act, 1961 (the Act), there should be good and sufficient reasons for non-availability of such information.

Circular on condition relevant to identity development centres engaged in contract R&D services with insignificant risk (circular no. 3/2013):

The circular clarifies that a development centre in India may be treated as a contract R&D service provider with insignificant risks if all the following conditions as given below are satisfied:

- **Functions:** All the economically significant functions involved in R&D are performed by the foreign AEs and the India R&D centre undertakes economically insignificant functions
- **Funding:** The AE provides funds and economically significant assets including intangibles. The taxpayer does not use any other economic significant assets for the said activity
- **Risk profile:** The signficant risks are to be borne by the AE in line with the contractual arrangement. However, if the AE is in a low tax jurisdiction, it will be presumed that it does not bear any risk unless the taxpayer can prove to the contrary
- **Ownership rights:** The taxpayer does not have any ownership over the intangibles.

Editor's note: *In the above circulars, the CBDT has emphasised the term 'substance' at the level of the foreign principal, as a pre-condition for the Indian R&D centre being accorded contract R&D service provider status. The CBDT has mentioned that if the principal is located in a low tax jurisdiction, the general presumption would be that it might not have necessary substance. However, the CBDT hastened to add that the said presumption would be rebuttable by the taxpayer through adducing necessary evidence around substance at the level of the principal. Furthermore, an evaluation of each of the R&D structures would have to be case specific and would need to be undertaken independently based on a review of the significant people funcitons and conduct of the parties in each case.*

Tolerance band for FY 2012-13 announced

Prior to the Finance Act 2011, the second proviso to section 92C(2) of the Act provided for a tolerance band of 5% with respect to the arithmetic mean for the purpose of computing the arm's length price (ALP). With the implementation of the Finance Act 2011, effective FY 2011-12 (AY 2012-13), this tolerance band of 5% was replaced with variable percentages for different industries to be announced by the central government from time-to-time.

Thereafter, the Finance Act 2012 further amended the tolerance band from FY 2012-13 and onwards. The upper limit of the tolerance band was not to exceed 3%, i.e. the transaction was to be considered at arm's length if the difference between the transfer price and arithmetic mean did not exceed the number as notified by the government, subject to an upper limit of 3%. In this regard, the government has now issued a notification for FY 2012-13 (AY 2013-14), which specifies the tolerance band to be 1% for wholesale traders and 3% for all other cases.

Editor's note: *The notification issued by the CBDT has not provided any clarity as to which taxpayers are classified as 'wholesale traders'. The term 'wholesale trader' is a term of wide import in common commercial parlance, and therefore this point requires further clarification to eliminate ambiguity.*

Case laws

Delhi High Court upholds taxpayer's contentions on merits

The taxpayer was engaged in the provision of computer software services to its AEs. The taxpayer was also engaged in providing marketing support services. During the assessment proceedings, the TPO proposed an adjustment to the transfer price of the taxpayer after carrying out a fresh comparability analysis. The CIT(A) upheld the adjustment proposed by the TPO. On appeal, the Income-tax Appellate Tribunal (the Tribunal) ruled in the favour of

the taxpayer based on various grounds and held that since the profit level indicator (PLI) of one of the comparables out of the total set of comparables was less than the PLI of the taxpayer, the international transactions was at an arm's length. Aggrieved, the revenue department filed an appeal before the high court (HC).

On appeal, the HC held the following:

- Rejecting the Tribunal's conclusion that where one of the prices determined by applying MAM was less than the price determined by the taxpayer, the same may be selected as the ALP, and there was no need to adopt the process of computing the arithmetical mean
- Where more than one price is arrived at by adopting the MAM, the statute requires that the arm's length price shall be taken to be the arithmetical mean of such prices
- The TPO cannot conduct a fresh search for comparables unless the comparables chosen by the taxpayer are rejected
- The Tribunal should limit its power in deciding on the facts of the comparables given by the taxpayer and the comparables chosen by the TPO, and should not have reduced the total number of comparables for the purpose of determining ALP
- The OECD guidelines were not relevant in view of the specific provisions of rule 10B(2) and (3) and the first proviso to section 92C(2) of the Act.
- However, on merits, the HC held that the arithmetical mean of the PLI of comparables accepted by the Tribunal was less than the PLI of the taxpayer, and accordingly the ALP determined by the taxpayer was acceptable in law.

CIT *v* Mentor Graphics (Noida) Pvt Ltd [2013] 32 taxmann.com 300 (Delhi)

Editor's note: *This case was the first of its kind in dealing with the comparability issues in transfer pricing matters at the Tribunal level, which was successfully argued by PwC. This HC ruling vindicates the taxpayer's position.*

Chandigarh Tribunal upholds only foreign brand marketing intangible adjustment

The taxpayer was engaged in the manufacturing and selling of malted milk products and drinks under various brand names and exported its products to group companies. In addition, the assessee was also involved in providing certain administrative support services such as marketing, sales inputs, IT support, training etc to its group companies. During the assessment, the TPO was of the view that the taxpayer had created marketing intangible asset by incurring huge advertising, marketing and sales promotion (AMP) expenditure on the AE brand. Thus, it should have been compensated at an arm's length by the AE. The TPO therefore made an adjustment on account of AMP expenses incurred by the taxpayer. The Dispute Resolution Panel (DRP) upheld the TPO's adjustments.

On appeal, the Tribunal ruled the following:

- Excessive AMP expenses incurred by the taxpayer constitute an international transaction
- No adjustment was required to be made for advertisement expenses attributed to promotion of domestic brands owned by the taxpayer
- The TPO ought to consider the point raised by the taxpayer that AMP expenses on foreign brands were lower than AMP expenses on domestic brand, and re-determine the

ALP in relation to AMP expenses.

- While computing the ALP of the transaction relating to AMP expenses, sales expenditure such as sales discount and service charge paid to selling agents are to be excluded.

GlaxoSmithkline Consumer Healthcare Ltd *v* ACIT [2012] 20 taxmann.com 2 (Chandigarh)

Mumbai Tribunal upholds LIBOR for consistency, despite accepting Fixed Deposit interest rate as safest comparable

The assessee was in the business of software development and web designing services, and had granted zero interest rate loans to its AEs as working capital advances. The assessee contended that the advances were on cost plus zero margin as the AEs were giving business to the assessee, without any cost borne by the company. During assessment proceedings, the TPO held that the assessee should have earned interest, and therefore made an adjustment considering the LIBOR as interest rate. The DRP held that when an Indian entity lends money outside India, the interest rate should be benchmarked against the rate prevailing in India and not LIBOR, which is applicable for inbound loans, and based on this they recomputed the adjustment.

On appeal, the Tribunal held the following:

- The transaction of advancing loans to its AE undoubtedly qualifies as an international transaction
- The tested party is always the taxpayer and not the AE as it is the effect of transaction on the income of the assessee that is to be considered, and not the effect on the AE. The transfer pricing regulations require an international transaction to be tested on the basis of the assessee's income, where a similar transaction is undertaken with a third party
- The interest on bank fixed deposit for a term equivalent to the term for which the loans were given to the AEs would be the safest comparable as it is free from credit risk and interest rate risk
- However, since the LIBOR has been accepted by the Tribunal in other cases, the ALP should be determined on the basis of LIBOR.

The Tribunal directed the AO to recompute the ALP by considering LIBOR plus 2% on the monthly closing balances of the advances.

Aurionpro Solutions Ltd *v* ACIT [TS-75-ITAT-2013(Mum)TP]

Editor's note:
Ordinarily, the tested party concept is applicable in cases where transactional profit methods are adopted. However, in the CUP method, the price charged in a controlled transaction is compared with the price charged under comparable circumstances in an uncontrolled transaction. Hence, the concept of tested party is of little relevance while adopting the CUP method. Besides, the Tribunals across the country have been taking different views on the determination of interest on loan transactions and this decision is one such example.

Taxing of goods and services
Indirect taxes

Notification / circular

Value added tax, sales tax, entry tax and professional tax

Value added tax audit report format prescribed under Delhi value added tax

Form AR-1 has been prescribed for an audit report for dealers having gross turnover of INR 100 million or more during the FY 2011-12 or subsequent years. The report should be filed within a period of seven and a half months from the end of the relevant year.

Notification no. F.7 (420) /Policy/VAT/2011/ 1203-1213 dated 11 February 2013)

Case law

Photography contracts are service contracts and not works contract for levy of value added tax

The Allahabad HC, relying on the SC's decision in CK Jidheesh v UOI [2005-13-SC-37], has held that photography contracts are service contracts and not works contract for levy of value added tax (VAT) as there is no element of sale in the photography papers transferred during the rendition of photography services.

Commissioner Trade Tax *v* Instant Auto Colour Lab [2013] NTN-Vol (51-1)

Case laws

CENVAT

Individual item supplied free of charge with a combi pack is subject to duty on maximum retail price of such item

The Delhi Customs, Excise and Service Tax Appellate Tribunal (CESTAT) has held that when any item is supplied free of charge along with another in a combi pack, both of which are chargeable to duty on maximum retail price (MRP) basis, then both the items will be subject to duty based on the MRP of the individual item and not as the combi pack.

Hotline Electronics Ltd *v* CCE [2013] 288 ELT 110 (All)

Discount given to buyer on discretion not deductible from assessable value

The Delhi CESTAT has held that discounts given to some buyers on discretion after the sale for which the criteria was were not known prior to the sale, will not be deductible from the assessable value.

Century Laminating Co Ltd *v* CCE [2013] 288 ELT 276 (Del)

Case laws

Service tax

Service tax cannot be levied on toll charges collected by contractor

The Mumbai CESTAT has held that service tax cannot be levied on toll charges collected by a contractor, even under the 'business auxiliary services' category. The decision is based on the facts that the construction of roads has been specifically excluded from the scope of service tax levy both under 'commercial and industrial construction service' and 'works contract service'. The repair and maintenance of roads have also been exempted from service tax retrospectively.

Ideal Road Builders Pvt Ltd *v* CST [2013] TIOL (136)

Issue of a show cause notice is not warranted where service tax along with interest is paid voluntarily

The Madras CESTAT has held that where the assessee did not pay the service tax due to financial crisis, it complied with all the provisions of law related to compliance and reporting and eventually paid the service tax with interest, the issue of show cause notice is not warranted.

CCE v SRS Cranes and Equipments & Services [2013] TIOL (143)

Case laws

Customs or foreign trade policy

Order passed without sharing relied upon documents with assessee tantamount to violation of natural justice

The Bombay HC has held that an order confirming duty demand cannot be passed when the documents relied upon are not supplied to the assessee as this amounts to violation of natural justice.

Abhirup Exports Pvt Ltd *v* UOI [2013] TIOL (65)

Special additional duty refund cannot be denied if filed within one year from the date of assessment of bill of entry

The Delhi CESTAT has held that the refund claim of special additional duty of customs (SAD) filed after the stipulated period of one year from the date of payment of duty cannot be rejected in the case it is filed within one year from the date of final assessment of bill of entry when the adjudicating authority has earlier rejected the refund application on the basis that the assessment is provisional and requested filing the refund after finalisation of the assessment.

Singla Trading Co *v* CC [2013] 195 ECR 47 (Del)

Conversion of shipping bill from one scheme to another cannot be denied where exporter is willing to pay back benefits along with interest already availed under one such scheme

The Madras CESTAT has held that conversion of shipping bill from a duty drawback scheme to an advance licence scheme in terms of section 149 of the

Customs Act, 1962 shall not be denied where the exporter is willing to pay back the drawback already sanctioned along with interest and such conversion to the advance licence scheme has not been denied by the directorate general of foreign trade or customs authority on account of any dispute.

Cherma's Exquisite Ltd *v* CC [2013] TIOL (155)

Notification/ Circulars

Basic customs duty paid on capital goods shall only be remitted under post-export EPCG scheme

The central government has provided that the basic customs duty paid on capital goods shall only be remitted in the form of freely transferable duty credit scrips under a post-export EPCG scheme. Earlier, this benefit was provided to whole of the duties of customs.

Notification no. 33 (RE-2012)/2009-2014 dated 8 February 2013

Deemed exports benefit available only to notified mega power projects

The central government has clarified that deemed exports benefits will be available for supply to the 111 mega power projects in notification no 49/2012-customs dated 10 September 2012 subject to fulfillment of the prescribed conditions.

Policy circular no. 14 (RE-2012) /2009-14 dated 4 February 2013

Following the rule book
Regulatory developments

FEMA

External commercial borrowings policy, corporate under investigation

In 2009, the RBI prohibited corporates that are under investigation by any law enforcing agencies such as the Directorate of Enforcement, etc. from accessing external commercial borrowings (ECB) under the automatic route.

The RBI reviewed these norms and has now permitted all entities to avail ECBs under the automatic route, notwithstanding the pending investigations, adjudications, appeals by the law enforcing agencies, without prejudice to the outcome of such investigations, adjudications or appeals.

The authorised dealer (AD) bank or the RBI needs to intimate the concerned agencies of such entity availing ECB by endorsing a copy of the approval letter.

AP (DIR Series) Circular no. 87 dated 5 March 2013

Export of goods and services, write-off of unrealised export dues

The RBI has amended the present policy on write-off unrealised export proceeds. These are as follows:

Self write-off

1. *Percentage of write-off*

- Self write-off as a percentage of the total export proceeds realised during the previous calendar year (earlier financial year) can now be as follows:
  - An exporter (other than status holder exporters) - 5%
  - A status holder exporter - 10%
  - As compared to the earlier policy, the amended policy has narrowed down the benefit of write-off as follows:
  - For an exporter (including status holder exporters) where the base amount now is the amount realised as against the amount due.
  - For an exporter (other than status holder exporters) the ceiling of write-off has been reduced from 10% to 5%.

2. *Conditions to be fulfilled*

- The relevant amount has remained outstanding for more than one year.

  Under the earlier policy, self write-off could be done only for an amount which has remained outstanding for the period prescribed for realisation of export dues i.e. 12 months from the date of export.
- The benefit of self write-off can now be availed subject to fulfilment of various conditions establishing the bona fides of the transaction and on production of a chartered accountant's (CA) certificate giving the required details. Such requirements were earlier applicable only in the case of a write-off which required AD bank approval.

Write-off with AD bank's approval

The policy in this regard has remained largely unchanged with the following exceptions:

- The period for calculating 10% of export proceeds realised has changed from the previous financial year to the previous calendar year.
- A CA certificate is now required to certify export proceeds realised during the preceding calendar year as compared to the previous three financial years.

The period of calculation of export proceeds has changed from the financial year to the calendar year. This could cause inconvenience to a majority of Indian exporters

whose accounting year does not coincide with the calendar year.

A.P. (DIR Series) Circular no 88 dated 12 March 2013

Financial services

Security and risk mitigation for electronic payment transactions

With ever-increasing volumes in electronic payment systems, the RBI is in the process of implementing the recommendations of the 2011 working group report on securing card present transactions. Increasing cyber attacks and the vulnerability of electronic payment systems to new types of misuse make it imperative for banks to introduce a minimal system of checks and balances in order to mitigate risk and minimise the impact of fraud. Banks are required to put in place risk and security control measures.

The following measures are to be implemented by banks for card payment transactions:

- All new debit and credit card issues will be for domestic use unless the customer seeks international usage, in which case the card will have to be essentially Europay, Mastercard and Visa (EMV) chip and pin enabled (by 30 June 2013).
- All MagStripe cards that have been used internationally at least once should be converted to EMV chip and pin (by 30 June 2013).
- All internationally active MagStripe cards are to have threshold limits based on customer risk profiles and are mutually agreed upon by the bank and the customer. Until such a process is completed, an omnibus threshold limit may be placed on all credit and debit cards that have not been used internationally yet (by 30 June 2013).
- Merchant terminals and all acquiring infrastructure are to be mandatorily certified for payment card industry data security standard and payment application data security standard (by 30 June 2013).
- Banks need to move towards real-time fraud monitoring and easier methods (such as SMS) for customers to block their cards at the earliest and get a confirmation to that effect after blocking the card.

The following measures are to be considered and effected by 30 June 2013, for electronic payment transactions:

- Customer induced caps on value, mode of transaction and beneficiaries, which may be exceeded by additional authorisation
- Daily limits on the number of beneficiaries and alerts when beneficiaries are added
- Velocity checks on the number of transactions effected per day and per beneficiary
- Dynamic factors of authentication for payment transactions
- Digital signatures for large value payments for all customers
- Capturing IP address as an additional validation check
- Ensuring sub-member banks adhere to the same security standards as the host bank
- Implementation of new technologies for fraud detection

RBI Circular DPSS (CO) PD no 1462 / 02.14.003 / 2012-13 dated 28 February 2013

Stock exchanges to introduce periodic call auction for illiquid scrips and extension of pre-open session to all scrips

It has been decided to introduce a periodic call auction mechanism for illiquid scrips and extend the pre-open session call auction mechanism to all

other scrips in the equity market. An illiquid scrip is defined as any of the following:

- The average daily trading volume of a scrip in a quarter is less than 10,000.
- The average daily number of trades is less than 50 in a quarter.
- The scrip is classified as illiquid at all exchanges where it is traded.

Rules

- Stock exchanges will identify illiquid scrips at the beginning of e very quarter and move them to periodic call auction mechanism.
- Scrips may exit the call auction mechanism if they have remained in period call auction for at least two quarters or are not classified as illiquid.
- Illiquid scrips are to be traded in the equity market only via periodic call auction.
- Periodic call auctions will be of one hour each and will run throughout trading hours.
- A maximum price band of 20% will be applicable on scrips through the day.
- Unmatched orders are purged at the end of the session.
- The Circular gives detailed procedures to be followed for the periodic call auction.

SEBI Circular CIR/MRD/DP/ 6/2013 dated 14 February 2013

Gold exchange traded fund investment in gold deposit scheme of banks

It has been decided to permit gold exchange traded funds of mutual funds to invest in gold deposit schemes of banks subject to the following:

- Total investment in the gold deposit scheme (GDS) to not exceed 20% of assets under management of such schemes
- Before investing in GDS of banks, mutual funds to put in place a written policy with regard to investment in GDS with due approval from their board and trustees
- The mutual fund to obtain the approval of its board and trustees for each investment proposal in GDS of any bank
- The policy to be reviewed at least once each year
- Gold certificates issued by banks to be held by mutual funds only in dematerialised form
- SEBI Circular CIR/IMD/DF/04/2013 dated 15 February 2013

Guidelines on partial two-way fungibility of Indian depository receipts

- Partial two-way fungibility has been extended to both future and existing Indian depository receipts (IDRs). The partial two-way fungibility means that IDRs can be converted into underlying equity shares and vice versa within available headroom. The headroom for this purpose will be the number of IDRs originally issued minus the number of IDRs outstanding, which is further adjusted for IDRs redeemed in underlying equity shares (headroom).
- Fungibility will be available only after one year from the date of listing. Thereafter, two-way fungibility will be provided on a continuous basis.
- For existing IDRs, this will be to the extent of 25% of the IDRs originally issued.
- IDRs may either

be converted into underlying shares or converted, sold and the proceeds returned to IDR holders, or both of the preceding.

- For existing IDRs, 20% to be converted into underlying shares will be reserved for retail investors and any excess or deficit over this due to higher or lower demand will be added to the unreserved portion.
- Options exercised and disclosed at the time of issue cannot be changed without SEBI approval.
- The issuer may convert underlying shares into IDRs at the behest of the holders.
- Available headroom and significant conversion or reconversion transactions will be continuously disclosed by the issuer.
- Detailed procedures are given in the Circular.

SEBI Circular CIR/CFD/DIL/6/2013 dated 1 March 2013

Glossary

AE	Associated enterprise
ALP	Arm's length price
AY	Assessment year
AAR	Advance Ruling Authority
CBDT	Central Board of Direct Taxes
CENVAT	Central value added tax
CESTAT	Customs, Excise and Service Tax Appellate Tribunal
CIT(A)	Commissioner of Income-tax (Appeals)
The Companies Act	The Companies Act, 1956
DRP	Dispute Resolution Panel
ECB	External Commercial Borrowings
FTS	Fees for technical services
FY	Financial year
IP	Intellectual Property
HC	High Court
RBI	The Reserve Bank of India
SAD	Special additional duty of customs
SC	Supreme Court
SEBI	The Securities and Exchange Board of India
The Rules	The Income tax Rules, 1962
The Act	The Income-tax Act, 1961
The tax treaty	India-USA Double Taxation Avoidance Agreement
The Tribunal	The Income-tax Appellate Tribunal
TNMM	Transaction net margin method
TO	Tax officer
TPO	Transfer pricing officer
VAT	Value added tax

Notes

Notes

About PwC

PwC* helps organisations and individuals create the value they're looking for. We're a network of firms in 158 countries with more than 180,000 people who are committed to delivering quality in assurance, tax and advisory services.

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