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Contents

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Article

Taxation of foreign companies regarded as 'resident' in India

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Tax liability under the Income-tax Act, 1961 ('the Act') of any person is determined based upon his residential status. A person resident of India is taxable on his income accruing across the globe[1] while a non-resident is taxable only on the income accruing or arising or deemed to accrue or arise or is received in India[2]. Residential status of a company was historically being determined under the Act based on the test of 'control and management' being situated in India, during the 'whole' of any previous year[3]. In order to align with international best practices on taxation, the test for determination of residential status of a company was amended by the Finance Act 2017 to examine the 'Place of Effective Management' ('PoEM') is located in 'India in that year'[4]. The phrase PoEM has been defined as

> "a place where the key management and commercial decisions that are necessary for the conduct of the business of an *entity as a whole* are in substance made"

This definition is verbatim reproduction of second sentence in para 24 of the Commentary by Organisation for Economic Co-operation and Development (OECD) on Model Tax Convention.

Determination of the 'place' from where effective management is exercised

Managing the affairs of a company would involve undertaking several activities simultaneously, and in many times at different places across the globe. Broadly, based on judgments of Indian Courts[5] while interpreting erstwhile provisions of the Act and Foreign Courts[6] on interpreting provisions similar to erstwhile provisions of the Indian Act, as well as the guidance given by OECD, the following factors are useful in determining the PoEM;

a. Place where the Board Meetings are held and the business transacted by the Board
b. Categorization of the decisions taken by the Board as critical policy decisions and routine operational decisions and identifying (i) the person or the Body taking such decisions and (ii) the place where such decisions are so taken
c. Whether the Board deliberates intensively on the proposals or do they, as a formality, approve the proposals put forth before it
d. Place where the Executive Officers exercise their functions
e. Place where the accounting records are kept
f. Place where the company is incorporated and the laws of the jurisdiction on functioning of the company from a place outside the jurisdiction

[1] Section 5(1) of the Act
[2] Section 5(2) of the Act
[3] Section 6(3) of the Act, prior to amendment by Finance Act, 2016 with effect from 01/04/2017
[4] Section 6(3) of the Act, as applicable today

[5] Erin Estate v CIT [1958] 34 ITR 1 (SC), CIT v Subbiah Chettiar [1947] 15 ITR 502 (Mad), Narottam and Pereira Ltd v CIT [1953] 23 ITR 454 (Bom), CIT v Bank of China [1985]154 ITR 617 (Cal), CIT v. Bank of China 23 Taxman 46 (Cal), CIT v Chitra Palayakat Co [1985] 156 ITR 730 (Mad), to note a few
[6] De Beers Consolidated Mines Limited v Howe, [1906] A.C. 455, Unit Construction Co Ltd v Bullok [1959] 3 WLR 1022, Egyptian Hotels Ltd. v. Mitchell [1915] 6 TC 542

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Additional statutory safeguards

Apart from change brought out from examination of place of control and management to the place of effective management, the Act has also made two other significant changes in determination of residential status of a company. *Firstly*, the amended statute now explicitly provides that the test would require a 'substance' test for control as against the form in which the control is shown to be exercised. Though the amendment has only legislatively incorporated a requirement which has been emphasized by the Courts[7] over the years, in the absence of legislative mandate, every decision of Revenue Authorities in according value to substance over form were subject to challenge before a Court of law.

Additional safeguards postulated by the CBDT

The Central Board of Direct Taxes ('CBDT'), in exercise of the power vested in it to make rules for carrying out the purposes of the provisions, has issued various Circulars explaining the concept and effect of PoEM. In Circular No. 6 of 2017[8] the CBDT had issued certain administrative guidelines to the Revenue Authorities on practical aspects to be examined in determination of PoEM. A few of them include analysis of active and passive income earned by the foreign company, examination of delegated powers of the Board of Directors, etc. These guidelines, though stringent in some aspects, provide some light on a relatively new challenge being faced by foreign companies in India.

Effect of having PoEM in India

If a foreign company is regarded as a resident of India due to its PoEM being located in India, it would be subject to taxation in India on its global income. But, the computation of the taxable income is not as easily done as said. Unlike an Indian Company that regularly maintains its books in India and files annual returns in India claiming the eligible deduction, assessing the income or loss of a Foreign Company would be difficult absent any accounting records in India.

This would post practical challenges in the following aspects

a. Determination of depreciation claim for any year
b. Quantifying credit for taxes paid in the country of incorporation
c. Allowability of accumulated losses incurred in the country of incorporation
d. Treaty entitlement

Section 115JH of the Act was introduced by the Finance Act, 2017 to specifically empower the CBDT to issue guidelines on these aspects. The CBDT has accordingly issued 'draft guidelines[9]' on the entitlement of a foreign company that would be regarded as a person resident of India. The guidelines are broadly as under

(i) Allowability of depreciation

Depreciation is a deduction allowable to a person earning taxable business income. The deduction is based on various factors like cost of the asset, the use of the asset, prescribed rate of depreciation, effect of disposal of assets, etc. These facts cannot be determined or verified in the case of a foreign company which would be subject to tax in India, more so when the assets have been used by the company for many earlier years. In addition, India follows an unique system of allowing depreciation on the 'Written Down Value[10]' of a 'block of asset[11]. The CBDT

[7] [2010] [2010] EWCA Civ 778,
[8] Dated 24th January, 2017

[9] F.NO.270142/19/2017-TPL] dated 15th June, 2017
[10] Representing the original cost of the asset reduced by accumulated depreciation – See section 43(6) of the Act
[11] Representing a group assets of similar class, entitled to the same rate of depreciation – See Section 2(11) of the Act

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has decided to rely on the tax records maintained by the foreign company in its home jurisdiction and has proposed that the value on which depreciation would be allowed shall be,

(a) If the foreign company is assessed to tax in the foreign jurisdiction, the written down value (WDV) of the depreciable asset as per the tax record in the foreign country on the 1st day of the previous year shall be adopted as the opening WDV for the relevant previous year, and

(b) If the said foreign company is not assessed to tax in the jurisdiction where it is based, then WDV of the depreciable asset as appearing in the books maintained in accordance with the laws of that foreign jurisdiction shall be adopted.

Though the recommendation seems to solve many a trouble, it presupposes that the foreign jurisdiction follows the same taxation system as that of India, requiring the foreign companies to maintain records of WDV and block of assets. Many countries however do not follow this system. It is therefore expected of the CBDT to specify rules for determination of depreciation in the case of companies incorporated in countries where the concept of WDV and block of asset does not exist.

(ii) Set off of losses

Generally, tax is levied on the income of a person after allowing for set off of losses incurred in the earlier years. The CBDT proposes to allow set off of brought forward losses of the foreign company in the following manner;

(a) If the foreign company is assessed to tax in the foreign jurisdiction, its brought forward loss or unabsorbed depreciation as per the tax record shall be determined year wise on the 1st day of the previous year in which it is said to be resident in India.

(b) Where the foreign company is not assessed to tax in the foreign jurisdiction, its brought forward loss or unabsorbed depreciation as per the books prepared in accordance with the laws of that country shall be determined year wise on the 1st day of the previous year in which it is said to be resident in India.

The allowability of set off of losses would however be subject to conditions as contained in the Act, which would include provisions restricting intra head set off[12], requirements on minimum share holding[13], etc.. Here again, the CBDT has presumed that the foreign jurisdiction would have the same manner of classification of income into different heads, which does not happen in many countries. The CBDT shall have to provide for alternate mechanisms for setting off of losses in cases where the home jurisdiction of the foreign company has laws that are divergent with Indian taxing laws.

(iii) Other clarifications

India follows April to March as the tax year while countries across the globe use calendar year as their tax year. The CBDT has provided that, where the financial year of the foreign company is other than the tax year adopted by India, the foreign company has to prepare its accounts for the Indian tax year and compute its tax liability accordingly.

The CBDT has also provided that the foreign company regarded as being resident of India will be entitled to credit for taxes paid in other

[12] See section 71 of the Act
[13] See Section 79 of the Act

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countries in accordance with the Double Taxation Avoidance Agreement entered into by India with the country of source of income, and where no such agreement exists, in accordance with the Act.[14]

The CBDT has sought to clear the air on determining the tax liability of a foreign company being regarded as resident of India due to the new PoEM rules. However, regulations are required on much larger aspects and scope, which are still awaited from CBDT.

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Notification

Method of valuation of unquoted equity shares notified

By way of Notification No.61/2017 dated 12-7-2017, the final rules providing method of valuation of unquoted equity shares applicable in relation to assessment year 2018-19 onwards have been notified. As per the new Rule 11UAA of the Income Tax Rules, 1962 the value of unquoted shares for the purpose of Section 50CA of the Income Tax Act would be determined in the manner provided in Rule 11UA of the IT Rules. In terms of the newly substituted sub-clause (b) of Rule 11UA, the value of certain asssets, namely jewellery, artistic work, immovable property, shares would be taken at fair market value and not at book value as earlier provided. The fair market value of unquoted shares is calculated by determining the difference between value of assets and liabilities as per Rule 11UA, divided by the total amount of equity capital shown in the balance sheet and multiplied by the paid up value of such equity shares. *(Kindly refer to Tax Track No.8 dated 17-7-2017 for details)*

Certain amendments and clarifications in respect of cash transactions

By way of Notification No. 58/2017 dated 3-7-2017 certain amendments have been made in Form 3CD to report particulars of transactions covered by Section(s) 269SS, 269T pertaining to acceptance of loans and deposits and their repayment.

Section 269ST mandates that no person shall receive an amount of two lakh rupees or more in aggregate from a person in a day, in respect of a single transaction or in respect of transactions relating to one event or occasion from a person otherwise than by cheque or bank draft or electronic clearing. Circular No. 22/2017 dated 3-7-2017 clarifies that in respect of receipt in the nature of repayment of loan by NBFCs or HFCs, the receipt of one instalment of loan repayment in respect of a loan shall constitute a 'single transaction' as all the instalments paid for a loan shall not be aggregated for the purposes of determining applicability of the provisions of Section 269ST.

14 Section 91 of the Act

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Ratio Decidendi

Service PE can be created even without satisfying the threshold for physical presence

The assessee provided certain services including advise on security, risk review, development of occupational health safety systems, development of regional training programmes etc., under a service agreement. The services were provided to group entities in India, Middle East and Africa. The assessee contended that there was no specific clause in the India-UAE DTAA to tax these services of managerial nature as FTS and such services did not satisfy the definition of royalty either. The ITAT held that since the AE had not produced a valid certificate of residence, it was not eligible for treaty benefits. It then rejected the contentions that the payment received was not taxable as royalty and that since the assessee did not have a PE in India, the payment could not be taxed as other income. The ITAT in this regard was of the view that since services were rendered by the assessee over phone, mail etc., even though three employees of the assessee had stayed only for 25 days, a PE would be created if the assessee rendered service for nine months in a twelve month period. Further it went on to hold that the payment received for providing the services was taxable as royalty since it was for use of or right to use industrial, commercial information. The ITAT opined that the information shared was of such nature that it was not available in the open market and it contained IPRs which continued to be with the assessee. [*ABB-FZ LLC* v. *DCIT, IT(TP)* No.1103/Bang/2013, IT(TP) No. 304/Bang/2015, ITAT Bengaluru, Order dated 21-6-2017]

Keeping shares in escrow account can be treated as transfer for levy of capital gains

The assessee company, consequent to a family settlement sold shares that it held in a company , the effective control of which was the subject matter of the family settlement, and realised gains on the transfer. The assessee argued that the said gains would not amount to capital gains since the same were on account of family settlement. This argument was not accepted since the assessee was a separate legal entity whose shareholders only were party to the settlement and not the assessee itself. During the appeal before the High Court, a direction of remand was issued for computing the cost of shares. During the remand proceedings, the assessee took a new ground that the shares were only kept in an Escrow account and thus the same cannot be construed to be a valid transfer. It was held that, in a remand proceeding, the authority is bound to strictly go by the remand directions and there is no power to adjudicate any new ground which is beyond the scope of the remand. The Tribunal also opined that by depositing the shares in an Escrow account, the assessee ceased to have control or possession of the shares, thus alienating ownership in such shares and such alienation of interest would amount to transfer within the meaning of Section 2(47) of the IT Act. [*Mangala Investments Limited* v. *DCIT*, TS-245-ITAT-2017-Bang]

No ALP adjustment to be made where AMP expenses solely benefitted India brands

The assessee is engaged in the business of processing, bottling and selling IMFL. It incurred advertisement, marketing and promotion (AMP)

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expenses in order to promote sale of brands which were owned by the AE. The TPO held that the AMP expenses would have to be apportioned between the AE and the assessee since the incurring of these expenses in turn promotes the brand of the AE. The ITAT however observed that factually brands for which AMP expenses were incurred were India brands and these brands were not sold outside India. It was hence held that the expenditure incurred is solely related to the Indian market and no attribution to the AE is required to be made. [*Pernod Ricard* v. *DCIT*, [2017] 82 taxmann.com 204 (Delhi - Trib.)]

Transfer of divisions not constituting demerger - Carry forward of loss not denied to existing company

The assessee-company had three divisions namely, Petro Chemical division of Polymer (PCD), Rubber Chemical Division (RCD) and the Plastic Product Division (PPD). A scheme of demerger was proposed under Sections 391 to 394 of the Companies Act, 1956, which was approved by the High court. As per the arrangement specified assets and liabilities of the PCD and PPD divisions were transferred to Relene Petrochemicals and NOCIL Petrochemicals respectively. Movable and immovable properties and liabilities of the PCD and PPD divisions which were not transferred to Relene Petrochemicals and NOCIL Petrochemicals continued to belong and remain vested with the assessee. The issue before the Tribunal was whether the accumulated loss and unabsorbed depreciation pertaining to the PCD and PPD divisions could be allowed to be carried forward and set off in the hands of the assessee. The Tribunal affirmed the Order of the CIT(A) holding that the transfer of divisions in the present case does not constitute demerger as defined in Section 2 (19AA) since only specified assets and liabilities were transferred and Relene and NOCIL Petrochemicals did not satisfy the definition of resulting companies. Therefore, accumulated loss and unabsorbed depreciation relating to the transferred divisions would remain with the assessee for set off and carry forward for set-off in future years. [*DCIT* v. *NOCIL Ltd.*, (2017) 82 taxmann.com 267 (Mumbai-Tribunal)]

Section 14A read with Rule 8D is applicable even when no expenditure is incurred

The assessee, made certain investments before the start of his business 'management consultation'. In the assessment year under consideration the assessee had not made any investment yielding exempted income and not incurred any expenditure to earn exempt income. The issue before the Tribunal was whether Section 14A read with Rule 8D (2) (iii) is applicable to the instant case. The Tribunal held that even in case where the assessee claims that no expenditure was so incurred, the statute has provided for a presumptive expenditure which had to be disallowed by force of the statute. Further, the Tribunal observed that Section 14A (3) creates a deeming provision. When such deeming provision is made based on statutory presumption, the requirement of factual evidence is replaced by statutory presumption and the Assessing officer has to follow the consequences. It means that even in a case where no expenditure is stated to have been incurred, the assessing authority must apply Rule 8D. [*Mr. M. A. Alagappan* v. *ACIT* (TS-244-ITAT-2017 (CHNY)]

Section 115JB insulated from disallowance under Section 14A

The issue before the Tribunal was whether the expenditure incurred to earn exempt income computed under Section 14A could be added while computing book profit under Section 115JB of the Income Tax Act, 1961. The Assessee placing reliance on the decision of the Apex

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Court in the case of *Ajanta Pharma Ltd* v. *CIT* (327 ITR 305) contended that:

a. Section 115JB is a complete code in itself and it overrides all other provision of the Act.

b. Section 115JB by a deeming fiction deems book profit as the total income of the assessee at variance with the income computed under the normal provisions of the Act.

c. Section 115JB of the Act does not authorize the AO to go beyond the audited financial statement of the Assessee.

The revenue contended that Section 14A read with Rule 8D must be read into clause (f) to Explanation 1 to Section 115JB (2) while computing book profit under MAT provisions. The Tribunal however held that Section 115JB is a complete code in itself. It was held that Chapter XII B provides alternate scheme for computing tax liability of certain companies, whose total income under normal provisions is below the threshold book profit as prescribed under Chapter XII B. The question was answered in favour of the assessee by holding that the computation under clause (f) to Explanation 1 to Section 115JB (2) is to be made without resorting to the computation as contemplated under Section 14A read with Rule 8D of the Income Tax Rules 1962. [*ACIT* v. *Vireet Investment (P) Ltd* (2017) 82 taxmann.com 415 (Del-Tri)(SB)]

Amnesty scheme covers penalty imposed dehors assessment proceedings

Penalty had been imposed on the assessee for non-compliance of provisions of Section 269SS, 269T and 285B of the Income Tax Act. While the appeal filed by the assessee before the CIT(A) was pending, the assessee sought to settle the issue under the Direct Tax Dispute Resolution Scheme 2016 (Amnesty Scheme) and filed declaration before the designated authority. Under the DTDR an assessee can settle the tax arrears by paying, in case of disputed penalty, 25% of the minimum penalty levied along with tax and interest. If the application by a assessee under the said scheme was considered, then all appeals with regard to the tax issue would be withdrawn. The declaration filed by the appellant in the instant case was rejected on the ground that only penalty that was linked to total income finally determined can be covered under the Scheme. The High Court observed that the scheme itself specifically provided for scenario where the tax arrears relates only to penalty. It held that the condition that the tax and interest should also be collected cannot be taken to penalty imposed consequent to an alteration in total income and that it should be covered under the Scheme. [*Grihalakshmi Films* v. *JCIT* [TS-251-HC-2017 (Ker)]

Penalty not imposable on interest as same not covered under “tax in arrears”

The High Court in a recent decision has held that penalty imposed under Section 221(1) would not include interest component and cannot exceed the amount of tax in arrears. The moot question before the Hon’ble court was whether the phraseology “amount of tax in arrear” as envisaged in Section 221 will include interest also. Relying on Section 156, it was held that tax, interest and penalty are separate components and that under no principle of interpretation sub-section 2 of Section 221 would include amount of interest payable. It was observed that the definition of tax under Section 2(43) did not include interest component. Reliance was also placed on decision of Harshad Shantilal Mehta v. Custodian & others. [*CIT* v. *Oryx Finance & Investment Pvt. Ltd.*, ITA No. 1 of 2015, Bombay High Court]

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