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India Spectrum

Volume 5 Issue 11
November 2012

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Editorial

We are delighted to present another issue of India Spectrum.

At the outset, we would like to wish our readers a very happy and safe new year 2013.

In a significant development, the United States (US) Congress passed the bill to avert the fiscal cliff that had threatened a recession in the US economy. The proposal includes income tax increase on rich Americans and defers large cuts in Pentagon spending and other government programs. Elsewhere in Europe, the UK announced its plans to adopt the general anti avoidance rule (GAAR) in order to tackle tax avoidance issues and yet maintain the competitive environment of the UK as a commercial place to do business. The GAAR would act as blanket legislation to differentiate between responsible tax planning and abusive tax avoidance. The UK government also released draft legislation for the Finance Bill 2013, proposing to cut the corporate tax rate to 21% (which was previously planned to be reduced to 22%) from 2014 against the current 24%.

The winter session of the Indian Parliament saw the Companies Bill 2012 being passed by the Lok Sabha. The Companies Bill proposes key changes like mandatory spending by companies on social upliftment, rotation of auditors, one person companies, requirement of women director on boards of certain classes of companies, constitution of serious fraud investigation office, etc .

With the government focused on reforms, the Finance Minister is considering the proposal by foreign institutional investors (FIIs) to moderate the rates of withholding tax on long-term government debt instruments. The government is also keen to adopt measures that would make the foreign investment environment more attractive to investors.

Ketan Dalal

Shyamal Mukherjee

On the Indian economic front, the index of industrial production (IIP) rose to 8.2% in October 2012 due to the rise in sugar production which accounted for almost one fifth of the growth rise. The net direct tax collection growth was 15.04% during April–November 2012, as against an average required growth of 15% to meet the budgeted growth requirement. This is despite a slowdown in economic activities and the growth rate.

The Reserve Bank of India has now permitted FIIs to approach any authorised dealer (AD) category-I bank for hedging currency risk on the market value of entire investments in equity and/or debt in India as on a particular date, subject to certain conditions. Earlier the AD category–I banks would only maintain accounts of FIIs for hedging currency risk.

On the judicial front, in the case of the National Petroleum Construction Company, the Delhi bench of the Tribunal held that a composite turnkey contract (umbrella contract) may be considered a divisible contract where the consideration for different activities are agreed upon separately. Therefore, in such cases, profit from offshore activities is not taxable in India. It was also held that in case of such a contract, taxability in India is only confined to the profit attributable to the permanent establishment and cannot be extended to the entire contract revenue. In another ruling in the case of Maganbhai Hansrajbhai Patel, the Delhi High Court held that the expression 'tax due' under section 179(1) in respect of a private company does not include interest and penalty. It was held that a director is not liable for company's tax dues if the non-recovery is not attributable to any gross negligence, misfeasance or breach of duty on the part of the director. Please refer to pages 7 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

Fees for included services

Outsourcing payment made to US subsidiary for e-publishing of books not taxable as fees for included services

The assessee, an Indian company, is engaged in the business of e-publishing of books. It had entered into three separate agreements with its US-based subsidiary (TTI, USA) to provide marketing, and overseas and offshore development services. Under the agreements, TTI, USA was to forward marketing inquiries, collect manuscripts from the assessee's US-based customers, upload the manuscripts for the assessee's retrieval and perform digitisation services related to manuscripts. The assessee, after typesetting, re-uploaded the manuscripts to the database of TTI, USA for delivery to the clients in the US. For utilising services of TTI, USA, the assessee paid outsourcing charges, on which no tax was withheld.

The tax officer (TO) observed that TTI, USA was rendering technical services in terms of Explanation 2 to section 9(1)(vii) of the Act and section 9(2) of the Income-tax Act, 1961 (the Act). Therefore, the TO disallowed the outsourcing charges under section 40(a)(i) of the Act, since the assessee had failed to withhold tax under section 195 of the Act.

The Commissioner of Income-tax (Appeals) (CIT(A)) held that technical expertise was not made available to the assessee as per Article 12(4)(b) of the India-US tax treaty. Therefore, payments made to TTI, USA could not be regarded as fees for technical services. Accordingly, the CIT(A) deleted the disallowance under section 40(a)(i) of the Act. The revenue authorities appealed to the Income-tax Appellate Tribunal (the Tribunal).

The Tribunal observed that the assessee was governed by the India-US tax treaty (US treaty) and could avail its benefit if it was advantageous to the assessee. However, the TO had ignored the US treaty provisions under Article 12(4) and had referred only to the provisions of Explanation 2 to section 9(1)(vii) of the Act and section 9(2) of the Act. It was held that where the assessee proved that the services rendered by the entity abroad were not covered by Article 12(4) of the US treaty, such income would not be taxable in India.

After referring to the agreements, the Tribunal observed that under the marketing agreement, no technical knowledge, skill or experience was made available to the assessee. Further, in accordance with the overseas services agreement, the entire task of collecting manuscripts and dispatching them to customers was done by TTI, USA and no technical knowledge was made available to the assessee. Accordingly, no tax was required to be withheld under the above two agreements.

However, under the offshore development agreement, the assessee was using the instructions of TTI, USA for digitisation of manuscripts. Therefore, the Tribunal relied on the decision in the case of CIT *v.* De Beers [TS-312-HC-2012 (Kar)] where it was held that instructions sent by the entity abroad, which could be used after the expiry of a contract, would be covered by the expression fees for included services (FIS).

Therefore, under the offshore agreement, the assessee would be liable to withhold tax while making the payment. The matter was remitted back to the AO to analyse and decide on the nature of the payment by the assessee under the offshore development agreement.

ACIT v. TexTech International Pvt Ltd [TS-775-ITAT-2012 (Chny)]

Composite contract

A composite contract can be divisible if the consideration is agreed separately for various activities; profit from offshore activities is not taxable in India

The assessee, a tax resident of the UAE, entered into a contract with ONGC for a project involving fabrication and installation. It established a project office in India (India PO) for the execution of the project, which lasted for four and a half months. The assessee also entered into an agreement with Consultant A located in India, for the purpose of gathering information and assisting in representation work.

The tax return submitted by the assessee was restricted to the installation work conducted in India. It did not offer to tax the income relating to the fabrication work carried out outside India as it did not have a permanent establishment (PE) in India.

The TO treated the India PO as a fixed base PE under the India-UAE tax treaty, Consultant A as a Dependent Agent Permanent Establishment (DAPE) for the fabrication work and as an installation PE for the installation services. The TO further held that the contract was executed on turnkey basis, as it was a composite contract wherein the title of the goods passed in India and the material was utilised by the PE. Accordingly, the entire profits were liable to tax in India. The DRP upheld the order of the AO.

On appeal before the Tribunal, the assessee contended that no installation PE was constituted, as the installation activity lasted for only four and a half months, as against nine months under the tax treaty. The PO was only used as a communication channel and no fixed place PE was constituted. Consultant A was an independent agent and was providing consultancy services in the normal course of business, and therefore, could not be considered as a DAPE. The contract was a divisible contract with separate activities and consideration for each activity. The assessee contended that all the activities relating to fabrication work were carried out outside India. Accordingly, income earned outside India cannot be attributed to the PE in India.

The TO contended that a fixed place PE was constituted as the India PO was not used as a channel for communication but for monitoring the progress of the contract. The duration of the installation PE was to be considered from the date of the establishment of the PO, which was more than nine months, and hence, an installation PE was constituted. The TO contended that the contract was a composite contract and not a divisible one.

The Tribunal held that the India PO was a fixed place PE as no evidence was produced that it was only a channel of communication. The India PO existed from the date the contract was awarded, which was more than nine months, resulting in an installation PE. Consultant A was a DAPE as he was exclusively involved in the assessee's project.

However, the contract cannot be regarded as a turnkey contract as either party could revoke the contract and the liability of payment under the contract or refund of amounts received, accrued only on completion of the contract. Hence, it was held that the contract cannot be regarded as a turnkey contract and only the profits attributable to the PE can be taxed in India. Since, the profits from offshore supplies were not attributable to the PE, they were not taxable in India.

National Petroleum Construction Company v. ADIT [TS-756-ITAT-2012(Del)]

Retrospective amendment

Retrospective amendment to law does not lead to interest on delayed payment of tax liability

The assessee had submitted its tax return computing book profit under section 115JB of the Act, on the basis of which no advance tax was payable on the income of the assessee. The tax return was processed under section 143(1) of the Act. Due to a retrospective amendment by the Finance Act, 2009 with effect from 1 April, 2001 to section 115JB of the Act, amount set aside as provision for diminution in value of any asset was to be added back to the net profit. The TO levied interest under section 234B of the Act on the tax liability that arose and held that the amended provisions must be assumed to be in existence at the time of submission of the tax return. The CIT(A) upheld the order of the AO.

The assessee, relying on the decision in the case of Emami Ltd *v.* CIT [2011] 337 ITR 470 (Cal) contended that interest cannot be levied under sections 234B and 234C if the tax liability arose due to a retrospective amendment.

On appeal, the Tribunal also relied on the decision in the case of Emami Ltd (above) and held that for an assessee, the law existing on the date of payment of advance tax has to be seen and hence, an assessee cannot be treated

as a defaulter in payment of advance tax in consequence of a retrospective amendment. Accordingly, the Tribunal held that no interest under section 234B of the Act was payable.

Essar Investments Ltd v. ITO [TS-860-ITAT-2012 (Mum)]

Tax withholding

No tax withholding on payment to a non-resident for availing telecom voice mail services

The assessee, a tax resident in India, is a company engaged in the business of IT-enabled services. It had made payment to a non-resident (N Ltd) for a telecom voice mail service without withholding tax.

The TO held that the payment for voice mail charges is fees for technical services (FTS), subject to withholding tax under section 195 of the Act. Accordingly, the payment was disallowed under section 40(a)(i) of the Act on grounds of failure to withhold tax. The CIT(A) upheld the order of the AO.

Before the Tribunal, the assessee contended that the payment for telecom voice mail services was neither in the nature of FTS nor a royalty. Also, in the absence of a PE of the assessee in India, the income was not chargeable to tax as business income, therefore, the payment was not liable to withholding tax.

The Tribunal held that the payment made to a non-resident in respect of telecom voice mail services used outside India cannot be termed as FTS. The Tribunal relied on the decision in the case of CIT *v*. De Beers India Minerals Pvt Ltd [2012] 346 ITR 467 (Kar), where it was held that unless technical expertise or technical knowledge was made available, no tax liability arises. It also relied on GE India Technology Centre (P) Ltd *v*. CIT [2010] 327 ITR 456 (SC), where it was held that liability to tax withholding arises only if the payment is chargeable to tax in India.

Therefore, the Tribunal held that the amount was neither chargeable to tax in India nor liable to withholding tax.

Clearwater Technology Services Pvt Ltd v. ITO [TII-164-2012-ITAT-BANG-INTL]

Loan to subsidiary

Write-off of loan given to subsidiary company for strategic investment in an overseas concern is a tax deductible item

The assessee is a company engaged in the manufacture of pharmaceuticals. It had advanced a loan to its 100% subsidiary, REPL, which was in the business of bioinformatics and biotechnology. The loan was advanced to REPL so that it could invest in the shares of a non-resident company, Biosoft Inc., with the intention of having a business connection in the biotechnology industry in the US. The transaction resulted in a loss. Consequently, REPL sold the investment in Biosoft Inc. The assessee wrote off the loan amount given to its subsidiary and claimed it as bad debt under section 36(1)(vii) of the Act.

The AO treated the loss as capital in nature and not incidental to the business. The CIT(A) upheld the order of the AO.

Before the Tribunal, the assessee contended that the investment in Biosoft Inc. was made to establish the assessee's name in the bioinformatics business in the US, and therefore, the loss claimed was incidental to the business. The revenue authorities contended that the loan advanced to REPL was in the nature of investment to earn returns and had no nexus with the assessee's business. Thus, the loss was a capital loss.

The Tribunal held that a loss can be claimed as a business loss where there is a direct nexus between the business operations and the loss incurred. The investment was made in Biosoft Inc. by the assessee through REPL, to establish itself in the bioinformatics market in the US by collaborating with a company in the related line of business, and not to earn returns from the investment.

Accordingly, it was held that the loss was incidental to the business of the assessee and was allowable to be written off, under the provisions of section 36(1)(vii) of the Act.

Kemwell Pvt Ltd v. DCIT [2012-TIOL-545-ITAT-BANG]

Depreciation

Loan waiver not deductible from written down value to compute depreciation

The assessee, a 100% subsidiary of a Netherlands-based company (CH), is a manufacturer and trader in industrial products. During the year, it borrowed funds from its UK group entity (CEL) for import of machinery.

Subsequently, pursuant to the acquisition of CH group by the Akzo Nobel group, the loan was transferred to Akzo International BV, Netherlands (AI) in FY 1998-99. As part of business restructuring exercise, and in the absence of RBI approval, AI waived the loan amount of the assessee in AY 2001-02. The assessee had computed depreciation on machinery written-down-value (WDV) basis from the AY 1997-98.

During the course of assessment proceedings for AY 2004-05, the AO noted the loan waiver by AI and initiated reassessment proceedings for AY 2001-02, and recomputed the depreciation amount after reducing the amount of loan waiver from the opening WDV for AY 2001-02.

On appeal, the CIT(A) held that the loan waiver could not be reduced from the WDV. However, depreciation already allowed till AY 2000-01 should be reduced in computing the opening WDV for AY 2001-02.

On further appeal, the Tribunal noted and held the following:

- The loan waiver was shown as a capital receipt, which was not taxable in the year of receipt.
- A loan waiver is neither an addition nor a receipt from sale, discarding or demolishment of the asset, to compute the WDV of a block of asset under section 43(6)(c) of the Act.
- A loan waiver is not any subsidy or reimbursement, which should be reduced from the actual cost of asset under section 43(1).
- There is a lacuna in the law, which benefitted the assessee in treating the loan waiver as non-taxable capital receipt, as well as in reducing the WDV by the amount of loan waiver.
- Therefore, it was held that loan waiver cannot be reduced from the WDV to compute depreciation.

Akzo Nobel Coatings India Pvt Ltd v. DCIT [TS-783-ITAT-2012 (Bang)]

Editor's note: This case has been argued by PwC India Tax Litigation Team.

Liability of director

'Tax due' does not include interest and penalty; Director not liable for company's tax dues in absence of any gross neglect or breach of duty

The petitioner is a director in a private limited company (the company) that had defaulted in paying its tax dues. As the company's tax arrears remained unpaid, the tax recovery officer (TRO) seized the personal property of the petitioner to settle the company's tax dues, which included interest and penalty.

The petitioner appealed to the High Court (HC) that the revenue department had failed to proceed against the company for recovering the tax dues as required by section 179(1) of the Act. Furthermore, under section 179 of the Act, the company's tax dues does not include interest and penalty, and in the absence of negligence, misfeasance or breach of duty on the part of the petitioner, he cannot be held liable for tax arrears by the company.

The HC held that the revenue department had taken strenuous steps to recover the tax dues from the company, and therefore, the basic requirement of section 179(1) of the Act was satisfied.

As regards the levy of interest and penalty on the tax dues, the expression used in section 179(1) of the Act is 'tax due' as against the expression 'sum payable' used in section 156 of the Act, which includes tax, interest, penalty or any other sum which is payable in consequence of any order

under the Act. Therefore, the expression 'tax due' cannot be said to include interest and penalty.

Section 179(1) of the Act provides for vicarious liability of the director for payment of the company's tax dues, which cannot be recovered from the company. However, the director would not be liable if he proves that the non-recovery cannot be attributed to any gross negligence, misfeasance or breach of duty on his part in relation to the affairs of the company.

There was no record stating that the non-recovery of company tax was attributable to the petitioner's gross neglect, misfeasance or breach of duty as the director. Therefore, in the absence of such negligence, the petitioner cannot be held liable under section 179 of the Act to pay the tax dues of the company.

Maganbhai Hansrajbhai Patel v. ACIT [2012] 26 taxmann.com 226 (Guj)

Carry-forward or brought-forward loss

Restriction on set-off of brought-forward losses applies from actual allotment of shares

The assessee, a closely held company, claimed a set-off of brought-forward losses in its tax return against the profit earned during the year.

The AO disallowed the set-off of loss under section 79 of the Act on the ground that there was a change of more than 51% in the shareholding of the company during the year. The CIT(A) upheld the order of the AO.

On appeal to the Tribunal, the assessee contended that although the shares were allotted during the year, the share application money was received in an earlier year and thus there was no change in shareholding. Therefore, the restriction on set-off of losses should not apply.

The Tribunal held that section 79 restricts the setting off and carrying forward of brought-forward losses if there is a change of more than 51% in the shareholding in the year. The Tribunal also held that since the shares were allotted during the year, there was change in the shareholding pattern of the assessee during the year. An application for allotting shares does not lead to the applicant becoming a shareholder. Therefore, set-off of the brought forward loss was not allowable to the assessee under the provisions of section 79 of the Act.

People Heritage Hospital Ltd v. DCIT [2012] 26 taxmann.com 170 (Agra)

Unabsorbed long-term capital loss can be set-off against short-term capital gains for years after 2002 amendment

The assessee is engaged in the business of investment banking and dealing in securities and had submitted its tax return for assessment year (AY) 2003-04. It had claimed a set-off of long-term capital loss incurred in the AY 2001-02 against short-term capital gains earned during the AY 2003-04.

The TO denied the set-off of long-term capital loss against short-term capital gains, observing that the assessee was entitled to set off the brought-forward long-term capital loss only against long-term capital gains and not against short-term capital gains, by virtue of the provisions of section 74(1) of Income-tax Act, 1961 (the Act), as amended with effect from 1 April 2003. The CIT(A) confirmed the order of the TO.

On further appeal, the matter was referred to the Special Bench (SB), since contrary views were taken by different benches of the Tribunal. The SB allowed the appeal of the assessee and held that the provisions of section 74 of the Act, which deal with carry forward and set-off of losses under the heading "capital gains", as amended by the Finance Act, 2002, will apply only to the unabsorbed capital loss for AY 2003-04 onwards. In other words, these provisions will not apply retrospectively. The Tribunal noted the references made by the authorised representative to various decisions of higher courts which dealt with provisions of other sections in which a similar principle was discussed and arrived at.

Hence, section 74 of the Act, as amended by the Finance Act, 2002, did not apply to unabsorbed long-term capital losses incurred in relation to AY 2001-02, and these were available for set-off against short-term capital gains earned during the AY 2003-04.

Kotak Mahindra Capital Co Ltd v. ACIT [2012] 138 ITD 57 (Mum)(SB)

Speculation loss

Loss from trading in derivatives is not speculative

The assessee is an individual engaged in the business of derivatives trading in commodity and investment in shares. During AY 2007-08, the assessee had incurred a loss from derivatives trading on the MCX Stock Exchange (MCX). The assessee treated this loss as a normal business loss, in accordance with clause (d) of proviso to section 43(5) of the Act, which excludes trading in derivatives carried out on a recognised stock exchange from being deemed as a speculative transaction.

The TO treated this loss as a speculation loss on the grounds that for the purpose of section 43(5) of the Act, MCX was notified as a recognised stock exchange only in 2009, and accordingly, the exclusion in respect to derivative transactions on MCX should not apply to the AY under consideration. The CIT(A) reversed the order of the TO.

On appeal, the Tribunal held that once the statute has provided that an eligible transaction carried out on a recognised stock exchange shall not be deemed to be a speculative transaction for the purpose of these provisions, then simply because the procedural mechanism has taken a long time to recognise a particular stock exchange, it does not mean that the provisions would be applicable from the date of the notification.

Accordingly, the Tribunal held that the loss incurred on account of derivative trading through MCX is a normal business loss and not a speculation loss.

ACIT v. Arnav Akshay Mehta [2012] 25 taxmann.com 252 (Mum)

Book profit

Agreed addition of unexplained cash loan would form part of the adjusted net profit while computing book profit

The assessee is engaged in the business of construction. During the relevant AY, it had taken and repaid a loan in cash. During the course of assessment proceedings, details of loans and advances were required to be provided to the TO. In reply, the assessee offered the loan amount as taxable income. The TO added back the loan amount to the net profit and the adjusted net profit was taken as a base for computing book profit under section 115JB of the Act.

The assessee relied on the decision in the case of Apollo Tyres Ltd *v.* CIT [2002] 255 ITR 271 (SC) and contended that no adjustment, other than those provided in section 115JB of the Act, can be made to the book profit. Thus, the TO was not justified in adding the loan amount while computing the book profit under section 115JB of the Act. However, the CIT(A) upheld the order of the TO.

The Tribunal, in principle, agreed with the contentions of the assessee that only the adjustments specified by section 115JB of the Act could be made to the book profit. As the assessee had agreed to offer the loan amount to be taxed, it formed part of the net profit in the profit and loss account, and the adjusted net profit was to be taken as a base for computing the book profit. Accordingly, the Tribunal held that the cash loan was not an adjustment made to the book profit, but was an addition made to arrive at the adjusted net profit which was to be considered as the base for computing the book profit under section 115JB of the Act.

Accordingly, it was held that the addition on account of the loan would form part of the adjusted net profit for the purposes of applying section 115JB of the Act.

Dream Shelters Pvt Ltd v. ITO [TS-800-ITAT-2012 (Agr)]

Principle of mutuality

Interest earned on NOSTRO accounts with HO or overseas branches not taxable on principle of mutuality

The assessee, a company carrying on banking business in India, was required to maintain NOSTRO accounts with its overseas head office (HO) and other branches for receipts and payments in foreign currency. During the year, the assessee earned certain interest on the NOSTRO balances that it maintained. The TO, based on the observation that the NOSTRO accounts maintained by the assessee were akin to a bank account of the Indian branch with the HO, held that the interest earned by the assessee was liable to tax.

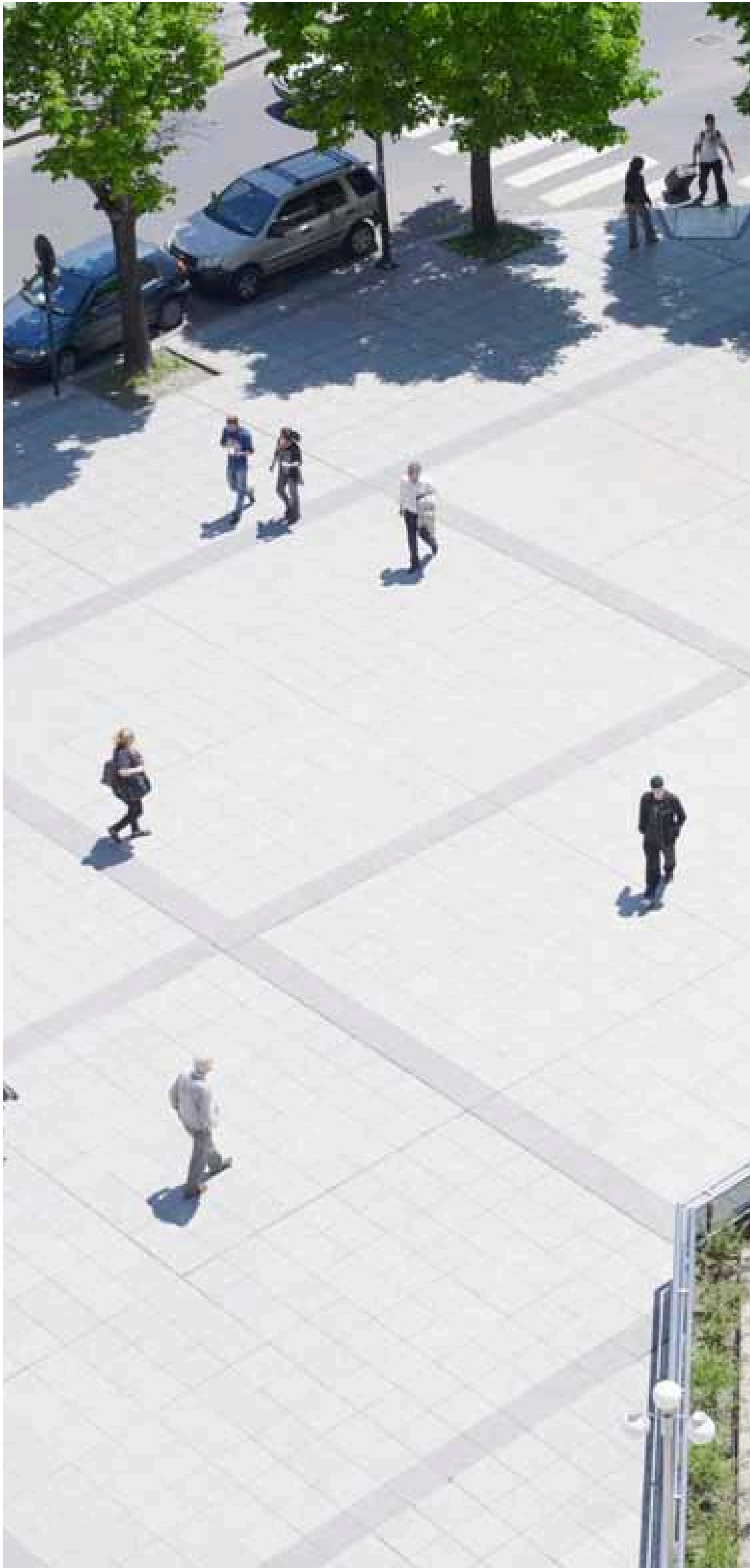
On appeal to the CIT(A), it upheld the order of the TO, but additionally held that any interest paid by the assessee to the HO or other branches would be allowable as expenditure while computing the total income of the assessee.

The Tribunal observed that the SB of the Tribunal in the case of ABN Amro Bank NV *v.* ADIT [2005] 97 ITD 89 (Kol) (SB) had held that the branch of the bank cannot be treated as a separate legal entity from the HO, and hence, transactions between an HO and its branch resulting in interest income or interest expense are to be viewed as transactions with self. Hence, based on the principle of mutuality, the Tribunal held that the income earned by the branch on the NOSTRO balances maintained with the HO or other branches would not be treated as income of the recipient branch. Similarly, any interest expense incurred by the said branch on such NOSTRO accounts would also not be allowed as a deduction. The Tribunal distinguished its own recent judgment in the case of ADIT *v.* Credit Agricole Indosuez [ITA No. 6615/Mum/2003], where it held that interest earned on NOSTRO account balances were taxable, given that the NOSTRO accounts were being held with other overseas banks and that the principle of mutuality could not be applied in such a case. The Tribunal specifically observed that this judgment was in the context of the Act and not in the context of determining the taxability of a permanent establishment under the Double Taxation Avoidance Agreement.

ADIT v. Credit Lyonnais [TS-761-ITAT-2012 (Mum)]

Assessing personal tax

Personal taxes



Salary or perquisite

Case law

Tax paid on rent-free accommodation by the employer not taxable as salary

The assessee had claimed exemption on account of taxes paid on rent-free accommodation, stating that this was related to non-monetary benefits, and therefore, was excluded from taxation under section 10(10CC) of the Act.

The TO held that the benefit considered by the assessee was a monetary benefit and the tax paid by the employer in this respect was not eligible for exemption under section 10(10CC) of the Act, and was to be grossed up.

The CIT(A) decided in favour of the assessee. The Tribunal supported the decision of CIT(A). The revenue, being aggrieved by the decision of the Tribunal, appealed to the High Court (HC).

The HC held that a combined reading of Rule 3 of the Income-tax Rules, 1962 and section 10(10CC) of the Act excludes the tax components borne in respect of perquisite and rent-free accommodation paid by the employer. Accordingly, the assessee was allowed the exemption under section 10(10CC) in respect of tax paid by the employer on rent-free accommodation.

CIT v. Adam Robert John Mynott [2012-TII-38-HC-Del-INTL]

Structuring for companies
Mergers and acquisitions

Case laws

Loss on sale of non-convertible portion of debentures is not to be treated as acquisition cost of convertible portion

The assessee was allotted 15% secured redeemable partly convertible debentures (PCD) in a right issue. Each PCD consisted of two parts. Part A was the convertible portion and Part B was non-convertible portion. Subsequently, in accordance with the agreed arrangement, the assessee sold Part B to a third party, on which it incurred short-term capital loss.

The TO disallowed the short-term capital loss. The CIT(A) set aside the disallowance made by the TO.

On appeal to the Tribunal, the revenue submitted that Part A and Part B of the debentures allotted were not severable. It further submitted that the loss was incurred by the assessee at a time when Part A had not been converted into shares and, therefore, the loss had to be constituted as the cost of acquisition of debentures. The HC decided the case in favour of the assessee, relying on its own decision in the case of Karam Chand Thapar and Brothers Ltd [ITA No 130 of 1998], where it was held that, "…disposing of the Part B non-convertible debenture resulting in capital loss could not take on a different aspect because the convertible portion being Part A was held on by the assessee. A separate treatment given by the assessee to its two separate types of property is not illegal and, therefore, it could not affect the assessee's interest in any adverse manner whether for tax purpose or otherwise."

JCT Ltd *v.* CIT [TS-701-HC-2012]

Demerger scheme by transfer of passive infrastructure assets (and not liabilities) at nil consideration is valid.

The assessee had filed a scheme of arrangement (scheme) under sections 391 to 394 of the Companies Act, 1956 for the demerger of passive infrastructure assets (PIA) (without the transfer of liabilities) from seven group companies to Vodafone Essar Infrastructure Ltd (VEIL) for nil consideration.

The income tax authorities (ITA) challenged the scheme, contending that the object of the scheme was to avoid tax by transferring PIA to VEIL at nil consideration and subsequently merging VEIL

into Indus. Furthermore, since no liabilities were transferred, the transfer was not a case of demerger for tax purposes.

The assessee contended as follows:

- The ITA had no *locus standi* to raise objections to the scheme.
- The reconstruction was in line with government policies and global trends and the scheme sought to achieve a commercial purpose.
- Even if no liabilities were transferred, it would still be considered as a reconstruction under the Companies Act, 1956, irrespective of its treatment for tax purposes.

The Gujarat High Court considered the following two questions:

(i) Whether the ITA had a *locus standi* to raise objections to the scheme

(ii) Whether the sole object of the scheme was avoidance of tax

The high court held as follows:

- Since there are dues payable by the assessee to the ITA, the ITA were creditors of the assessee company and accordingly have had a locus standi in raising objections to the scheme.
- The sole object of the scheme was not tax avoidance as there are were commercial benefits arising from the proposed reconstruction and the reconstruction is was in lines with government policy.
- There is no bar which restrains a transaction being treated differently under different laws. Accordingly, the scheme could be treated as a gift (and not a demerger) under the Income-tax Act, 1961.
- Identical schemes have been approved by other high courts and similar contentions of the ITA have been quashed by the Delhi High Court.

Accordingly, the scheme was approved by the court.

Vodafone Essar Gujarat Ltd *v.* Department of Income-tax [TS-27-HC-2010 (Guj)]

Pricing appropriately
Transfer pricing

Case laws

Prelude

Continuing on from our previous communiqué, we have provided a summary of the India chapter detailed in the United Nations Transfer Pricing Practice Manual (UN TP Manual or Manual) which primarily discusses some of the emerging transfer pricing (TP) issues in India, as described by the Indian tax administration. Since TP is one of the most controversial tax issues in India, and indeed globally, additional international guidance is always welcome. Since the UN TP Manual's focus is on developing countries, the guidance should be particularly relevant for taxpayers as well as revenue authorities in an emerging economy like India, not only for resolving disputes but also for improving tax administration practices. However, the India chapter provided in the UN TP Manual does not necessarily reflect the official view of the United Nations (UN) and is not binding on the judiciary.

Notable developments in the TP arena this month include the first decision of the SC of Canada on a TP case which no doubt would have a far-reaching effect on how the Canadian transfer pricing legislation is interpreted and applied.

United Nations draft practical manual on transfer pricing for developing countries

The UN recently released eight draft chapters of its Manual for developing countries. The Manual intends to address the needs of developing countries for clearer guidance on the policy and administrative aspects of applying TP analysis. Also included in the Manual are a foreword and a draft chapter (chapter 10) containing country-specific perspectives which explain the TP administrative practices prevalent in four countries: Brazil, China, India (subsequently referred to as the India chapter), and South Africa.

India chapter primarily discusses some of the emerging transfer pricing issues in India as described by the tax administration. Some of the India issues have been discussed in the UN TP Manual, while others have not yet been addressed at all in the Manual.

Use of contemporaneous data: The Manual, as a general rule, suggests that contemporaneous data most likely reflects similar economic conditions and ensures a higher degree of comparability. However, it recognises that as an exception, multiple year data may also be used when it reveals facts which could have an influence on the determination of transfer prices. This appears to be a departure from the Organisation for Economic Co-operation and Development (OECD) TP Guidelines. The Manual also states that the circumstances that may warrant consideration of data from multiple years include the effect of business cycles in the taxpayer's industry or the effect of lifecycles for a particular product or intangible good.

Allocation of risks: The viewpoint of the UN in the TP manual suggests that the allocation of risk depends upon 'who exercises control over risk', since eventually this would impact 'allocation of return' as well. Since this is a factual analysis, the facts must be entirely substantiated and documented. The India chapter specifically takes an example of contract research and development (R&D) activities undertaken by Indian related parties of multinational enterprises, to drive home the point that the entitlement to return would depend upon who has control over the risk of such R&D.

Arm's length range: The UN TP Manual, at different places, refers to ALP or profit (or range of prices or profits). Regarding this, firstly, the UN Manual clarifies the otherwise implicit understanding that it could be arm's length price or profit, depending upon the TP method used. Secondly, the UN Manual appears to reflect flexibility in using the mean of ALP or profit, or range (range of prices or profits).

Comparability adjustments: The UN TP Manual acknowledges the need to make comparability adjustments where appropriate and where required, such that the comparables are accurate and reliable. The Manual discusses adjustments for accounting (or classification) differences, working capital adjustment, and even a functional adjustment. An adjustment for differences in the transactional structure is also contemplated in the Manual. However, where comparables have significant intangibles, the Manual suggests rejection of such comparables rather than an adjustment of them. As for risk adjustment, the Manual acknowledges that similarity in the level of risk is an important consideration in selecting a comparable, and that comparability is impaired when the entities assume different economically significant risks. The UN cautions that a risk adjustment should be made only if a reasonable and accurate adjustment is possible.

Location savings: The UN TP Manual has dealt with the issue of location savings in fair detail. According to the UN, location savings may be offset at times by dis-savings, which are higher costs incurred, for example, on account of poor infrastructure in a particular location. Thus, the net location savings should be considered.

Intangibles: The current draft of the UN TP Manual does not contain a detailed discussion on the issue of intangibles, which is likely to be featured in the next edition of the Manual. There is, however, a brief section on intangibles in the first chapter, in which intangibles have been stated to be divided into trade intangibles and marketing intangibles. The UN TP Manual discusses market penetration, market expansion and market maintenance strategies, and recognises that this may involve substantial costs, the allocation of which, between the foreign AE and the local subsidiary, is an important issue from a TP perspective.

Intra-group services: The Manual does not contain a detailed discussion on the issue of intra-group services. However, the Manual does put forth that the intra-group services will call for an ALP determination if there is a need for the service and if the recipient would be willing to pay for it, and also specifies that any incidental benefits without any specific services being provided should be ignored. Furthermore, when there is no direct comparable, the ALP determination can be done using the cost plus method. The documentation for intra-group services should demonstrate and focus on whether the services have actually been provided, the benefits, and the intra-group charge.

Financial transactions: The Manual does not contain any discussion on financial transactions.

Dispute resolution: The dispute resolution process has been described in the India chapter, and the introduction of legislative provisions for entering into advance pricing agreements has also been briefly touched upon.

PricewaterhouseCoopers Pricing Knowledge Network

Supreme Court of Canada: Decision in GlaxoSmithKline transfer pricing case

The taxpayer, a pharmaceutical company, purchased ranitidine, the active ingredient (AI), under the brand name Zantac from a Switzerland-based related party. A licence agreement conferred rights and benefits to GSK Canada and the supply agreement set the terms and price for the supply of ranitidine. The combined effect of the licence and supply agreement allowed the taxpayer to purchase, manufacture and market the final product under the trade name Zantac. The Canada Revenue Agency (CRA) re-assessed the taxpayer on the basis that the price paid for the AI was greater than the amount that would have been paid in arm's length circumstances. The case was heard by both the Tax Court of Canada (TCC), which decided in favour of CRA, and the Federal Court of Appeal (FCA), which set aside the decision and

returned the case to the TCC for reconsideration. Both the parties filed an appeal before the Supreme Court (SC).

On appeal, the SC held as follows:

- The economic and business reality of a given transaction generally should be considered in setting transfer prices. Specifically, all circumstances of a taxpayer relevant to the price paid ought to be considered.
- There was a link between the licence and supply agreements, such that the rights and benefits of the licence agreement were contingent on the taxpayer entering into the supply agreement. The taxpayer was paying for at least some of the benefits of the licence agreement through the price it paid for the AI. The TCC had erred in its refusal to consider the effect of the licence agreement on the price paid by the taxpayer.
- The SC demolished the TCC's argument that the generic comparables represent ALP, on the grounds that these comparables did not reflect the economic and business reality of the taxpayer.
- TP is not an exact science, and that some leeway must be given in determining the reasonable amounts.
- In determining the transfer price, the respective functions, risks and assets of a Canadian entity *vis-a-vis* a global group of companies must be taken into consideration.
- ALP should be established with regard to the independent interests of each party to a transaction. Higher prices are not necessarily indicative of a non-arm's length relationship.

The matter was remanded back to the TCC to determine the reasonableness of the prices paid by the taxpayer for the AI.

Delhi Tribunal accepts comparables having 25% related party transactions, Sony India ruling not binding

The assessee was engaged in providing financial advisory and management consultancy services to its AEs. During the course of assessment proceedings, the TPO carried out a fresh comparability analysis and arrived at a final set of comparables, proposing an adjustment to the transfer price of the assessee. The taxpayer appealed to the DRP which upheld the adjustment made by the TPO. Aggrieved, the taxpayer filed an appeal before the Tribunal.

On appeal the Tribunal held the following:

- The related party is not defined in the Act, and with reference to the ruling in the case of Sony India Pvt Ltd *v.* DCIT [2008] 315 ITR 150 (Del), the Tribunal examined the facts of the case for verifying the ALP. The Sony India ruling can be taken as a guiding factor only, and has no binding on other adjudicating authorities.
- Since the related party is not defined in the Act, the closest link could be the expression associated enterprises. AEs are defined as when an enterprise holds a 26% share in the other enterprise, and the interested person has been defined as a person holding not less than a 20% share. On the basis of the above, an entity can be taken as uncontrolled if its related party transaction (RPT) does not exceed 25% of its total revenue.
- Profit and losses are two incidences of the business and merely on account of high or low profit or loss, an otherwise functionally comparable company would not be made into an incomparable company. However, if there is vast fluctuation in the results of the company over a period of years, then such a company should be excluded.

- Comparables incurring advertising expenses are acceptable, since such expenses need not necessarily create intangibles for services industries like ITES services, as compared to manufacturing and distribution companies where these marketing intangibles would be helpful for getting better business.
- Comparables cannot be rejected only because they are in a different line but operating in the same sector. Applying the qualitative filter was a very subjective issue and the TPO was required to find just and reasonable comparables. Hence, if the ITES was dissected further, as according to the assessee's contentions, then there would have been no end to it. Therefore, the assessee's contentions on this regard were rejected.

In the result, the appeal of the assessee was partly allowed.

Actis Advisers Pvt Ltd v. DCIT [TS-688-ITAT-2012 (Del)]

Editors' note: This case was represented by the PwC Litigation Team

Ahmedabad Tribunal: Application of aggregation/ portfolio approach

The assessee was engaged in the manufacture of chemicals and dyes. The AEs of the assessee undertook the selling of dyes and chemicals manufactured by the assessee. The assessee had adopted the CUP method to establish the arm's length nature of its sale transactions with AEs. During the course of the assessment proceedings, the TPO called for additional details and evidence. The assessee had claimed adjustments in relation to differences in application, quantity discount, market risk and financial risk. The TPO accepted all other adjustments claimed by the assessee except for adjustments on account of differences in application and quantity discount, proposing an adjustment to the transfer price of the assessee. The DRP upheld the adjustment proposed by the TPO.

Aggrieved, the assessee filed an appeal before the Tribunal.

On appeal, the Tribunal held as follows:

- Rule 10A of the Income-tax Rules defines the term transaction to include a number of closely linked transactions. Closely linked transactions are those which cannot be segregated and if segregated, cannot be evaluated adequately on a separate basis, and for which it is impractical to determine the price of each individual product or transaction. This is also the purport of the OECD Guidelines. On fact, as the transactions were neither of same product-line nor routed-in-parts, the portfolio approach was not called for.
- An adjustment towards difference in application, i.e. that the ALP should be determined depending on what the end user uses the product for, was not acceptable because the purpose for which the buyer uses the product has no relevance in fixation of sale price.

- An adjustment towards quantity discount was permissible because it is a common market practice that bulk purchasers are generally given some discount. The assessee had to show that such discount has been given to non AEs as well.
- The argument that the revenue department has to show a tax avoidance motive before invoking transfer pricing provisions was not acceptable because the language used by the legislature was clear following the judgment in the case of Aztec Software and Technology *v.* ACIT [2007] 107 ITD 141 (Bang) (SB).
- While it was true that the TPO could not inquire into matters that were not referred to him by the AO, it was a fact that he could not make a reference to the TPO because the information about the transaction was not reported in Form 3CEB. The assessee could not take advantage of its own mistake. Even if the TPO's report on that issue was illegal, the AO was now aware of the fact that there was such an international transaction, and he was empowered under section 92C(3) of the Act to determine its ALP.

Atul Ltd. *v.* ACIT [TS-697-ITAT-2012 (Ahd)]

Taxing of goods and services
Indirect taxes

VAT, sales tax, entry tax and professional tax

Case laws

Petrol/diesel filled in new vehicles at the time of sale to dealers not eligible for input tax credit

The Haryana Tribunal held that input tax credit is not allowable on petrol/diesel which is filled in new vehicles at the time of assembling, testing, transportation and ultimate sale of vehicles to the dealers. The diesel/petrol filled in new vehicles is neither used in the process of manufacture of vehicles nor is it resold and the value of the petrol/diesel is not included in the tax invoices for sale of vehicles. Accordingly, no input tax credit is eligible on the purchase of such petrol/diesel.

Maruti Udyog Ltd *v.* State of Haryana [2012] 430 PHT 48 (HTT-FB)

State cannot impose state value added tax on inter-state sales under section 4(2)

The Allahabad HC has held that under section 4(2) the state cannot impose state value added tax (VAT) on an inter-state sale. Where natural gas is handed over, in accordance with the agreement, to the bailee or transporter at Gadimoga, Andhra Pradesh, for transportation outside the state, that itself is indicative of the fact that the sale qualifies as an inter-state sale. A change in quantity at the time of delivery to buyers in Uttar Pradesh or processing of gas after the sale does not change the nature of the transaction, especially where there is no material on record to reflect that there was any consideration for such variation or processing.

Reliance Industries Ltd *v.* State of Uttar Pradesh [2012] VIL 66 (ALH)

Notification/ circular

Online submission of certain specified details made mandatory under Delhi VAT Act

Online submission of details of purchases/stock transfer of goods received from outside Delhi has been made mandatory, effective from 1 October 2012 for all dealers.

Notification no. F.7 (433)/ Policy-II/ VAT/2012/585-595 and circular no. 17 of 2012-13 dated 5 September 2012

CENVAT

Case law

Selling cars at a whole sale price less than cost of production for as long as five years cannot be considered as sale at normal price.

The Supreme Court (SC) has held that selling cars at a wholesale price which is less than the cost of production, even if it is to counter the competition in the market, cannot be considered as sale at a normal price. Since here the transaction value is not the sole consideration, and the assessing authority was not able to derive value for the extra consideration, there is nothing wrong in their resorting to a best judgment assessment and arriving at a value based on the cost accountant's report.

Fiat India Pvt Ltd [2012] TIOL 58 (SC-CX)

CENVAT credit admissible on tool kits and medical kits sold along with the two-wheeler

The Delhi Customs, Excise, Service Tax Appellate Tribunal (CESTAT) has held that Central Value Added Tax (CENVAT) credit is admissible on tool kits and medical kits sold along with the two-wheeler, on the grounds that such kits are supplied in accordance with statutory provisions and qualify as accessories of the final product.

Honda Motor Cycles & Scooter India Pvt Ltd *v.* CCE [2012] 282 ELT 533 (Delhi)

Duty cannot be demanded on account of delay in submission of proof of export unless there is diversion of goods for domestic consumption.

The Ahmedabad CESTAT has held that duty cannot be demanded on account of a delay in submission of proof of export, as well as a failure to seek an extension of time, unless there is diversion of goods for domestic consumption.

Hindustan Dorr Oliver Ltd *v.* CCE [2012] 282 ELT 473 (Ahmd)

Service tax

Case law

A rule without a corresponding provision in the Act has no legality.

The Himachal Pradesh HC held that a rule without a corresponding provision in the Act has no legality. Accordingly, the collection of service tax from the importer of services on a reverse charge basis is permissible only from 18 April 2006, i.e. the date on which section 66A was first introduced, even though Rule 2(1)(d)(iv) of Service Tax Rules, 1994 introduced *vide* notification no. 12/2002-ST, dated 1 August 2002, provides that the collection of service tax is applicable from 16 August 2002 from the service receiver in such a case.

Malwa Cotton Spinning Mills Ltd *v.* CCE [2012] VIL 71 (HP-ST)

Company registered under section 25 of Companies Act, 1956 would qualify as association of persons.

The Ahmedabad CESTAT has held that a company registered under section 25 of the Companies Act, 1956 would qualify as association of persons for the purpose of notification no. 42/2011-Service Tax, which exempts club and association services provided by an association for treatment and recycling of effluents and solid waste.

Vapi Waste & Effluent Management Co *v.* CCE [2012] TIOL 1104 (Ahmd-CESTAT)

Notification/ circulars

It is clarified that vocational, education/training courses recognised by a central or state law would fall within the ambit of negative list of services.

The Central Board of Excise and Customs (CBEC) has clarified that vocational, education/training courses (VEC) offered by an institution of the government or a local authority are not subject to service tax. An independent institution offering degree, diploma or certificate courses approved or recognised by any entity established under a central or state law, including delegated legislation for granting recognition to any education course including a VEC, would fall in the ambit of the negative list of services and would not be liable to service tax.

Circular no. 164/15/2012-ST, dated 28 August 2012

Customs/foreign trade policy

Case law

Declaration of MRP for purpose of levy of CVD required only when goods intended for retail sale

The Mumbai CESTAT held that the declaration of MRP for the purpose of levy of countervailing duty (CVD) is required only when the imported goods are intended for retail sale in terms of Legal Metrology (Packaged Commodities) Rules, 2011.

Starlite Components Ltd *v* CC [2012] TIOL 1090 (Mumbai-CESTAT)

Notification/ circulars

Mandatory e-payment of customs duty for specified importers from 17 September 2012

The central government has mandated e-payment of customs duty with effect from 17 September 2012 for the following importers:

- Importers paying customs duty of 100,000 INR or more per bill of entry.
- Importers registered under Accredited Client Programme (ACP).

Circular no. 24/2012 dated 5 September 2012

Rates of customs duty in relation to goods imported under SAFTA amended

The central government has amended the rates of customs duty for goods imported under the South Asian Free Trade Agreement (SAFTA) and also reduced the number of tariff lines in the sensitive list for non-least developed countries.

Customs notification no. 48/2012 dated 6 September 2012

Customs duty exempt on re-import of goods originally exported by EOU and rejected by the foreign buyer

The central government has clarified that goods that were originally exported by export oriented units (EOU) are exempt from customs duty on re-import, on account of being rejected by the foreign buyer.

Customs notification no. 53/2012 dated 13 September 2012

Following the rulebook
Regulatory developments

SEBI

Indirect acquisition does not envisage pro-rating of shareholding through intermediate holding companies.

Arch Pharmalabs Ltd (APL) holds 63.6% shares of Avon Organics Ltd (AOL), a listed company. The promoter group holds 34.3% of share capital of APL. One of the promoter entities proposed to subscribe to fully convertible debentures (FCD's) of APL, which on conversion will increase the promoter's shareholding in APL to 41.5%. The effective increase of the promoter's stake in AOL will be 4.5%, i.e. below the creeping limit.

The assessee submitted that after conversion there will be no change in the voting rights and control of AOL and hence promoters should not be required to make an open offer under regulations 3 and 5 of the takeover code. Reference was made to the SEBI's decision in the case of SNL Bearings Ltd (May 2003), where it was held that a mere increase of the acquirer's stake in the holding company which it already controls has no effect on the holding company's voting rights in the subsidiary company.

The Board observed that pursuant to conversion of FCD's, the promoter group of APL will continue its control of APL and, consequently, continue to control AOL. Therefore, based on the facts, there is no change of control in AOL as a result of the proposed acquisition and thus the open offer obligation is not triggered.

Informal guidance: Arch Pharmalabs Ltd dated 28 August 2012

Financial services

Facilities for persons residing outside India: Foreign institutional investors

Until now, only the designated branches of authorised dealer (AD) category-I banks maintaining accounts of foreign institutional investors (FIIs) were allowed to act as market makers to FIIs for hedging their currency risk. However, it has now been decided to allow FIIs to approach any AD category-I bank for hedging their currency risk on the market value of entire investment in equity and/or debt in India as on a particular date subject to certain conditions.

RBI circular - RBI/2012-13/258 [A.P. (DIR Series) circular no. 45 dated 22 October 2012]

Supply of goods and services by special economic zones to units in domestic tariff areas against payment in foreign exchange

Authorised dealer banks are allowed to sell foreign exchange to a unit in domestic tariff areas (DTA) for making payments in foreign exchange to a unit in the special economic zones (SEZs) against the services rendered. However, it must be ensured that there is an enabling provision for supplying these goods/services from the SEZ unit to the DTA unit, and for payments in foreign exchange for such goods/services to the SEZ unit, in the letter of approval (LoA) issued to the SEZ unit by the development commissioner (DC) of the SEZ.

RBI circular - RBI/2012-13/259 A. P. (DIR Series) circular no. 46 dated 23 October 2012

Glossary

AE	Associated enterprise
ALP	Arm's length price
AY	Assessment year
CENVAT	Central value added tax
CESTAT	Customs, Excise and Service Tax Appellate Tribunal
CIT(A)	Commissioner of Income-tax (Appeals)
DRP	Dispute Resolution Panel
FY	Financial year
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 Act	The Income-tax Act, 1961
The tax treaty	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

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NJ 440 - January 2013 Spectrum-Jan.indd
Designed by: PwC Brand and Communications, India