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In this issue

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Editorial

I am delighted to bring to you the latest issue of India Spectrum.

After 100 days in power, the newly elected Government has sent out a message of its being a speedy decision maker by clearing several pending projects that were earlier stalled. The new government had made many promises that it yet has to meet, but expectations are that they will slowly, but surely fulfill its pre-poll promises.

Expectations of acceleration in growth rates evidenced by economic indicators ruled high as the Indian economy registered a gross domestic product growth of 5.7 percent in the April-June quarter of 2014-15. The Indian economy registered its highest growth in nine quarters this financial year. The Ministry of Finance also released its annual report 2013-14 that provided visibility on the quantum of money locked in both, direct and indirect tax appeals, during the financial 2013-14 – INR 2.87 trillion and INR 1.44 trillion respectively. FII inflows are rising by the day, and the exchange rate is clawing back the losses over the past year. S&P has upgraded its sovereign rating outlook for India from ‘negative’ to ‘stable’. Business confidence is higher than it has been for years, evidenced by the stock market indices touching new highs routinely.

On the international front, the United Nations (UN) has called for a new legal system to help countries resolve unsustainable levels of debt. This was a result of the default by Argentina, for the second time in a little over a decade. The UN resolution is a sign of international concern about the potential implications of Argentina’s situation.

With the view to providing greater flexibility for structuring external commercial borrowing (ECB) arrangements, the existing guidelines have been modified by the Reserve Bank of India (RBI) to allow recognised non-resident ECB lenders to extend loans in INR, subject to conditions.

These conditions include requiring lenders to mobilise INR through swaps undertaken with an authorised dealer bank in India, for which it can set up a representative office in India. Also, the all-in-cost of such ECBs should be commensurate with the prevailing market rates.

In an attempt to clear the air on the long lasting issue relating to 'indirect transfer' under the Indian tax law, the Delhi High Court (HC) in a recent decision in the case of Copal Research Limited, ruled in favour of the taxpayer, prescribing a threshold of 50% before triggering any capital gains tax in India. The Delhi HC interpreted the term 'substantial value' relying on the recommendations made in the Shome Committee Report, Direct Taxes Code Bill 2010 and the Organisation for Economic Co-operation and Development and United Nations Model Convention commentaries on cross-border taxation. This is the first court ruling in India that laid down a clear threshold for triggering capital gains tax on overseas indirect share transfers.

In another ruling, in the case of Mondial Orient Limited, the Karnataka HC held that sourcing services, which included identification of the vendor, ensuring quality of the merchandise being manufacturing and timely delivery, provided by an Indian branch office of a foreign company, entitled it to avail the benefit of purchase exclusion provision. In GECF Asia Limited, the Mumbai Bench of the Income-tax Appellate Tribunal held that a service that did not impart technical know-how or transfer of any knowledge, experience or skill, did not constitute 'royalty'.

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

Shyamal Mukherjee
Leader, Tax and Regulatory Services

Analysing tax issues
Corporate tax

Case law

Withholding tax

Section 40(a)(ia) disallowance not attracted on account of retrospective amendment in definition of royalty for pre-amendment period

ACIT *v.* NGC Networks (I) Private Limited [TS-415-ITAT-2014(Mumbai-Tribunal)]

Facts

The taxpayer paid placement charges to cable operators for placing its channel on a particular frequency or bandwidth so as to improve picture and sound quality and maximise viewership of the channel being aired. The taxpayer withheld 2% tax on such payments under section 194C of the Income-tax Act, 1961 (the Act). The tax officer (TO) disallowed the aforesaid payment under section 40(a)(ia) of the Act on the ground that –

- payment made by the taxpayer for placement of its channel constituted royalty under section 9(1)(vi) of the Act, and
- tax ought to have been withheld thereon at the rate of 10% under section 194J of the Act.

The Dispute Resolution Panel (DRP) noted the retrospective amendment to the definition of royalty by Finance Act, 2012 (wherein the 'process' had been defined to include satellite transmission by way of up linking, downlinking etc.) and concluded that the payment of placement fees did not tantamount to payment of fees for transmission, and therefore did not constitute 'royalty' under the Act.
The revenue preferred an appeal before the Income-tax Appellate Tribunal (Tribunal).

Held

The Tribunal held that the channel placement fee paid to cable operators/ DTH provider could not be considered as royalty as it was not covered under the definition of 'royalty' under Explanation 2 to section 9(1)(vi) of the Act.

The Tribunal held that the retrospective amendment to the definition of royalty would not be applicable while considering the disallowance under section 40(a)(ia) of the Act since such provision amended was not on the statue at the point of withholding of tax by the taxpayer. The taxpayer had bona fide withheld tax under section 194C of the Act, keeping in mind the nature of payments and facts of the case. It was not supposed to foresee the subsequent retrospective amendment in the statute to withhold tax under section 194J of the Act. In this regard the Tribunal relied on the decisions of Mumbai Tribunal in SKOL Breweries Limited *v.* ACIT [2013] 153 TTJ 257 (Mumbai-Tribunal) and Channel Guide India Limited *v.* ACIT [2012] 139 ITD 49 (Mumbai-Tribunal) and Ahmedabad Tribunal in Sterling Abrasive Limited *v.* ACIT [2011] 140 TTJ 68 (Ahmedabad-Tribunal).

Further the Tribunal relied on the decision of Mumbai Tribunal in SKOL Breweries Limited (*supra*) to hold that the amended definition of royalty (Explanation 6 to section 9(1)(vii)) cannot be relied upon while considering disallowance under section 40(a)(ia) of the Act since the section only referred to the definition of royalty under Explanation 2 to section 9(1)(vi) of the Act and not Explanation 6.

The Tribunal also relied on decision of Calcutta High Court (HC) in CIT *v.* S. K. Tekriwal [ITA No. 183 of 2012] to hold that disallowance under section 40(a)(ia) of the Act was not triggered in case of short withholding of tax.

Royalty

A service not imparting technical know-how or transfer of any knowledge, experience or skill does not constitute royalty

GECF Asia Limited *v.* DIT [TS-482-ITAT-2014(Mumbai-Tribunal)]

Facts

The taxpayer was a non-resident company incorporated in Thailand. It had entered into a master services agreement with a GE group company based in India to render multiple services such as accounting and finance support, human resource, legal and compliance, risk management, quality consultation and training, sales and marketing, information technology and system support, strategic management assistance etc. During the relevant year under consideration, the taxpayer had received payments for providing the aforementioned services. It had submitted a "nil income" tax return on the ground that payment was in the nature of "business income" under the India-Thailand Double Taxation Avoidance Agreement (tax treaty) and the same could not be taxed in the absence of a permanent establishment (PE).

The TO held that:

- the payment received by the taxpayer was as a result of a business connection in India and hence, taxable under the Act
- such services would be covered within the definition of fees for technical services (FTS) under section 9(1)(vii) of the Act, or as royalty under Article 12(3) of the tax treaty, and hence taxable in India.

The DRP without opining on business connection/ FTS, held that the payments received by the taxpayer were for providing industrial, commercial or scientific experience and hence, the payments were taxable as royalty as defined under Article 12(3) of the tax treaty with Thailand. The taxpayer preferred an appeal against the aforesaid order of the DRP.

Held

The Tribunal held that the taxpayer did not have a PE and therefore the only point which remained to be decided was whether payment received by the taxpayer constituted royalties under the India-Thailand tax treaty. The Tribunal noted the revenue's contention that services rendered by taxpayer were in nature of "information concerning industrial, commercial or scientific experience constituting royalties under the India-Thailand tax treaty.

The Tribunal observed that the Organisation for Economic Co-operation and Development (OECD) Model Commentary on Article 12 has explained royalty payment received as consideration for concerning industrial/ commercial/ scientific experience to concept of know-how.

It observed that the thin line of distinction that needed to be considered while rendering the services on account of information concerning industrial, commercial and scientific experience was whether there was any imparting of know-how or not. If there was no 'alienation' or 'use of' or the 'right to use of' any 'know-how' i.e., there was no imparting or transfer of any knowledge, experience or skill or know-how, then it could not be termed as royalty. The services may have been rendered by a person from his own knowledge and experience, but such knowledge and experience had not been imparted to the other person, as the person retained the experience and knowledge or know-how which was required to perform the services for clients. Hence, in such a case, it could not be held that such services were in the nature of royalty. Since the revenue had not examined the nature of the service rendered by the taxpayer, the Tribunal remitted the matter back to the TO to examine the nature of the services in view of the aforementioned principles.

Branch income

Income from foreign branch to be includible in taxable income in India

Bank of Baroda *v.* ACIT [TS-479-ITAT-2014(Mumbai-Tribunal)]

Facts

The taxpayer a bank had branches located in foreign countries, and these branches were tax residents in those foreign countries under various tax treaties. The taxpayer claimed that as income tax was paid on the income of such branches in the respective countries, hence the same should have been excluded from the return taxable in India, in view of Article 7 of the respective tax treaties, under which the income from such branches was not taxable again in India. The TO allowed credit/ relief for the taxes paid abroad out of the taxes payable in India on the income of the taxpayer in India. The TO further noted that according to section 90(3) of the Act, the Central Government had notified that for the grant of relief of tax, on any income of a resident of India, the phrase "may be taxed in other country" had to be interpreted as taxable in India also, thus the income of the PE was to be included in the total income chargeable to tax in India subject to relief in accordance with the tax treaty. The CIT(A) however agreed with the taxpayer's contention and directed the TO to exclude the income of foreign branches with whom India had entered into a tax treaty.

Held

Before the Tribunal, the taxpayer contended that once the tax had been paid in the source state the same could not be taxed again in the state of residence placing reliance on the case of CIT *v.* PVAL Kulandagan Chettiar [2004] 267 ITR 654 (SC), wherein it was held that once tax was paid on certain income in source country, then the same was precluded from being taxed in India. Further, the taxpayer also placed reliance on the decision in the case of Bank of India *v.* DCIT [ITA No. 2781 and 3534/Mum/2011] which followed the decision of the Supreme Court (SC).

On the other hand, the revenue placed reliance on the decision of the Mumbai Tribunal in the case of Essar Oil Limited *v.* ACIT [ITA No. 2428/Mum/2007], stating that the Tribunal not only considered the decision of the SC in the case of PVAL Kulandagan Chettiar (*supra*), but also in various other decisions, and the amendment to sub-section (3) of section 90 of the

Act w.e.f. assessment year 2004-05 and notification dated 29 August 2008. After considering all these, the Tribunal held that the income of branches/ PEs had to be included in the total income of the taxpayer, but the credit of tax paid in the source country had to be allowed here in the state of residence. The Tribunal also analysed in detail the meaning of the phrase, "may be taxed", to conclude that it did not preclude the state of residence from taxing a resident taxpayer on the income which had been earned by its PE in the source country and liable to tax in that country which issue had been discussed in detail by the Tribunal in Essar Oil Limited (*supra*). Following the co-ordinate bench decision in Essar Oil Limited (*supra*), the Tribunal held that the income of the branches of the taxpayer would also be taxable in India, i.e., it would be included in the return of income filed by the taxpayer in India, and credit for taxes paid by the branches in the other contracting states, i.e., the source countries, would be given. Thus, the Tribunal held that income of the taxpayer bank's foreign branches was taxable in India.

Purchase exclusion

Sourcing services provided by the Indian branch office of a foreign company is entitled to avail the benefit of purchase exclusion provision

DIT *v.* Mondial Orient Limited [TS-518-HC-2014(Karnataka)]

Facts

The taxpayer, a company based in Hong Kong, operated in India through its branch offices. The foreign buyers would approach with the taxpayer with their requirements, price range, quality, etc. and subsequently, the taxpayer would locate the appropriate Indian vendor. The main activity of the branch offices was to identify appropriate Indian vendors, assess their suitability for foreign buyers, and ensure the quality of merchandise and its prompt dispatch. The taxpayer was remunerated by the foreign buyer for rendering the aforementioned services.

The taxpayer claimed that its income from such services was not taxable in India under purchase exemption provision contained in clause (b) of Explanation 1 to section 9(1)(i) of the Act (which provides for exemption of income from operations confirmed to purchased good since the services rendered in India were towards the purchase of merchandise for export.

The TO denied the benefit of purchase exclusion since the taxpayer was not actually engaged in purchasing merchandise on its own account, and was instead rendering services to foreign buyers that purchased the merchandise. On appeal, the Tribunal granted the benefit of purchase exclusion on the basis that it was not necessary for the taxpayer to directly export the merchandise. As long as the taxpayer assisted in purchasing the merchandise which was exported, the benefit of purchase exclusion provision could be availed. The revenue preferred an appeal before the HC.

Held

The HC held that the purchase exclusion provision under the Act, did not require the taxpayer to specifically undertake purchase of goods. As long as the taxpayer carried out operations in India that resulted in the purchase of merchandise for export, the benefit of the purchase exclusion provision under the Act was available. The object of the purchase exclusion provision was to encourage the export of merchandise from India, which facilitates Indian vendors in earning foreign exchange. The purchase exclusion provision was an incentive granted to a non-resident to conduct business in India. The mere fact that the taxpayer did not place purchase orders made no difference. Even without placing an order in its name, the taxpayer enabled foreign buyers to place orders directly with Indian vendors after the taxpayer approved the Indian vendors, and took responsibility for maintaining quality and delivery. Considering this, the objective of the purchase exclusion provision was met. Accordingly, the HC upheld the tribunal's decision of allowing the taxpayer to avail of the benefit of purchase exclusion provision.

Tax deduction at source

No tax to be deducted at source on interest payments made to members by a co-operative society 'carrying out banking business'

The Bagalkot District Central Co-operative Bank *v.* JCIT [TS-392-ITAT-2014(Bangalore-Tribunal)]

No tax is required to be deducted at source on interest payments made by a co-operative society to its members, which is engaged in carrying out the business of banking. The exception available to all co-operative societies under section 194A(3)(v), not to deduct tax at source on payments made to members, cannot be denied to a co-operative society carrying out banking business.

Facts

The Bagalkot District Central Co-operative Bank, a co-operative society, engaged in the business of banking, paid interest on deposits to its members as well as non-members. Payment to each depositor exceeded the threshold of INR 10,000. However, the taxpayer did not deduct tax at source on such interest payments.

The TO disallowed the interest payments under section 40(a)(ia). The taxpayer contended that it is a co-operative society carrying out the business of banking, and hence, interest payments should be allowed as a deduction under section 194A(3)(v). The TO contended that section 194A(3)(i)(b) specifically applies to co-operative societies carrying out the business of banking, which requires deduction of tax at source. Accordingly, section 194A(3)(i)(b), being a specific provision, would override section 194A(3)(v), being a general provision. The TO held that the taxpayer was responsible for deducting tax at source, and thus, disallowed the interest expenditure.

Held

The Tribunal partially accepted the submissions made by the taxpayer, and made the following observations:

- While section 194A(3)(i)(b) pertains to interest paid by a co-operative society engaged in the business of banking, section 194A(3)(v) is specifically for any payment made by a co-operative society to its members or other co-operative societies. Co-operative societies engaged in the business of banking cannot be excluded from the latter provision.
- Also, CBDT Circular No. 9 dated 11 September 2002, has very clearly laid down that the provisions of tax deduction at source do not apply to a co-operative society engaged in the business of banking, when it pays interest on deposits given by its members.

In view of the above, the Tribunal held that the taxpayer is not required to deduct tax at source on interest payments made to its members. The disallowance should be restricted only to the extent of interest paid by the taxpayer to non-members without deducting tax at source, if the payment exceeds the threshold of INR 10,000.

Capital gains *v.* business income

Income from transaction in equity shares is to be characterised asbusiness income and not as capital gains

Equity Intelligence (India) P. Ltd *v.* ACIT [TS-542-ITAT-2014(Cochin-Tribunal)]

High volume, frequency and regularity of activity carried out in a systematic manner in respect of share transactions, would partake the character of business activity and not investment. It was observed that the accounting treatment, decision of directors, not investing borrowed funds, etc. are not conclusive grounds to consider that the shares were held in the nature of investments.

Facts

The taxpayer, an Indian company engaged in portfolio management services, undertakes the buying and selling of shares. The shares were accounted as investments in the books of accounts and relevant accounting standards were complied with. The investments were made out of own funds and as under the object clause in the memorandum of association of the taxpayer. The investment decisions were taken by the Directors and the trading in shares was frequent. The income from the sale of shares was characterised as capital gains by the taxpayer in the tax return. In certain earlier assessments, the TO had accepted the capital gains position.

Held

The Tribunal has applied the guidelines prescribed in the CBDT circular for ascertaining the nature of transactions in shares – trade or investment. It was observed that in the case of the taxpayer, the period of holding the majority of shares was for a short period and there was no intention to hold them for long term and to earn dividend income. The ratio of dividend income received was low as compared to the value of shares held. In addition, the investment from borrowing is not necessary as the funds were generated internally. The actual involvement of the Directors in day to day management cannot be a reason to say that the decision was only to make an investment. It was observed by the Tribunal that an organised and systematic activity was carried out and that the establishment expenses were being charged to the profit and loss account. The consistent buying and selling of shares showed the motive to maximise profit from the sale of shares and not to remain invested for a long time. Reliance was placed on the SC decision in case of Kedarnath Jute Mfg. Co. Ltd *v.* CIT [1971] 82 ITR 363 (SC), wherein it was held that treatment given in the books of accounts is not conclusive or decisive while applying the provisions of the Act. Reliance was also placed on Distributors (Baroda) P. Ltd. *v.* UOI [1985] 155 ITR 120 (SC) wherein it was held that principles of the *res judicata* does not apply to income-tax proceedings. The Tribunal held that high volume, frequency and regularity of activity carried out in a systematic manner, would partake the character of business activity and not investment.

Possession under SARFAESI

Tribunal reiterates 'possession' is a 'relative' concept, not an absolute one

Rajasthan Petro Synthetics Ltd. *v.* ACIT [TS-525-ITAT-2014(Delhi-Tribunal)]

In a welcome ruling, the Delhi bench of the Tribunal recently held that the taking over of assets by secured lenders under the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (the SARFAESI Act), was not a 'transfer' under section 2(47) of the Act.

Facts

The taxpayer, Rajasthan Petro Synthetics Limited, is a public company engaged in the manufacturing and trading of synthetic yarn. The taxpayer had borrowed loans to purchase capital assets prior to 1999. In 1999, the taxpayer ran into losses and its net worth was fully eroded, thus, it became sick under the Sick Industrial Companies (Special Provisions) Act, 1985. The taxpayer was served notice under the SARFAESI Act from a financial trust that had taken over the loans advanced by lenders and who was authorised to act for itself and on behalf of all secured lenders. The trust took over physical possession of the secured assets and sold the same.

The TO considered that the lender acquired the title to the secured assets of taxpayer on taking over possession of the assets. Thus, he made an addition to income on account of the short-term capital gains (STCG).

Held

The Tribunal examined whether the taking over of possession of the assets of the taxpayer (borrower) by the lenders should be regarded as a transfer of assets from the borrower in default to lenders.

The Tribunal observed that when a lender took over possession of mortgaged assets, the lender who was never the owner of assets did not acquire ownership. The Tribunal held that the only situation in which the lenders acquire ownership interest is when the lenders appropriate the asset to their

own books of accounts. The legal procedure required for this was not followed in this case.

By examining the provisions of the SARFAESI Act, the Tribunal noted that at no stage of the process of sale, did the lender acquire any right of ownership and actions under SARFAESI Act were to prevent the frittering away of value of the mortgaged assets. The taking over of possession under the SARFAESI Act is for the purpose of enforcement of security interests.

The Tribunal referred to the SC ruling in Transcore *v.* UOI & Anr. (Appeal (Civil) No. 3228 of 2006), wherein it was held that 'possession' was a relative concept and not an absolute concept and, therefore, the drawing of a dichotomy between symbolic and actual possession did not find place in the scheme of the SARFAESI Act. Further, the Tribunal distinguished the SC ruling in CIT *v.* Attili N Rao [2001] 252 ITR 880 (SC).

The Tribunal concluded that a restraint on dealing with the assets resulting in from the issuance of notice under the SARFAESI Act is merely a prohibition against private alienation and does not pass any title to the authority which held a lien. The purpose of the exercise of powers under the SARFAESI Act is for the realisation of security.

Thus, ruling in favour of the taxpayer, the Tribunal held that the lenders acquired merely a special right to execute or implement the recovery of its dues from dealing with those assets of the taxpayer. The ownership rights did not at any stage stand transferred and the sale consideration received by the lender(s) actually belonged to the borrower, which by the operation of law remained retained by the lenders to recover their costs, dues, etc.

Notification/ Circular

Tax Treaty with Republic of Fiji notified

Notification No. 35/2014 dated 12 August 2014

The Government of India has notified a comprehensive tax treaty with the Republic of Fiji *vide* notification no. 35/2014 dated 12 August 2014.

Assessing personal tax
Personal taxes

Case law

Employee stock option plan

Employee stock option plan (ESOP) perquisite proportionately taxable only to the extent of stay of India

ACIT *v.* Robert Arthur Keltz [TS-354-ITAT-2013(Delhi-Tribunal)]

Only ESOP benefits proportionate to services rendered by taxpayers in India are taxable in India, and not the entire benefit.

Facts

The taxpayer, an employee of United Technologies International Operation, USA (UTIO), was on deputation to its Indian liaison office from 1 April 2006. The taxpayer was a tax equalized employee while on deputation to India. During AY 2007-08, he was a resident and not ordinarily resident (RNOR). He was granted an ESOP of 34000 shares by UTIO in January 2004, having a vesting period of three years from the grant date. The ESOP shares vested in January, 2007, i.e, after the taxpayer started his deputation in India. The taxpayer exercised this ESOP immediately in February 2007, while on deputation in India. The taxpayer offered to tax in India the amount of proportionate ESOP perquisites earned in India, i.e. proportionate to the number of days of his assignment in India.

The taxpayer contended that since shares were allotted outside India, the benefit arising therefrom could not be deemed to have been received in India. He argued that the option granted on 9 January 2004 represented the employee's future right to receive shares of UTIO only once the vesting requirement of continued employment with UTIO vesting period of three years was satisfied. Thus, it was argued that stock options would accrue to the employee for services rendered by him during the grant period of three years.

The TO treated the entire amount of ESOP as perquisite (difference between fair market value of stocks on the date when the stock option rights were exercised and the cost recovered from the taxpayer), as being taxable in India.

Held

Ruling in favor of the taxpayer, the Tribunal confirmed that only proportionate ESOP perquisites relatable to the service rendered by the taxpayer in India were taxable in India.

The Tribunal followed the principle laid down in the case of Ellis D' Rozario [ITA 2918/Del/2005] regarding taxability of proportionate salary in India pursuant to the period of rendering services in India.

The HC held that the taxpayer was an employee of a company registered in the USA. The option given to the assesse was in pursuance of his employment with a US entity. The Tribunal's decision was just and fair, and accordingly the appeal was dismissed.

Editor's Note

This judgment reiterates that ESOP perquisites given to the taxpayer in pursuance of his employment in India are taxable only to the extent the services are rendered by the taxpayer in India. Though the judgment is given in case of RNORs, it should also be applicable in case of non-resident taxpayers.

House property

"Agreement-to-sale" triggered a "transfer", and not a sale deed, and accordingly benefit under section 54 of the Act was allowed

Sanjeev Lal *v.* CIT [TS-397-SC-2014]

The SC grants benefit of section 54 of the Act to the taxpayer, though the sale agreement of original asset was "executed" after more than one year prior to the purchase of new assets; holds that under 'peculiar facts of this case', the 'transfer' took place when the 'agreement to sell' was entered into and earnest money was received.

Facts

The taxpayer had entered into an 'agreement to sell' on 27 December 2002 to transfer a residential house (original asset), and he received earnest money. He purchased another residential house (new asset) on 30 April 2003. The original asset had been vested in the taxpayer under a will. However, the validity of the will was challenged by another family member by filing a civil suit, wherein the trial court by an interim order had restrained the taxpayer from dealing with the house property.

During the pendency of the suit, the family member who had instituted the suit passed away, leaving behind no legal heirs. The suit filed was dismissed in May 2004. The taxpayer executed the sale deed on 24 September 2004, after dismissal of suit, when the validity of the will was upheld. Believing that long-term capital gains (LTCG) were not chargeable to tax due to tax exemption under section 54 of the Act on purchase of new asset within one year of entering into a sale agreement, the taxpayer claimed LTCG deduction for AY 2005-06.

The TO held that the taxpayer was not entitled to any benefit under section 54 as the transfer of the original asset was effected only on 24 September 2004, whereas the new residential house was purchased on 30 April 2003, i.e., more than one year prior to the purchase of the new asset. The TO held that therefore, the taxpayer was liable to pay tax on capital gain. The CIT(A), the Tribunal and the HC ruled in favor of the Revenue.

Held

To avail the benefit under section 54, one had to purchase a residential house/new asset within one year prior or two years after the date of transfer of the residential house in respect of which the long term capital gain had arisen. In the present case, there was a lapse of around two years in the execution of sale deed due to the challenge of the taxpayer's ancestor's will (which devolved the original asset to the taxpayer) by his legal heir.

The SC observed that "by executing an agreement to sell in respect of an immovable property, a right *in personam* is created in favour of the transferee/ vendee. When such a right is created in favor of the vendee, the vendor is restrained from selling the said property to someone else because the vendee, in whose favor the right *in personam* is created, has a legitimate right to enforce specific performance of the agreement, if the vendor, for some reason, is not executing the sale deed."

The SC further held that under normal circumstances, a property could not be said to have been sold at the time when an agreement to sell was entered into. However, on perusing section 2(47) which defines "transfer", the SC observed that if a right in the property is extinguished by execution of an agreement to sell, the capital asset can be deemed as transferred. The "agreement to sell" was entered into and the taxpayer had also received earnest money. Due to the pendency of litigation between taxpayer's legal heir and the taxpayer, the latter was restrained in dealing with the property and the sale deed could not be executed. The intention of the Legislature, or the purpose with which the said provision has been incorporated in the Act, was also very clear in line with the taxpayer being given some relief.

The SC pointed out that once an agreement to sell was executed in favor of one person, the said person got a right to get the property transferred in his favor by filing a suit for specific performance. Therefore, in the present case, "some right, in respect of the said property, belonging to the appellants had been extinguished and some right had been created in favor of the vendee/transferee, when the agreement to sell had been executed."

Thus, the SC held, in view of the aforestated peculiar facts of the case and looking at the definition of the term "transfer" under section 2(47) of the Act, the appellants were entitled to relief under section 54 of the Act in respect of the LTCG.

Editor's Note

The apex court has given this ruling in favor of the taxpayer on peculiar facts of the case. However, it also clarified that under normal circumstances, property cannot be said to have been transferred at the time when an agreement to sell is entered into.

Capital Gains – Relief under section 54

Investment in a house located outside India is also eligible for exemption under section 54

N. Ranganathan *v.* ITO [TS-396-ITAT-2014(Chennai-Tribunal)]

The Tribunal allowed section 54 exemption to a taxpayer for investment of capital gains arising from sale of a residential property in another residential property located outside India. The CIT(A)'s contention that investment made in foreign currency disqualified taxpayers from claiming a deduction, was rejected.

Facts

The taxpayer sold his residential house in financial year (FY) 2008-09, resulting in capital gains. Thereafter, he purchased a residential house in Singapore. For AY 2009-10, taxpayer claimed exemption under section 54 of the Act for re-investment of capital gains for the purchase of his new house, and declared his income at nil. The TO framed a "regular" assessment and accepted the taxpayer's claim under section 54. However, the CIT initiated revision proceedings under section 263 to deny the benefit of section 54 on the ground that it could be allowed only in case of purchase of new house in India, and not in a foreign country. Accordingly, he directed the TO to frame a *'de novo'* assessment. Consequently, the TO disallowed the taxpayer's claim.

On appeal, the CIT(A) observed that the taxpayer had purchased his new house in Singapore, and paid the consideration in foreign currency, which was more than the sale consideration realised from the sale of the Chennai house, and that his accounts statement did not provide exact information about the flow of money. Accordingly, the CIT(A) rejected the taxpayer's appeal.

Aggrieved, the taxpayer preferred an appeal before the Tribunal.

Held

The Tribunal referred to the Bangalore Tribunal ruling in the case of Vinay Mishra *v.* ACIT (2012) 20 ITR 129 (Bangalore-Tribunal), wherein it had been held that a deduction claim under section 54 could not be rejected merely on the grounds that the new house purchased was in a foreign country. In absence of any distinguishing case law, the Tribunal held the CIT's order on this ground as unsustainable. The Tribunal also held that the excess of sale consideration was immaterial for claiming exemption under section 54 of the Act. On the CIT(A)'s claim that the taxpayer's account statement did not provide for exact fund flow, the Tribunal observed that if this reason was accepted, it would amount to an imposition of superficial conditions for the taxpayer to utilize the very consideration money received in purchasing the new asset. Holding that section 54 was a beneficial provision, the Tribunal decided in favour of the taxpayer.

Editor's Notes:

The Tribunal held that a deduction claim under section 54 cannot be merely rejected on the ground that the new house purchased was in a foreign country, emphasizing that the provisions were beneficial provisions. It is important to note that the Finance (No. 2) Act, 2014 has amended section 54 and section 54F in order to specifically restrict tax exemptions only in case the new house purchased is in India.

Structuring for companies
Mergers and acquisitions

Case law

No capital gains under section 45(4) when property is not transferred by firm to retiring partners

CIT *v.* Karnataka Agro Chemicals [TS-465-HC-2014(Karnataka)]

Facts

The taxpayer, a partnership firm, revalued its assets and recognised goodwill and credited it to the current accounts of the four partners proportionately. Out of the four partners, two partners retired in the same year. The retiring partners were paid the amount due to them including their share of goodwill.

The TO brought this goodwill to tax as long term capital gains in accordance with the provisions of section 45(4) of the Act. On appeal before the CIT(A), it was held that there was no transfer within the terms of section 45 and section 2(47) of the Act and it was a case of goodwill arising from revaluation of assets. Goodwill was carried in the balance sheet and there was no transfer of any assets by the firm to the retiring partners.

After the Tribunal upheld the CIT(A)'s order, the Revenue preferred an appeal before the HC.

Held

To attract section 45(4) of the Act, there should be a transfer of the capital asset from the firm to retiring partners, and the firm should cease to have any right in the property so transferred. In other words, the right to the property should stand extinguished, and the retiring partners should acquire absolute title to the property.

In the instant case, the taxpayer did not transfer any right in the capital asset in favour of the retiring partners. Consequently, as the taxpayer's right to the property was not extinguished, there could be no taxable capital gains.

Editor's note

This is a ruling by Karnataka HC which rightly rules that section 45(4) does not apply in case no property is transferred by the firm to the retiring partners.

Related party transactions – Key amendments and clarifications

General Circular No 30/2014 dated 17 July 2014 and Notification dated 14 August 2014

The Ministry of Corporate Affairs has made clarifications and amendments in the context of approval of related party transactions under the Companies Act 2013 which are as follows;

S.No	Criteria	Amendments
1	Paid-up share capital threshold	Minimum threshold based on share capital removed (earlier limit INR 100 million)
2	Sale, purchase or supply of any goods or material (directly or through agent)	10% of the turnover of the company or rupees INR 1,000 million, whichever is lower (earlier limit > 25% of annual turnover)
3	Selling or otherwise disposing of, or buying property of any kind (directly or through agent)	10% of net worth of the company or INR 1,000 million whichever is lower (earlier limit > 10% of net worth)
4	Leasing of property of any kind	10% of net worth of the company or 10% of turnover or INR 1,000 million (earlier limit > 10% of net worth or 10% of turnover)
5	Availing or rendering of any service	10% of the turnover of the company or INR 500 millions whichever is lower (earlier limit > 10% of net worth)
6	Appointment to any office or place of profit in the company, its subsidiary company or associate company	No change, i.e., remuneration exceeds INR 0.25 million per month
7	Underwriting the subscription of any securities to the company or derivatives thereof	No change, i.e., remuneration exceeds 1% of Net Worth

It is also clarified that the limits shall apply for all companies and for transactions 2 to 5 in the table above to be entered into, either individually or taken together with the earlier transactions during a FY.

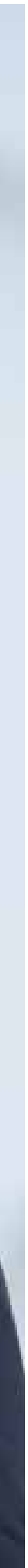
Other clarifications

- A member would be considered as a related party only with reference to a contract/ arrangement for which the 'said special resolution' is being passed.

- Transactions arising out of compromises, arrangements, and amalgamations that are dealt with under the specific provisions of the Companies Act, 1956/ the Companies Act, 2013 will not attract the requirements of section 188 of the Companies Act 2013.

- Contracts that were entered into by a company before 1 April 2014 in compliance with section 297 of the Companies Act, 1956 will require fresh approval only after the expiry of the original term of such contracts, or if any modifications are made in such contracts.

Pricing appropriately
Transfer Pricing



Prelude

During the past month, the Indian Finance Ministry released its annual report for the FY 2013-14, wherein the transfer pricing adjustments for the ninth round of audit cycle (i.e. FY 2009-10) were reported to be around INR 596 billion. According to sources, the adjustments during the year was less than the adjustments in the previous year, with transactions, notably marketing intangibles and the provision of bank guarantees contributing to this figure of adjustments. The readers will recall the Budget speech of 2014, wherein the Finance Minister had stated that the tax demand of more than INR 4 trillion is under dispute and litigation before various courts and appellate authorities. Towards this aspect, in order to speed up the legal disposal system in the Income-tax department (IT), the Central Board of Direct Taxes (CBDT) has created over 240 new posts in the IT Department. Also, the CBDT has issued internal guidance to ensure a better administration and to bring about uniformity in the approach by the transfer pricing officers. This step of the Government and CBDT is extremely welcome, especially in the current situation, where the Indian Courts are grappling with more tax and transfer pricing cases to ensure timely disposal.

On the global front, recently, the Dutch Ministry issued a new decree (the Decree) to provide guidance on the application of the arm's length principle. The Dutch transfer pricing legislation is largely based on the OECD transfer pricing guidelines, with some modifications to reflect the Dutch business practices. The decree provides guidance on the interpretation of the OECD Guidelines, particularly where there is ambiguity in the guidelines, or where there is a need for additional explanation. The Decree clarifies how certain issues should be approached in practice. At the very outset, from a practical standpoint, the Decree sets out a general principle that setting transfer prices is not a fixed science, and that the tax authorities should be flexible in their approach, and not expect unrealistic accuracy from the taxpayer in respect of its transfer prices.

This communiqué also summarises a few income-tax Tribunal rulings passed during the past month on cases involving transfer pricing issues.

Case law

Mumbai Tribunal - Rejects classification of IT enabled services (ITeS) into knowledge process outsourcing and business process outsourcing

Tecnimont ICB Pvt Ltd *v.* ACIT [TS-188-ITAT-2014 (Mumbai-Tribunal) - TP]

The taxpayer was engaged in the provision of engineering design services to its associated enterprises (AEs) using CAD/ CAM software. Apart from rendering engineering design services, the taxpayer was also involved in the provision of administrative support services to its AEs. The taxpayer selected the transactional net margin method (TNMM) to benchmark its international transactions. During the assessment proceedings, the transfer pricing officer (TPO) rejected all the comparables (mainly segments of companies engaged in the provision of engineering design services) selected by the taxpayer on the premise that the functions performed by the taxpayer were akin to knowledge process outsourcing (KPO) services and not business process outsourcing (BPO) services, thereby proposing an adjustment to the transfer price of the taxpayer. The DRP upheld the adjustments made by the TPO.

On appeal, the Tribunal held that:

- Potential comparables of ITeS had to be selected by applying a broad functional test to compare specific functions carried out by the tested party against comparable companies. The classification of ITeS into BPO services and KPO services for a comparability analysis would not be just and proper;
- The action of TPO in rejecting comparable companies on the criteria of BPO/ KPO was not sustainable;
- When services provided by the taxpayer to its AEs were similar to the business profile of the comparables, especially with a particular business segment of comparable companies (say, engineering design services), then rejection by the TPO of the comparables selected by the taxpayer was not proper and justified; and
- A comparability analysis had to be carried out on the basis of the nature of

the business carried out by the tested party *vis-à-vis* comparable companies, and further, where segmental data was used, the business activity of the particular segment had to be compared with the tested party.

Bangalore Tribunal allows risk adjustment

Supportsoft India Private Limited *v.* ITO [TS-373-ITAT-2013 (Banglore-Tribunal)-TP]

The taxpayer was engaged in providing software development services and marketing support services to its AEs. During the relevant year, the taxpayer selected the cost plus method (CPM) as the most appropriate method (MAM) to benchmark its international transactions. The taxpayer also claimed a risk adjustment of 20% in its transfer pricing study report on the basis that the taxpayer was a captive service provider, and therefore was insulated from the risks that the comparables were bearing. In addition, as this was the first year of the project, the taxpayer's margins were lower because of possible inefficient operations in the first year. The taxpayer substantiated this by proving that the margins in the subsequent years were higher. During the course of the assessment, the TPO rejected the CPM method adopted by the taxpayer and carried out a fresh transfer pricing (TP) analysis using the TNMM, thereby proposing an adjustment to the taxpayer's transfer price. Additionally, the TPO also rejected the taxpayer's claim of risk adjustment. The CIT(A) upheld the approach adopted by the TPO.

On appeal, the Tribunal ruled on the comparability analysis, and in respect of the risk adjustment, it held that:

- The single customer risk attributable to the taxpayer was only an anticipated risk whereas the risk attributable to the comparables was an existing risk. In such a case, the TPO should have given the risk adjustment to the net margin of the comparables for bringing them on par with the taxpayer. The Tribunal relied on the ruling of Intellinet Technologies India Private Limited *v.* ITO (ITA 1237/ Bang/2007); and
- The TPO should reconsider the contention of the taxpayer and decide the appropriate percentage of the risk adjustment that should be granted to the taxpayer.

The Tribunal set aside the impugned order and restored the matter to the TO/ TPO for reconsideration of the issues in accordance with the law and in light of the observations made by it.

Editor's note

There have been recent rulings wherein the Tax Tribunals have adopted differing views in respect of the allowability of risk adjustment. Based on the risk profile of the entities in a transaction, it would be prudent to decide on the claim for this adjustment. Risk adjustment has been a highly litigated issue over the years. Captive service providers were not being granted risk adjustment on the grounds that they are still exposed to single customer risk, and also for want of a method to measure the risk adjustment. This Tribunal ruling provides useful guidance to taxpayers on this subject.

Pune Tribunal - Holds that CUP method applied by the taxpayer rendering software development services on "man month" rate is the most appropriate method over TNMM

Nihilent Technologies Private Limited *v.* DCIT [TS-238-ITAT-2014 (Pune-Tribunal)-TP]

The taxpayer was engaged in rendering software development and consultancy services to its AEs as well as to unrelated third parties in the relevant year. The taxpayer applied the internal comparable uncontrolled price (CUP) method as the MAM to determine the arm's length price of its international transactions. During the course of the assessment proceedings, the TPO rejected the application of the internal CUP method on the grounds that internal CUP could not be used since the transactions compared were not identical. The TPO conducted a fresh comparability analysis and applied the transactional net margin method TNMM to determine the arm's length price of the international transactions. The CIT(A) upheld the approach adopted by the TPO.

On appeal, the Tribunal held as below:

- The law did not deny the application of the 'per month' rate for comparability under the internal CUP method;
- The onus was on the Department to prove that the method adopted by the TPO/ TO gave much more accurate results than that of the taxpayer;
- The arm's length price adjustments were counter measures to ensure the prices at which international transactions were entered into by the AEs were not so contrived as to adversely affect the tax base, and therefore,

the MAM should be decided in the light of this basic governing principle;

- The consideration as to which method is more beneficial to the Revenue did not hold. Reliance was placed on the ruling of ACIT *v.* MSS India (P) Ltd. [TS-14-ITAT-2009 (Pune-Tribunal)-TP]; and
- TNMM was the method of last resort, and it had to be applied when traditional methods like the internal CUP could not be reasonably applied. Reliance was again placed on the ruling of MSS India (*supra*).

The Tribunal set aside the CIT(A)'s order and directed the TO to accept the ALP determined by the taxpayer in the TP study report and delete the addition.

Taxing of goods and services
Indirect taxes

Case law

VAT/Sales tax/Entry tax/ Professional tax

Supply of food and beverages to employees through canteen run according to the requirements of Factories Act held liable to VAT

TVS Motors Company Ltd *v.* State of Karnataka (2014-VIL-185-Karnataka)

The Karnataka HC held that the supply of food and non-alcoholic beverages to employees and guests at subsidized rates through canteen run by the company as per the requirements of the Factories Act fell under the definition of 'business' under the Karnataka value added tax (VAT) laws. Accordingly, the company was held liable to pay VAT on the consideration received from employees for the supply of food and non-alcoholic beverages, irrespective of the profit or loss on such supplies.

CENVAT

Capital goods received by a job worker under a leave and licence agreement with the principal were eligible for credit

CCE *v.* Ilgin Automotive (P) Limited (2014 (299) ELT 129)

The Madras HC held that capital goods received by a job worker under a leave and licence agreement with the principal were eligible for credit even if the job worker was not the owner of the capital goods.

CENVAT credit not required to be reversed on inputs issued for production that are destroyed in fire

Virender Processors Pvt Ltd *v.* CCE (2014-TIOL-1019-CESTAT-Mumbai)

The Mumbai Tribunal held that CENVAT credit was not required to be reversed on inputs issued for production which were destroyed in a fire.

Service tax

Profit margin earned on sale of CNG at fixed RSP cannot be held to be commission towards rendition of BAS

Bharat Petroleum Corporation Ltd, Hindustan Petroleum Corporation Ltd *v.* CST (2014-TIOL-1114-CESTAT-Mumbai)

The Mumbai Tribunal held that where the appellant had purchased compressed natural gas (CNG) from the supplier of CNG to be sold to customers at retail outlets owned and managed by the appellant, merely because the appellant had provided some infrastructure to the supplier to compress the gas at the retail outlet before it was sold to the customers, the transaction could not be held to be a service liable to tax under the 'business auxiliary services' (BAS) category.

The Tribunal also held that simply because the retail sale price (RSP) was fixed by the supplier of CNG, the profit margin earned by the appellant on the sale of CNG to retail customers could not be held to be commission towards the rendition of BAS.

Rule 5(2) held ultra vires, no general audit to be conducted

Travelite (India) *v.* UoI and Ors (2014-TIOL-1304-HC-Delhi-ST)

The Delhi HC quashed Rule 5A (2) of the Service Tax Rules, 1994, that provided for a general audit by officers or by audit party designated by the Commissioner or the Comptroller and Auditor General of India (CAG). The only type of audit contemplated under section 72A of the Finance Act, 1994, the HC held, was the special audit to be conducted under specified circumstances only. Accordingly, Rule 5A was held to be beyond the legal power of section 72A and section 94(1) of the Finance Act, 1994.

Customs / foreign trade policy (FTP)

Refund of excess duty paid held liable to be rejected where duty incidence formed part of capital goods, and the same was capitalised as fixed assets in the balance sheet

CC *v.* Hind Offshore Pvt. Ltd. (2014-TIOL-1092-CESTAT-Mumbai)

The Mumbai Tribunal held that a refund of excess duty paid was liable to be rejected where the duty incidence had formed a part of capital goods, and the same had been capitalised as fixed assets in the balance sheet, as the claim would be hit by the bar of unjust enrichment.

Where excess duty paid was shown as recoverable in the balance sheet, refund held available, as it was established that the excess payment was not passed on to the buyer

Deepak International *v.* CC (2014 (304) ELT 438)

The Delhi Tribunal held that where excess duty paid was shown as recoverable in the balance sheet, supported with chartered accountant's certificate and photocopies of invoice, it had been established that the excess payment was not passed on to the buyer. Consequently, a refund would be available, regardless of the non-production of an original invoice.

Rebate of duty not allowable in cases where goods were exported without payment of duty, even if duty was paid after export

Sandhar Automotives *v.* Joint Secretary, GoI (2014 (305) ELT 193)

The Delhi HC held that rebate of duty was not allowable in cases where goods were exported without payment of duty, even if the duty was paid after export, as it would not be in compliance with the condition for claiming rebate, *viz.*, the export of goods after the payment of excise duty.

Notification/ circular

VAT/Sales tax/Entry tax/ Professional tax

WCT-TDS rate increased in Haryana

Notification No.S.O.67/ H.A.6/2003/ S.24/2014 dated 20 June 2014

Effective 24 June, 2014, the rate of Works Contract Tax - Tax Deductible at Source (WCT-TDS) has been increased from 4% to 5%.

Service tax

Rate of exchange to be applied according to generally accepted accounting principles

Notification No. 19/2014-Service tax, dated 25 August 2014

A new Rule 11 has been inserted in the Service Tax Rules, 1994 which provides that the rate of exchange applicable shall be the rate of exchange according to generally accepted accounting principles, on the date when the point of taxation arises in terms of the Point of Taxation Rules, 2011

Customs / foreign trade policy (FTP)

The central government has fixed rate of interest to be paid on refund of pre-deposit at 6% per annum

Notification No. 70/2014-Cus (NT) dated 12 August 2014

The central government has fixed the rate of interest to be paid on the refund of pre-deposits made under section 129E of the Customs Act, 1962 at 6% per annum.

Quantity of input to be allowed under advance authorisation/ duty free import authorisation shall be in proportion to the quantity of input actually used/ consumed in production

Notification No. 90(RE-2013)/2009-14 dated 21 August 2014

The central government has provided that the quantity of input to be allowed under advance authorisation/duty free import authorisation shall be in proportion to the quantity of input actually used/ consumed in production.

Following the rulebook
Regulatory developments

FEMA

Foreign Direct Investment (FDI)

Foreign investment in government dated securities

A.P. (DIR Series) Circular No. 13 dated 23 July 2014 and 22 dated 28 August 2014

The RBI has made the following amendments with respect to investment in government securities:

Change in limit:

Increased by USD 5 billion for Foreign institutional Investors (FIIs)/ Qualified Foreign Investors (QFIs)/ Foreign Portfolio Investors (FPIs), and reduced by USD 5 billion for long term investors. The overall limit of USD 30 billion for investment in government securities remains unchanged.

Increase in minimum maturity period

The incremental investment limit of USD 5 billion and all future investment against the limit vacated through the selling/ redemption of current investments is required to be invested in government bonds with a minimum residual maturity of three years.

However, there will be no lock-in period, and FIIs/ QFIs/ FPIs shall be free to sell the securities (including those that are presently held with less than three years of residual maturity) to domestic investors.

Manner of acquisition

The stipulation as to the manner of acquisition of government securities by eligible investors (*viz.*, purchase directly from the issuer of such securities or through a registered broker on a recognized Stock Exchange) has been removed. Eligible investors can acquire government securities in any manner according to the prevalent/ approved market practice.

Use of National Industrial Classification 2008 (NIC) while reporting the issue/ transfer of shares

A.P. (DIR Series) Circular No. 6 dated 18 July 2014

The RBI has instructed that NIC 2008 be used instead of the NIC 1987 version, while reporting of issue and transfer of shares. In addition, it has also introduced a uniform State and District code to be mentioned while reporting the issue of shares.

External Commercial Borrowings

ECB in Indian rupees

A.P. (DIR Series) Circular No. 25 dated 3 September 2014

Presently, all eligible borrowers are eligible to raise ECB in INR from foreign equity holders as per the extant ECB guidelines.

With a view to providing greater flexibility for structuring of ECB arrangements, the RBI has now permitted recognised non-resident ECB lenders to extend loans in INR, subject to prescribed conditions, which inter alia include:

- The lender should mobilise INR through swaps undertaken with an Authorised Dealer (AD) bank in India. For this purpose, the recognised ECB lender can set up a representative office in India by following the applicable process;
- The all-in-cost of such ECBs should be commensurate with the prevailing market conditions.

Refinancing of ECB at lower all-in-cost – simplification of procedure

A.P. (DIR Series) Circular No. 21 dated 27 August 2014

Presently, cases of refinancing existing ECB by raising fresh ECB, where new Average Maturity Period (AMP) of the fresh ECB is more than the residual maturity of outstanding ECB, are considered by the RBI under the approval route.

The RBI has now delegated this power to AD bankers, subject to the following key conditions:

- All-in-cost of fresh ECB should be less than that of the all-in-cost of existing ECB
- Refinancing needs to be undertaken before the maturity of the existing ECB; and
- Consent of the existing lender is required

It is pertinent to note that overseas branches/ subsidiaries of Indian banks are not permitted to extend ECB for refinancing an existing ECB.

Further, this facility is also extended to those cases where existing ECBs were raised under the approval route, provided the amount of the new ECBs is eligible to be raised under the automatic route.

Review of all-in-cost ceiling – ECB and Trade Credits

A.P. (DIR Series) Circular No. 16 & 17 dated 28 July 2014

The extant all-in-cost ceiling of ECB and Trade Credits has been kept unchanged until 31 December 2014. The rates will be subject to review thereafter. Thus, the ceilings presently applicable are as per adjacent table:

<table>
<tr><th rowspan="2">Average Maturity Period</th><th colspan="2">All-in-cost ceilings over 6 months LIBOR*</th></tr>
<tr><th>ECB</th><th>Trade Credits</th></tr>
<tr><td>Up to one year</td><td rowspan="2">350 basis points</td><td rowspan="3">350 basis points</td></tr>
<tr><td>More than one year and up to three years</td></tr>
<tr><td>More than three years and up to five years</td><td>500 basis points</td></tr>
</table>

**LIBOR: London Inter-Bank Offered Rate*

Export of Goods and Services

Project and Service exports

A.P. (DIR Series) Circular No. 11 dated 22 July 2014

Presently, project exports and deferred service exports proposals for contracts exceeding USD 100 million in value require approval of a working group (consisting of representatives from Exim bank, ECGC & RBI). In addition, the relevant forms for obtaining post-award approvals were required to be submitted within 30 days of entering into the contract.

The RBI has now dispensed with the working group and allowed the AD banks/ Exim Bank to consider awarding post-award approvals without any monetary limit and permit subsequent changes within the relevant FEMA guidelines/ regulations. Hence, the requirement of submitting forms for seeking post-award approval is no longer required.

Financial Services

Flexible structuring of long term project loans to infrastructure and core industries

RBI/2014-15/126 DBOD.No.BP. BC.24/21.04.132/2014-15 dated 15 July 2014

The RBI has clarified that it would not have any objection to banks financing long term projects in the infrastructure and core industries sector, provided that:

- At the time of the initial appraisal of such projects, banks may fix an amortisation schedule (original amortisation schedule) while ensuring that the cash flows from such projects and all necessary financial and non-financial parameters are robust even under stress scenarios;
- The bank offering the initial debt facility may sanction the loan for a medium term, say five to seven years. The repayment schedules of the initial debt facility should normally correspond to the original amortisation schedule, unless there is an extension of the date of commencement of commercial operations;
- If the initial debt facility or refinancing debt facility becomes NPA at any stage, further refinancing should stop, and the bank which holds the loan when it becomes non performaning asset (NPA), would be required to recognise the loan as such and make the necessary provisions as required under the extant regulations. Once the account comes out of NPA status, it will be eligible for refinancing in terms of these instructions;
- From a risk management perspective, banks should recognise that there will be a probability that the loan will not be refinanced by other banks, and should take this into account when estimating liquidity needs as well as stress scenarios. Furthermore, unless part or full refinancing by other banks is clearly identified, the cash flows from such refinancing should not be taken into account for computing liquidity ratios. Similarly, once committed, the refinancing bank should take into account such cash flows for computing their liquidity ratios

The above structure will apply to new loans to infrastructure projects and core industries projects sanctioned after the date of this circular. Furthermore, the RBI's instructions on 'take-out finance' (circular dated 29 February 2000) and 'transfer of borrowal accounts' (circular dated 10 May 2012) will cease to be applicable on any loan to infrastructure and core industries projects sanctioned under these instructions. The RBI will review the instructions at periodic intervals.

Issue of long term bonds by banks – financing of infrastructure and affordable housing

RBI/2014-15/127 DBOD.BP.BC. No.25/08.12.014/2014-15 dated 15 July 2014

Banks have been permitted to issue long-term bonds denominated in Indian rupees with a minimum maturity of seven years to raise resources for lending to (i) long term projects in infrastructure sub-sectors, and (ii) affordable housing. The instruments shall be fully paid, redeemable and unsecured, and would rank equally with other uninsured, unsecured creditors.

These bonds will be exempted from the computation of net demand and time liabilities (NDTL), and would therefore not be subjected to CRR/ SLR requirements. Eligible bonds will also get exemption in the computation of Adjusted Net Bank Credit (ANBC) for the purposes of priority sector lending (PSL).

Regulatory incentives (as prescribed in the circular) will be restricted to the bonds that are used to incrementally finance long term projects in infrastructure and loans for affordable housing. The computation of credit eligible for regulatory incentives will be as prescribed in the circular.

Regulatory framework for Securitisation / Reconstruction Companies (SCs/ RCs) – Certain amendments

RBI/2014-2015/164 DNBS (PD) CC. No.41/ SCRC/26.03.001/2014-2015 dated 5 August 2014 and RBI/2014-2015/169 DNBS (PD) CC. No. 42/ SCRC/26.03.001/2014-2015 dated 7 August 2014

- SCs/ RCs shall invest a minimum of 15% of the security receipts (SR) issued by them on an ongoing basis till the redemption of all the SRs issued under such scheme
- Before bidding for stressed assets, SCs/ RCs may seek from the auctioning banks not less than 2 weeks for due diligence of the account
- The planning period for SCs/ RCs for realization of the NPAs of the selling bank for reconstruction cannot exceed 6 months
- The initial valuation of the SRs should be done within six months of acquiring the underlying asset
- The management fees should be charged as a percentage at the lower end of the range of the net asset value (NAV), provided that it is not more than the acquisition value of the underlying asset
- SCs/ RCs are to also be part of Joint Lenders Forum formed for distressed assets in terms of the 'Framework for Revitalizing Distressed Assets in the Economy'
- Additional disclosures for SCs/ RCs are as prescribed in the circular

Modification of guidelines on mortgage guarantee companies (MGCs)

RBI/2014-15/170 DNBS (PD) CC. No.20/ MGC/03.011.001/2014-15 dated 8 August 2014

- Capital adequacy – the mortgage guarantees provided by MGCs may be treated as contingent liabilities, and the credit conversion factor applicable to these contingent liabilities will be fifty percent
- Contingency reserve – If losses exceed 35% of the premium or fee earned during a FY, the contingency reserves could go to a minimum of 24% of the premium or fee earned, such that the aggregate of provisions made towards losses and contingency reserves is at least 60% of the premium or fee earned during a FY. In addition, the contingency reserve can be used without the prior approval of RBI for meeting and making good the losses suffered by the mortgage guarantee holders
- Classification on investments – investments made towards government securities, quoted or otherwise, government guaranteed securities, and bonds not exceeding the MGC's capital, may be treated as "held to maturity (HTM)" for the purposes of valuation and accounted for accordingly
- Provision for loss on invoked guarantees – In case the provisions already held for loss on invoked guarantees are in excess of the contract-wise aggregate of 'amount of invocation'), the excess may be reversed, subject to conditions

Timelines for credit decisions

RBI/2014-15/199, DBOD.No.BP.BC. 35/21.04.048/2014-15 dated 1 September 2014

The RBI has advised that banks should clearly delineate the procedure for disposal of loan proposals, with appropriate timelines, and institute a suitable monitoring mechanism for reviewing applications pending beyond the specified period. It is, however, reiterated that there should not be any compromise on the due diligence requirements. Banks may also make suitable disclosures on the timelines for conveying credit decisions through their websites, notice-boards, product literature, etc.

Implementation of Basel III Capital Regulations in India – amendments

RBI/2014-15/201, DBOD.No.BP. BC.38/21.06.201/2014-15 dated 1 September 2014

Banks may now issue additional Tier 1 and Tier 2 capital instruments with the principal loss absorption through either (i) conversion into common shares, or (ii) a write-down mechanism (temporary or permanent) which allocates losses to the instruments.

It has been decided that

the call option on additional Tier 1 instruments (Perpetual Non-Cumulative Preference Shares and Perpetual Debt Instruments) will be permissible at the initiative of the issuer after the instrument has run for at least five years.

It has been decided that banks can issue additional Tier 2 capital instruments with a minimum original maturity of at least five years.

Limits on admitting additional Tier 1 and Tier 2 capital for the computation of Capital to Risk Weighted Asset Ratio have been withdrawn. A bank, having met the minimum capital requirements, may admit excess additional Tier 1 capital and Tier 2 capital, if any, for the purpose of computing and reporting Tier 1 and CRAR.

Banks have also been permitted to issue additional Tier 1 and Tier 2 capital instruments to retail investors, subject to investor education and protection measures.

Upper age limit for whole time directors on the boards of banks

RBI/2014-15/217, DBOD. APPT.BC.No. 40 /29.39.001/2014-15 dated 9 September 2014

It has been decided that the upper age limit for MDs and CEOs and other WTDs of banks in the private sector should be 70 years, i.e., beyond which nobody should continue in the post. Within the overall limit of 70 years, individual banks' boards are free to prescribe a lower retirement age for the WTDs, including the MD & CEO, as an internal policy.

Guidelines on willful defaulters – clarification regarding guarantor, lender and unit

RBI/2014-15/221, DBOD.No.CID. 41/20.16.003/2014-15 dated 9 September 2014

It is clarified that:

- The term 'lender' covers all banks/ FIs to which any amount is due, provided it is arising on account of any banking transaction, including off-balance sheet transactions such as derivatives, guarantee and letters of credit.
- The term 'unit' appearing therein has to be taken to include individuals, juristic persons and all other forms of business enterprises, whether incorporated or not. In the case of business enterprises (other than companies), banks/ FIs may also report (in the Director column) the names of those persons who are in charge and responsible for the management of the affairs of the business enterprise.

While dealing with the willful default of a single borrowing company in a group, the banks/ FIs should consider the track record of the individual company, with reference to its repayment performance to its lenders. However, in cases where guarantees furnished by the companies within the group on behalf of the willfully defaulting units are not honoured when invoked by the banks/ FIs, such group companies should also be reckoned as willful defaulters.

The RBI has advised that in terms of section 128 of the Indian Contract Act, 1872, the liability of the surety is co-extensive with that of the principal debtor, unless it is otherwise provided by the contract. Therefore, when a default is made in making repayment by the principal debtor, the banker will be able to proceed against the guarantor/ surety even without exhausting the remedies against the principal debtor. As such, where a banker has made a claim on the guarantor on account of the default made by the principal debtor, the liability of the guarantor is immediate. In case the said guarantor refuses to comply with the demand made by the creditor/ banker, despite having sufficient means to make payment of the dues, such guarantor would also be treated as a willful defaulter. It is clarified that this would apply only prospectively and not to cases where guarantees were taken prior to this circular. Banks/ FIs may ensure that this position is made known to all prospective guarantors at the time of accepting guarantees.

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Date	Name	Subject Line
27 August 2014	DIT (International Tax) *v.* Copal Research Limited, Mauritius [TS-509-HC-2014(Delhi)]	Delhi High Court's landmark ruling on taxation of 'indirect transfer'
18 August 2014	Ace Multi Axes Systems Ltd *v.* DCIT [TS-484-HC-2014(Karnataka)]	Deduction under section 80-IB in subsequent years allowed to an SSI post 'formative conditions'
8 August 2014	CIT *v.* Siel Limited [TS 470-HC-2014(Delhi)]	Sale of shares to JV partner at a loss is not a colourable transaction
8 August 2014	Cadbury India Limited – Company petition 1072 of 2009	Cadbury minority buyout approved
5 August 2014	Zaheer Mauritius *v.* DIT [TS-464-HC-2014(Delhi)]	Gains on sales of equity shares and compulsorily convertible debentures characterised as capital gains and not as interest income
28 July 2014	Finance (No. 2) Bill, 2014 as introduced in Lok Sabha	Finance (No. 2) Bill, 2014 passed in Lok Sabha – Changes in tax proposals explained
25 July 2014	Redington (India) Limited *v.* JCIT [TS-419-ITAT-2014(Chennai-Tribunal)]	Gift of shares in a subsidiary by a company is not regarded as transfer under section 47(iii) of the Act and hence not liable to capital gains tax
25 July 2014	PGS Geophysical AS *v.* ADIT [TS-436-HC-2014(Delhi)]	Revenue earned by a non-resident from providing seismic services taxable under section 44BB if such income is effectively connected with PE of non-resident in India
24 July 2014	F.C. Sondhi & Company (India) Pvt. Limited *v.* DCIT [TS-243-ITAT-2014(Amritsar-Tribunal)]	Insurance premium paid under a Keyman insurance policy which is not a pure life insurance policy not a deductible expense
24 July 2014	GE Energy Parts Inc. *v.* ADIT [TS-400-ITAT-2014(Delhi)]	Information on social networking site - LinkedIn, admissible as additional evidence for determination of permanent establishment
22 July 2014	Draft guidelines for Licensing of 'Small Banks' and 'Payment Banks'	Draft Guidelines for Licensing of 'Small Banks' and 'Payments Banks'
18 July 2014	DIT(IT) *v.* Mahindra & Mahindra Limited [TS-404-HC-2014(Bombay)]	A limitation period is applicable to section 201(1)/ (1A) proceedings even though no time limit is prescribed
17 July 2014	Directions for preparatory activities for proposed changes on enhancement of statutory wage limit	EPFO issues directions for preparatory activities to effect the proposed changes on enhancement of statutory wage limit from INR 6,500 to INR 15,000
17 July 2014	Notification No FEMA 308/2014 notified *vide* G.S.R No. 436(E) 30 June 2014 and AP (DIR Series) Circular 3 dated 14 July 2014	RBI recognises partly paid up shares and warrants as permissible instruments for foreign investments
15 July 2014	Notification No. FEMA 306/ 2014 notification *vide* G.S.R. No. 435(E) dated 23 May 2014	RBI amends pricing guidelines - Valuation of shares as per internationally accepted pricing methodology on arm's length basis
4 July 2014	GFA Anlagenbau Gmbh *v.* DDIT/ ADIT [TS-383-ITAT-2014(Hyderabad-Tribunal)]	Technical and supervisory services does not create a PE in the absence of an independent site operation
2 July 2014	N Ranganathan *v.* ITO [ITA No. 863/ Mds/2014]	Reinvestment of capital gain yield from sale of residential property in India to purchase residential property abroad held eligible for deduction under section 54
1 July 2014	Fine Jewellery (India) Limited *v.* ACIT [TS-371-ITAT-2014(Mumbai-Tribunal)]	Recurring expenditure incurred for 'brand building' is revenue expenditure and deductible in the year of incurrence

Glossary

AE	Associated enterprise
ALP	Arm's length price
AY	Assessment year
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)
DRP	Dispute Resolution Panel
FTS	Fees for technical services
FY	Financial year
HC	High Court
PE	Permanent Establishment
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
TO	Tax officer
TPO	Transfer pricing officer
VAT	Value added tax

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