Lakshmikumaran & Sridharan
tax

Direct Tax amicus

An e-newsletter from
Lakshmikumaran & Sridharan, India

September 2016 / Issue–26

Contents

September
2016

Article

Spending less than ALP can also have adverse implication!

By **Sumeet Khurana**

Introduction

A person resident of India under the Income-tax Act, 1961 ('the IT Act') is liable to tax in India on his global income[1]. The resident, when transacting with its Associated Enterprise (AE) is obliged to offer to tax, the income arising from such international transaction, as *computed* having regard to Arm's Length Price[2] (ALP).

A person who is a non-resident of India is subject to tax in India (a) on receipt of income in India (b) on actual accrual of income in India and (c) on deemed accrual of income in India[3]. If the income taxable in India is earned by him from his AE then, the non-resident is also obliged to comply with Indian Transfer Pricing (TP) Regulations. While the requirement of compliance with transfer pricing regulations by all the AEs involved in a transaction has been a subject matter of intense debate and practically, many foreign AEs do not comply with TP regulations in India, a recent ruling of a Special Bench of Kolkata Tribunal emphasises the requirement of compliance with Indian TP regulations by non-residents even where they do not receive any income because of their relationship with Indian AE.

Background of the issue

As per the facts of the recently reported tax ruling[4] a non-resident entity provided interest free loan to its Indian subsidiary. Had it charged some interest, the same would have been chargeable to tax in India either on account of actual accrual or deemed accrual and the issue would have been limited to its arm's length nature. A question arose as to whether the non-resident entity is obliged to offer to tax an arm's length interest income even when the loan is extended without any interest. The Special Bench of Income Tax Appellate Tribunal, Kolkata held that an arm's length interest has to be taxed in India in such a case.

The facts of another taxpayer, who was an intervener before the Special Bench, involved payment of fee to its AE for receiving technical services. During the transfer pricing assessment of the resident AE, the amount of payment for services was found to be lower than the permissible range under ALP rule. The tax officer held that differential amount is taxable in the hands of non-resident AE under source rule and accordingly enhanced the income of non-resident AE, without of course granting a higher deduction to Indian payer.

This fact situation would prevail in many transactions entered into by a person resident

1 Section 5(1) of the IT Act

2 Section 92 of IT Act

3 Section 5(2) of the IT Act

4 *Instrumentarium Corporation Limited* v. *ADIT*, Kolkata [2016] 71 Taxmann.com 193 (Kol SB)

of India with its AE hence this decision is of immense significance in Indian TP landscape. The present article seeks to discuss the arguments from both sides, kinds of transactions that could be affected by this ruling and the approach that needs to be adopted by taxpayers going forward.

Taxpayer's arguments

In this ruling the taxpayer took following arguments:

a) Payment by Indian entity of an arm's length interest would have resulted in erosion of Indian tax base. Quantum of tax impact (loss to Indian revenue) by claiming interest expense is higher than the tax impact (gain to Indian revenue) on the imputed interest income. Hence it is not in the interest of Indian tax administration to insist on payment of interest.

b) Indian TP regulations apply only on the income arising (or expense incurred) in a transaction with AE. It cannot be applied where no income has actually arisen. This argument was supported by the famous decision of Vodafone[5] wherein receipt of share premium was held to be outside the domain of TP regulations as no income arises on account of issue of shares at premium.

Tribunal's observations

Tax Tribunal rejected the above contentions holding that it is not required to examine the tax impact on an aggregate basis by netting of the gain on taxing arm's length interest with loss on granting interest deduction. Apparently, to some extent at least, the tribunal was influenced by the fact that Indian taxpayer was incurring losses and there would not have been any loss to revenue on enhancing this loss in a situation of claiming interest deduction. On a plain reading of statute, the Special Bench of the Tribunal held that the non-resident AE of an international transaction would also be subject to Indian Transfer Pricing regulations and accordingly concluded that the non-resident AE would be subject to tax in India on the income that would have accrued to him, even if it was not actually accruing or received. The Special Bench of the Tribunal also held that the Indian Tax Authorities are however not obliged to grant a deduction of interest as the same was not claimed in books of account, absent an actual payment[6].

Other possible arguments

There can be other arguments to support the position adopted by taxpayer which have not so far been explored in Indian courts.

Domestic TP legislation is narrower in scope than tax treaty

Article 9 of the tax treaties between India and other countries is typically founded on OECD Model. That Article is worded to cover all kinds of situation wherein the tax base is eroded due to relationship between transacting entities.

5 *Vodafone India Services (P) Ltd.* v. *Union of India* 228 Taxman 25 (Bom HC)

6 It can also be noted that section 92(3) of IT Act specifically prevents a downside adjustment of profits by applying ALP principle

This is because of usage of catch-all phrase "any profits which *would, …., have accrued* to one of the enterprises,..". In contrast, the provision of Indian TP regulations read as "Any income *arising* from an international transaction shall be *computed* having regard to the arm's length price" and thus can cover only an income 'arising' not that could have arisen but for the relationship. Further, its scope is restricted to computation and no deeming fiction is built in law to deem the shortfall from ALP as resulting in accrual of income.

Transfer Pricing provisions of Treaty is narrower in coverage as against domestic TP legislation

While this issue has been debated extensively by international tax experts yet there does not seem to be any authoritative conclusion on this. Some scholars are of the view that owing to use of word 'profit', the scope of Article 9 is confined to such other articles using the same word. In contrast, the Articles that use the word 'income' or 'gain' are immune from operation of Article 9. This proposition needs to be tested in Indian courts.

Further arguments can be explored depending on the facts of a particular case.

Impact

Several kinds of transactions are undertaken between Indian entities and their overseas entities which if revisited in the context of this recent ruling would require reconsideration of the tax positions taken. These would include:

- Sending expatriates to India
- Allowing the Indian AE to use same trade-mark, brand-name without any license fee
- Rendering some administrative assistance to newly set-up subsidiaries without any cross charge. This usually happens, as subsidiary may not have financial capability to make payment in initial years of its set-up

To elaborate a bit, if expatriates are sent to work in Indian subsidiaries, a consideration for that, if charged, could be taxable in India as fees for technical services ('FTS'). FTS is taxable in India on source basis. Tax is levied on gross basis, usually at 10%. Sometimes the cost of expatriates is reimbursed by Indian entity without a mark-up. Such structures would now be questioned by tax authorities. Thus one needs to review existing positions in this regard.

Way forward

Considering the potential risk this ruling can have, one needs to undertake a holistic review of its tax positions. It would thus be a good idea to:

a) Carry out a detailed exercise of discovering transactions with AEs that are not being captured in financial books currently (e.g. use of trade-mark etc).

b) Review the current margins /prices and evaluate the transactions wherein payment is significantly lower than ALP.

c) Examine the tax impact of restoring current transaction prices / margins within the permissible range of deviation[7].

d) Evaluate the potential exposure to past transaction and evolve a strategy for dealing with past.

e) Decide a future course of action considering the above as well as BEPS Action Plans.

[The author is a Director, Direct Tax Practice, Lakshmikumaran & Sridharan, Bangalore]

Notifications and Circulars

Income Declaration Scheme, 2016 – Certain clarifications

CBDT has clarified (Circular No. 32/2016 dated 01.09.2016) that whenever in course of search under Section 132 or survey operation under Section 133A of Income Tax Act, 1961, any document is found as a proof for having already filed a declaration under the scheme, no enquiry would be made by the Income-tax Department in respect of sources of undisclosed income or investment in movable or immovable property declared in a valid declaration made in accordance with the provisions of the Scheme.

Acceptance of cash over the counter

In view of the Income Declaration Scheme, 2016, RBI has *vide* RBI Circular no. 13/09.07.005/2016-17 dated 08.09.2016 advised that all banks must accept cash, irrespective of the amount, over the counters from all declarants who desire to deposit cash at the counters, including deposit through challans ITNS-286.

Lenient view of application for waiver or reduction of penalty

As per the Income Declaration Scheme, 2016, an assessee is not eligible to file declaration for the years for which a notice under Section 142(1), 143(2) or 148 has been received. In order to provide relief to the assessees making declaration, CBDT has exercised power under Section 119 of the Income Tax Act, 1961 and by way of Circular No. 34/2016 dated 21.09.2016 ordered the Commissioners and Principal Commissioners of Income Tax to take lenient view in cases where the assessee has made declaration under the scheme for an year but could not make such declaration for other years owing to the notice under Section 142(1), 143(2) or 148. In such cases, assessees would be required to make an application to the CIT or Pr. CIT to exercise their powers under Section 273A of Income Tax Act, 1961 and to reduce or waive penalty on an application made by the assessee.

Streamlining the process of No Objection Certificate (NOC), Port Clearance Certificate (PCC), Voyage Return and Assessment in case of Foreign Shipping Companies

Section 172 of Income Tax Act, 1961 is a self-contained code which provides scheme of taxation of foreign shipping company. As per the provisions of this section, the income of a

[7] Presently, Indian TP regulations mandate no adjustment if the international transaction is undertaken within 35th percentile to 65th percentile of the dataset subject however to certain conditions [See Rule 10CA of Income Tax Rules, 1962]

foreign shipping company from a ship carrying passengers, livestock mail or goods shipped at a port in India is deemed to be seven and a half per cent of the amount paid or payable on account of carriage to the owner of the ship. It is further provided that the Customs Authorities shall not grant the Port Clearance Certificate unless the tax payable under section 172 has been paid or satisfactory arrangements for payment of such tax has been made. However, there are cases where the foreign shipping company is a resident of a country with which India has a DTAA, wherein the taxing rights on shipping income vest solely with such country.

In this regard, CBDT had issued circular no. 732 dated 20.12.1995 to do away with the procedural requirement of obtaining No Objection Certificate (NOC) for each voyage in cases where shipping income is not taxable in India by virtue of DTAA. As per this circular, jurisdictional AO's were authorized to issue annual NOC in such cases. However, owing to the diverse practices followed by the Port Assessing officers in issuing annual NOC's and making assessments for voyage returns, CBDT has now issued Circular No. 30/2016 dated 26.08.2016 stating that issuance of Voyage NOC and Annual NOC shall be dealt as follows:

(i) *Cargo belonging to single foreign company whose income is not taxable in India:* In cases where the cargo belongs to a single foreign company which is entitled to full DTAA relief, annual NOC will be issued by AO and no separate voyage NOC will be required.

(ii) *Cargo belonging to various foreign companies, each belonging to a country with full DTAA relief:* In cases where the cargo belongs to multiple foreign companies, each being entitled to full DTAA relief and to each annual NOC has been issued by their jurisdictional AO, no separate voyage NOC will be required. However, in order to facilitate verification by the Custom Authorities a certificate from a Chartered Accountant is required to be filed by the master of the ship before concerned Custom Authorities.

(iii) *Case other than (i) & (ii):* In any other case, the Master of the ship would be required to obtain a voyage NOC from the officer having jurisdiction over the port.

DTAA with Republic of Maldives - Avoidance of double taxation of income derived from air transport

An agreement has been signed between Government of India with Republic of Maldives for avoidance of double taxation of income derived from air transport on 11.04.2016 at New Delhi. The provisions of the said Agreement shall have effect in India in respect of income derived in the fiscal year beginning 01.04.2017. Notification No. 77/2016 dated 02.09.2016 has been issued in this regard.

Rescinding notification conferring benefits under Section 35(1)(ii)

Vide Notification no. 78/2016 and 79/2016 dated 06.09.2016 and 82/2016 dated 15.09.2016 the central government has rescinded benefits given to certain institutes under Section 35(1)(ii) of Income Tax Act, 1961 (scientific institutes) with retrospective effect from the day such registration was granted.

Ratio decidendi

Specific projects within a housing project can avail deduction under Section 80 IB

The taxpayer is a public limited company which is engaged in the business of real estate development and construction of residential/ housing projects. The taxpayer claimed deduction for three consecutive years under Section 80IB (10) of the Act with respect to two specific identified projects out of the entire housing project carried by it in Noida and Greater Noida. Section 80 IB provides for deduction in respect of profits and gains from certain industrial undertakings other than infrastructure development undertakings.

The Assessing officer denied deduction under Section 80 IB for the reason that the housing project must be considered as a whole unit as approvals are granted by the local authority treating it to be a single unit and just because some projects inside the housing projects satisfied the conditions stipulated under Section 80IB, the same cannot be severed and granted benefit of the Section. On appeal, the High Court held in favour of the taxpayer by concurring with the order of CIT (A) and ITAT for the reason that the term 'housing project' is not defined in the Act and therefore giving its ordinary meaning, the real estate development which on a standalone basis is complete in all respects i.e. which includes dwelling units, the necessary infrastructure, common areas and common facilities for the resident of the dwelling units would constitute a housing project for the purposes of Section 80IB. Hence, deduction was held to be allowable under Section 80IB for the two specific identified projects within the housing project. [*Principal Commissioner of Income Tax* v. *Omaxe Buildhome P. Ltd* [ITA Nos. 327-329 of 2016] (Delhi High Court)]

Employees' contribution to PF deposited after statutory due date but before filing return – Deduction to be allowed

The taxpayer is a public sector undertaking of Government of Bihar which is engaged in the business of warehousing. During the relevant assessment year under question, the Assessing officer disallowed the employee's contribution to Provident Fund made after the statutorily prescribed due date under Section 43B and treating the same as income from other sources as per Section 2(24)(*x*) read with Section 36(1)(va). The Hon'ble High court held that employees' contribution and employers' contribution should be treated on an equal footing by placing reliance on the Apex Court decision in the case of *CIT* v. *Alom Extrusions* (2009) 319 ITR 306 and therefore Section 43B is applicable even in case of employees contribution. The Court further held that re-characterization of employees' contribution as 'income from other sources' is not permissible under law. [*Bihar State*

Warehousing Corporation Ltd v. *CCIT & DCIT,* MA No. 302 of 200, Patna High Court, decision dated 16-3-2016]

Disallowance due to failure to deduct tax at source from payment to non-resident – Amendment effective from AY 2006-07

The taxpayer had made certain payments to a contractor during the previous year ending on 31st March 2005 without deducting tax at source. Section 40 (a) (ia) was introduced vide Section 11 of the Finance Act, 2004 to bring parity between tax deductibility of the payments made to a non-resident or a foreign company and that of payments made to residents and received President's assent on 10th of September 2004. Sub-section 2 of Section 1 of the Finance Act provided that Section 2 to 65 shall be deemed to have come into force on 1st day of April, 2004. However. Section 11 of the Finance Act, 2004 provided that the same shall come into effect on 01st April 2005. In this background, the substantial question of law before the Hon'ble High Court was whether the payments made to the Contractor is a deductible expenditure or in other words whether Section 40(a)(ia) is applicable from AY 2005-06 or FY 2005-06. The Hon'ble High Court held in favour of the taxpayer by stating that Section 40 (a) (ia) is only applicable from FY 2005-06 and therefore the payment made to the contractor is an allowable expenditure for the reason that the taxpayer could not have foreseen prior to 10th September 2004 that any amount paid to a contractor without deducting tax at source was likely to become non-deductible under Section 40.[*PIU Ghosh* v. *DCIT*,ITA No. 191 of 2009, Calcutta High Court Order dated 12-7-2016]

Expenditures prohibited under the IMC Regulations liable to be disallowed vide Explanation to Section 37(1)

The taxpayer incurred certain expenditures for (i) sponsoring doctors and their spouses for a tour abroad and (ii) distribution of free medicine samples to doctors and claimed the said expenditures as deduction under Section 37(1), being wholly and exclusively incurred for the purpose of the business of the taxpayer. The taxpayer's contention, with respect to the travel sponsorship was that the said expenditure was incurred to build relationship with doctors and they may prescribe the medicines. However, it could not prove that the expenses were incurred wholly for business purposes. With respect to physician samples, the taxpayer contended that the same was incurred to test the efficacy of the medicine, however no supporting evidences to the effect were produced. Upon examining the facts, the ITAT held that such expenditure would be hit by explanation to Section 37(1), by virtue of the prohibition in the Indian Medial Council (IMC) (Professional conduct, Etiquette and Ethics), Regulations, 2000 for a physician to accept any gifts, gratuity, commission or bonus for referring a patient (also refer Circular No. 05/2012 dated 05.08.2012). The ITAT, in the context of physician samples noted that where such samples are given before the introduction of the drug, the same would be allowable as a deduction. However, distribution of such samples as a means for sales promotion would be impermissible under IMC Regulations and hence not allowable as a deduction. [*Assistant Commissioner of Income Tax (Circle 6(3), Mumbai* v. *Liva Healthcare Limited)* I.T.A.No.904/Mum/2013), ITAT, Mumbai order dated 12-9-2016]

Call option is a capital asset when the rights in shares are in effect delineated for perpetuity

The taxpayer, a tax resident of Singapore held certain shares in an Indian company, 'A'. By virtue of an agreement, taxpayer granted call options to a Mauritian entity 'B' to purchase the shares held by the assesse in A. The call option, under the agreement was valid for a period of 150 years with a strike price at USD 1 per share, amounting in all to USD 24,50,000. Simultaneously, an irrevocable PoA was also executed by the taxpayer in favour of another entity 'C' in respect of all the shares held by the taxpayer in 'A', thus alienating the substantive and valuable rights as an owner of the shares for perpetuity (150 years) without alienating the shares itself. The ITAT held that, under the said facts, the agreement cannot be seen as a granting a call option simplicitor and that in the peculiar facts of the case, the valuable and substantive rights in shares would be capital assets in itself and parting with such rights would be transfer of an asset under Section 2(47) and hence would be taxable under the head 'Capital Gains'. The ITAT however added that by virtue of Article 6 of the DTAA between India and Singapore, such gains will not be taxable in the contracting state in which the alienator is resident, which, in this case was Singapore. [*Praful Chandaria* v. *Additional Director of Income Tax* (ITAT, Mumbai) [2016] 73 taxmann.com 14]

Mere passing of project specific drawings and designs does not amount to making available technical knowledge, know-how or process and no TDS was deductible for any payments made for the purpose.

The taxpayer, desirous of developing an SEZ entered into an agreement with a US company to provide services in connection to examining the site development requirements and providing conceptual designs and drawings and a final site plan of the main building, open space, parking etc. The payments made by the taxpayer were disallowed by the AO for non-deduction of tax, holding the payments to be in the nature of fee for technical services. The Pune Bench of the ITAT held that the payments made to the US Company would not fall within scope of expression 'fee for included services' under Article 12(4) of the DTAA between India and USA. The ITAT observed, in this case, that there was no transfer of any technology, technical know-how, skill or process by the US company and that mere passing of project specific architectural designs and drawings in a CD did not amount to 'making available' technical knowledge, know-how or process to fall within the ambit of Article 12(4). [*Gera*

Developments (P) Ltd v. Deputy Commissioner of Income-tax, (International Taxation-I), ITAT Pune, [2016] 72 taxmann.com 238]

Aggregation of the credit transaction with the underlying transaction of rendering of services for determination of ALP

The taxpayer rendered certain services to it's AE and had extended credit facility to the AE without charging Interest. The AO considered the same as international transaction and akin to a working capital funding and applied the rate of interest on unrated bonds to compute arm's length interest income and the same was added to the income of the taxpayer. The Bangalore Bench of the ITAT, following the Bombay High Court judgment in *CIT* vs. *Indo American Jewellery Limited* [2014] 44 taxmann.com 310 (Bom) held that the transaction of extending credit is a closely linked transaction with the transaction of providing services and cannot be treated as an individual transaction but must be clubbed with the original transaction for the purpose of determination of ALP. [*Tally Solutions Pvt. Ltd.* v. *ACIT I.T. (T.P)* A. No.1364/ Bang/2011, ITAT, Bangalore decision dated 20-8-2016]

NEW DELHI
5 Link Road, Jangpura Extension,
Opp. Jangpura Metro Station,
New Delhi 110014
Phone : +91-11-4129 9811

B-6/10, Safdarjung Enclave
New Delhi - 110 029
Phone : +91-11-4129 9900
E-mail : lsdel@lakshmisri.com

MUMBAI
2nd floor, B&C Wing,
Cnergy IT Park,
Appa Saheb Marathe Marg,
(Near Century Bazar)Prabhadevi,
Mumbai - 400025.
Phone : +91-22-24392500
E-mail : lsbom@lakshmisri.com

CHENNAI
2, Wallace Garden, 2nd Street
Chennai - 600 006
Phone : +91-44-2833 4700
E-mail : lsmds@lakshmisri.com

BENGALURU
4th floor, World Trade Center
Brigade Gateway Campus
26/1, Dr. Rajkumar Road,
Malleswaram West, Bangalore-560 055.
Ph: +91(80) 49331800
Fax:+91(80) 49331899
E-mail : lsblr@lakshmisri.com

HYDERABAD
'Hastigiri', 5-9-163, Chapel Road
Opp. Methodist Church,
Nampally
Hyderabad - 500 001
Phone : +91-40-2323 4924
E-mail : lshyd@lakshmisri.com

AHMEDABAD
B-334, SAKAR-VII,
Nehru Bridge Corner,
Ashram Road,
Ahmedabad - 380 009
Phone : +91-79-4001 4500
E-mail : lsahd@lakshmisri.com

PUNE
607-609, Nucleus, 1 Church Road,
Camp, Pune – 411 001.
Phone : +91-20-6680 1900
E-mail : lspune@lakshmisri.com

KOLKATA
2nd Floor, Kanak Building
41, Chowringhee Road,
Kolkatta-700071
Phone : +91-33-4005 5570
E-mail : lskolkata@lakshmisri.com

CHANDIGARH
1st Floor, SCO No. 59,
Sector 26,
Chandigarh - 160026
Phone : +91-172-4921700
E-mail : lschd@lakshmisri.com

GURGAON
OS2 & OS3, 5th floor,
Corporate Office Tower,
Ambience Island,
Sector 25-A,
Gurgaon- 122001
Phone: +91- 0124 – 477 1300
Email: lsgurgaon@lakshmisri.com

ALLAHABAD
3/1A/3, (opposite Auto Sales),
Colvin Road, (Lohia Marg),
Allahabad -211001 (U.P.)
Phone : +0532 – 2421037, 2420359
Email: lsallahabad@lakshmisri.com

INTERNATIONAL OFFICES :

LONDON
Lakshmikumaran & Sridharan Attorneys (U.K.) LLP
Octagon Point,
St. Paul's,
London EC2V 6AA
Phone : +44 20 3823 2165
E-mail : lslondon@lakshmisri.com

GENEVA
Lakshmikumaran & Sridharan SARL
35-37, Giuseppe Motta
1202 Geneva
Phone : +41-22-919-04-30
Fax: +41-22-919-04-31
E-mail : lsgeneva@lakshmisri.com

www.lakshmisri.com **www.gst.lakshmisri.com** **www.lakshmisri.ch**

www.addb.lakshmisri.com **www.lakshmisri.cn**