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Article
Month-end provisions and reversal – Is TDS called for? 2

Notifications and Circulars 5

Ratio Decidendi 6

News Nuggets 10

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Article

Month-end provisions and reversal – Is TDS called for?

By **Rajat Juneja**

Problem Statement

Multi-national enterprises (MNEs) do make monthly provision for various expenses in their ERP system at the end of each month. This might be a nearer approximation of the expenditure to be incurred. It is a method of generating a debit entry in the accounting system for an expenditure relating to, say, engineering, R&D, logistics, legal & professional charges or administrative expenses – based on their monthly budgeting process.

This is done primarily for two reasons:

1) The parent company ought to know the true and fair view of the profit or loss earned during the respective month/quarter/half year or on an annualised basis.

2) To amortise a provision for big ticket expense, which is budgeted and is accrued or is incurred over a period of time.

Accrual being one of the fundamental accounting assumptions requires that the provisions for expenses are recorded, as and when they are incurred or accrued.

AS-29[1] attempts to distinguish 'provisions' with 'contingent liabilities' and provides that 'provisions' are present obligations, i.e., its existence is considered probable (more likely than not), while 'contingent liabilities' are possible obligations, i.e., its existence is considered not probable.

Typically, such provisions are made on the last date of the every month, quarter or half yearly or annually, as the case may be, and usually reversed on the first day of the subsequent month /quarter / half year or year respectively. Usually, such provisions are made on estimated basis or on historical data base available in some cases.

The tax deduction provisions require that the payer should deduct taxes at source at the time of payment or credit to the account of payee, whichever is earlier. Further, it also provides that if the relevant amount is credited to a '*suspense account*' or '*any other account*' by whatever name called, even then it calls for deduction of tax at source.

Of late, the issue that whether the payer should be treated as '*assessee in default*' under section 201(1) of the Act[2] for not deducting tax at source on the year end provisions and whether the interest under section 201(1A) of the Act is leviable in such cases, has gained significance. Perplexed and wary of such situations, the payers' are taking varied stands.

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[1] 'Accounting Standard – 29' on 'Provisions, Contingent Liabilities and Contingent Assets' issued by ICAI

[2] Income Tax Act, 1961

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Legal framework

The crucial words in all the respective provisions relating to tax deduction at source are '*at the time of credit of such income to the account of payee or at the time of payment thereof........ whichever is earlier*'.

Thus, where such sum is (a) paid to the account of payee or (b) liability in respect thereof is booked with a corresponding credit to the account of payee, whichever is earlier, the obligation to deduct tax will trigger at that point of time.

Tax deduction was circumvented by large number of payers by adopting device of crediting the sum to 'suspense account' and it was easier for the payers in such cases to take a stand that though the liability was booked, so far as it was not credited to the account of the payee, tax thereon was ought not to be deducted. With a view to plug that loophole the Finance Act, 1987 first introduced the Explanation in section 194A of the Act to provide that, *"where any income by way of interest is credited to any account, whether called 'Interest payable account' or 'Suspense account' or by any other name in the books of account of the person liable to pay such income, such crediting shall be deemed to be the credit of such income to the account of the payee........."*

Similar amendment was later brought at relevant places in some of the other tax deduction provisions as well. Since then, the issue has been a subject matter of big dispute and there has been contradictory ruling on this aspect. Let us have a look at the key findings of some of these rulings.

Pfizer' case[3] - The provision for expenses was made without crediting the same to the accounts of the respective payees. The payer disallowed the entire expenditure in respect of the said provision under section 40(a)(i) and 40(a)(ia) of Act. In the next year the entire provision for expenses was reversed and the actual amounts paid to the respective payees were credited to their respective accounts after deducting tax thereon. On these facts, the Tribunal held that (a) as the payees were not identifiable, the tax deduction provisions were not applicable, the whole scheme of tax deduction is based on the assumption that the payer knows the identity of the payee, and (b) once the amount has been disallowed under section 40(a)(i) of the Act, it cannot be again subjected to deduction of tax.

IBM's case[4] - On similar set of facts, as stated in Pfizer's case *(supra)*, the Tribunal held that, (a) once there is a disallowance under Section 40(a)(i) and 40(a)(ia) of the Act, it is not possible to argue that there was no liability to deduct tax at source, (b) it is clear from the statutory provisions that the liability to deduct tax at source exists when the amount is credited to a '*suspense account*' or any other account by whatever name called, which will also include a '*provision*' created in the books of accounts,

[3] *Pfizer Ltd.* v. *ITO* (2013) 55 SOT 277 (Mum Trib.)

[4] *IBM India (P.) Ltd.* v. *ITO* (TDS) (2015) 59 taxmann.com 107 (Bang. Trib.)

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(c) the argument, that there is no accrual of expenditure as per the mercantile system of accounting since the payee is not identified, is not tenable and (d) the statutory provisions clearly envisage 'collection at source' *de hors* the 'charge under Section 4(1) of the Act'.

Ericsson's case[5] - On similar set of facts, the High Court held that the machinery sections of collection and recovery of tax cannot be read in isolation of the charging provisions. The credit of any sum to the account of payee would be subject to tax deduction only if credit of such amount reflects accrued income in the hands of the payee, which is chargeable to tax under the Act. The High Court further observed that, the rationale for imposing an obligation to deduct tax at source on a credit entry being passed by a payer in favour of payee, is that such entry represents an acknowledgement of debt by a payer in favour of a payee; the debt acknowledged is in respect of an income that has accrued in favour of the payee; and such income is exigible to tax under the Act. The High Court concluded that mere passing of book entries, which are reversed, would not give rise to an obligation to deduct tax at source by the payer, as clearly, there is no debt that can be said to be acknowledged.

Thus, the following important ratios emerge which may be determinative:

- ✓ where the payees were not identifiable, the tax deduction provisions are not applicable,
- ✓ once the amount has been disallowed under section 40(a)(i) of the Act, it cannot be again subjected to deduction of tax,
- ✓ mere passing of book entries, which are reversed, would not give rise to an obligation to deduct tax at source by the payer, since there is no debt that can be said to be acknowledged

However, given the aforesaid ratios, we still have two different tribunals with dramatically opposite conclusions and one High Court ruling amidst which one is left with no clear stand to adopt and follow.

There could be following two situations under which the payer is obliged to deduct taxes:

a) *where the liability has become due but is not paid*

b) *where the liability has not become due but is paid*

In case (a), the obligation to deduct taxes arises at the time of credit and, in case (b), such obligation arises at the time of payment.

However, there can be a third situation also,

a) *where the liability itself has not become due and is not paid also*

The revenue authorities in such cases seek to lay their hands on a sum, which is only an estimation of an eventual liability. This was never intended to be covered under the ambit of 'tax deduction' provisions. Similar view was

[5] *DIT v. Ericsson Communications Ltd.* (ITA No. 106/2002)

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also highlighted in CBDT Circular[6] issued in the context of section 194A of the Act.

Conclusion

Thus, mere book entries, being notional and interim in nature should ideally be not subjected to deduction of tax at source as per the relevant provisions of Act. With conflicting decisions of two Tribunals and one High Court decision to the rescue of the taxpayer, the legal position is quite perplexing for the taxpayers. However, since the accounts drawn up on a monthly/quarter/yearly basis are not final and subject to the test of law, it is fair to conclude that mere book entries and reversal shall not be subjected to the rigours of the provisions relating to deduction of tax.

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Notifications and Circulars

'Range' and 'multiple year data' codified

The CBDT, by Notification No. 83/2015, dated 19-10-2015, has amended Rule 10B and has inserted Rule 10CA of the Income Tax Rules, 1962 ('Rules') relating to determination and computation of arm's length price. The amended rules allow for use of a "range model" for determination of arm's length price (ALP) and "use of multiple year data" for undertaking a transfer pricing comparability analysis. *[Refer L&S Tax Track Vol. 3.37 for a detailed note]*

Fresh guidance on implementation of TP provisions

The CBDT has, *vide* Instruction No. 15/2015, dated 16-10-2015 provided guidance on implementation of Transfer Pricing (TP) provisions which seeks to streamline the process of TP scrutiny and ALP determination and also require the CIT (Transfer Pricing) to maintain database of all references received in his jurisdiction. *[Refer L&S Tax Track Vol. 3.36 for a detailed note]*

Domestic Transfer Pricing assessments to be handled by TPOs

The first set of assessments for Specific Domestic Transactions is underway. In this regard, the CBDT has clarified by Instruction No.11/2015 dated 16-9-2015 that cases involving Specified Domestic Transactions shall continue to be handled by Transfer Pricing Officers under the Commissioner (Transfer Pricing) as specified in Notification No.58 and 59/2014, dated 3-11-2014.

Agreement to implement FATCA notified

The Government of India and the Government of United States of America entered into an agreement to improve International Tax Compliance and to implement the Foreign Account Tax Compliance Act of the United States of America on 9-7-2015. The internal procedures required for entry into force of the said Agreement were completed by 31-8-2015 and accordingly, all provisions of the said Agreement have been made effective in India from 31-8-2015. Notification No. 77/2015, dated 30-9-2015 has been issued in this regard.

[6] Circular No. 3 of 2010 dated 2-3-2010

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Ratio decidendi

Liaison office established for purchase of goods does not constitute PE: The Karnataka High Court recently held that the liaison office of a foreign company, which is established in India for sourcing goods for exports to its overseas customers as per their requirements, will not be treated as a permanent establishment. The court held that it would not be a PE even when it engaged in activities like identifying the manufacturer, negotiating the price, choosing the material, and getting the material tested, besides others. The court concluded that all these activities are in pursuance to the obligation cast upon the liaison office, as it had to make purchases for its parent company, and these activities are necessary to be performed before the export of such goods. [*Columbia Sportswear Company* v. *DIT* [2015] 62 Taxmann.com 240 (Karnataka)]

Twin conditions of low/no taxability and taxation on receipt basis to be fulfilled to trigger LOB clause: Examining the applicability of Article 24 of the India-Singapore DTAA on Restriction of Relief (Limitation of Benefits caluse), the ITAT held that both the conditions of income being subject to lower taxes as well as taxation being on receipt basis only in the other contracting country have to be satisfied before benefits of the DTAA can be restricted. In the instant case, the assessee, was a resident of Singapore and payment for freight was received in UK. The revenue authorities contended that since the income had not been received in Singapore, it could not avail the benefit of the Indo-Singapore DTAA. However, the assessee had offered its global income for tax in Singapore and this included the impugned freight charges which were taxable on accrual basis in Singapore. Hence, the ITAT held that the shipping income of the assessee would be taxable in Singapore as per the DTAA. [*Alabra Shipping Pte Ltd* v. *ITO*, ITA 392/RJT/2014, Order dated 9-10-2015, ITAT, Rajkot]

TDS u/s 195 not required on credit entry of royalty payment, which is subsequently reversed: The assessee was required to make payments of royalty to its parent company in Sweden. Though a credit entry was made in the books, a clarification was sought from the Government regarding such royalty payment before actual payment was made. The Government stated that such payment was not permitted in the given facts of the assessee company's case. The assessee company reversed the credit entry earlier made in its books. In this context, the Delhi High Court recently held that mere passing of the book entries, which are reversed, would not give rise to an obligation to deduct tax u/s 195 by the assessee as clearly there is no debt that can be said to be acknowledged by the assessee. [*DIT* v. *Ericsson Communications Ltd* [2015] 61 Taxmann.com 117 (Delhi)]

Payment for procurement of goods, and specialized service of market research taxable as FTS: The assessee-company is a China-based subsidiary of an Indian holding company. It was providing services

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in China in connection with procurement of goods from vendors in China by the Indian company, and specialized services of market research on new developments in China with regard to technology or products. The Authority for Advanced Rulings, New Delhi, recently held that the payments received by assessee-company are taxable in India as fees for technical services. On the question that whether entire amount received or only the markup of 10% over the actual costs incurred is taxable, the AAR held that the entire amount shall be tax-deductible. It concluded that the scheme of tax deduction applied to gross sums as well, the whole of which might not be income or profit of the recipient. [*Guangzhou Usha International Ltd, In re* [2015] 62 Taxmann.com 96 (AAR Delhi)]

No disallowance under section 14A where no exempt income is earned during a year: The Taxpayer was engaged in the business of investment in shares. During the subject year, the taxpayer had not earned any exempt income. The Revenue Authorities however disallowed a part of the interest expense incurred by it, applying Section 14A of the Act read with Rule 8D of the Rules. On appeal, reversing the ruling of the Special Bench[7],the Delhi High Court held that the expression 'does not form part of the total income' in Section 14A of the Act envisages that there should be an actual receipt of exempt income during the relevant previous year . The High Court thus held that Section 14A will not apply if no exempt income is received or receivable during the relevant previous year. [*Cheminvest Limited* v. *CIT* [2015] 61 Taxmann.com 118 (Delhi)]

Disallowance u/s 14A upheld even when interest free funds are more than borrowed funds: The Taxpayer had earned certain income that was not subject to tax. The Revenue Authorities applied Section 14A read with Rule 8D to disallow a part of the interest expense incurred by it. The Taxpayer contended that the balance in its current account on which it did not suffer any interest cost, was much higher than the investments made by it and hence no disallowance was warranted. On appeal, the Tribunal held that there can be no presumption that, where the balance of interest free funds were higher than investments earning interest free income, disallowance under section 14A is not warranted. As the Taxpayer was not able to establish factually that the interest free funds available with it were actually invested to tax free income, the Tribunal declined to follow the judgment of the jurisdictional High Court in the Taxpayers own case[8]. [*HDFC Bank Ltd* v. *DCIT* [2015] 61 Taxmann.com 361 (Mumbai – Trib)]

No deduction for interest on disputed liabilities: The taxpayer had claimed expenditure for interest payable by it on account of an arbitration award, despite the taxpayer disputing it before the High Court, and the order awarding interest being stayed by the Court. In appeal, a Special Bench of the Tribunal held that the taxpayer did not

[7] *Cheminvest Ltd* v. *ITO* (121 ITD 318) (Del SB)

[8] [2014] 366 ITR 505 (Bom)

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have a legal obligation to pay such interest and hence the expenditure claimed by it cannot be allowed as a deduction. The Special Bench thus held that a deduction becomes available only on coming into existence of a liability to pay and the liability to pay arises when it flows from a legally enforceable order. [*National Agricultural Cooperative Marketing Federation of India Ltd* v. *JCIT* [ITA 1999 / Del/2008, decision dated 16-10-2015, ITAT Special Bench]

Transfer pricing adjustment shall be restricted to transaction with AEs alone: The taxpayer had entered into certain transactions with its Associated Enterprises ('AEs') as well as third parties. The revenue authority held that the margins earned by the taxpayer from transacting with its AEs were less than the margins earned by comparable companies on an entity level basis. Accordingly, the revenue authorities made adjustment to the profits earned by the taxpayer entity, including the transactions entered into with third parties. On appeal, the High Court held that any adjustment to transfer price shall have to be restricted to the transactions with AEs alone. [*CIT* v. *Tara Jewels Exports Pvt. Ltd* [ITA 1814/2013, decision dated 5-10-2015, Bombay High Court]

Intellectual property rights – Trademarks, copyright etc can be 'plant': The assessee claimed depreciation on intellectual property rights – trademark, copyright and know-how acquired by it pursuant to reorganization of business. The revenue authorities argued that the payment made by the assessee as the highest bidder in an auction was towards goodwill. The Supreme Court however held that intangible assets like trademark, copyright etc can be treated as 'plant ' since control over such rights is essential for a large business and the acquisition was of capital nature. It observed that the statute during the relevant period did not differentiate between tangible and intangible assets and hence the depreciation could be allowed on such rights which are 'plant'. [*Mangalore Ganesh Beedi Works* v. *CIT*, Civil Appeal No- 10547-10548 of 2011 decided on 15-10-2015, Supreme Court]

Compensation received from prospective 'employer' for breach of promise - Capital receipt: Reiterating the existence of employer-employee relationship for taxation under the head salary, the High Court of Delhi held that compensation for breach of promise to employ a person cannot be taxed under the head salary, profits in lieu of salary or under other sources. The amount received was held to be a capital receipt. The revenue authorities sought to tax the sum received as salary, reasoning that the employment agreement between the parties by which employment was to commence at a future date was sufficient to establish the relationship of employer-employee. However, the High Court opined that receipt from 'any person' has to be from 'employer'. [*CIT* v. *Pritam Das Narang*, ITA 203/2014, Order dated 16-9-2015, Delhi High Court]

Premium paid on Keyman Insurance Policy allowable as expenditure even if not a pure life insurance policy: Observing that the Act does not require the Keyman insurance policy

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to be a pure life policy and thus, there is no need to look through the investment pattern of the insurance policy as to how much is for the risk premium on life and for capital appreciation or investment funds, the Tribunal held that the assessee could claim the premium paid on such policy as business expenditure. In the instant case, the firm had taken a Keyman insurance policy on its partner and Revenue authorities sought to disallow the expenditure contending that as per IRDA's norms only term insurance policies could be issued as Keyman insurance policy and policy taken by the assessee did not fulfil the norm. However, the Tribunal did not agree with this view. [*Suri Sons* v. *ACIT* (ITA No.37/2010, Order dated 31-8-2015, ITAT, Amritsar]

Service tax collected does not form part of 'income': Disposing the appeal of the revenue authorities, the High Court of Delhi has held that service tax collected by the assessee will not form part of its taxable income under Section 44 BB of the Income Tax Act, 1961. The Court held that service tax is not an amount paid or payable or received or deemed to be received by the assessee for purposes of computing income on presumptive basis. It also found force in the assessee's argument that CBDT had itself clarified TDS is not required to be deducted on the service tax component of rent or fees for professional or technical services. [*DIT* v. *Mitchell Drilling International P Ltd*, ITA 403/2013 decided on 28-9-2015, Delhi High Court]

Payments to AE as per cost sharing agreement on actuals without markup – ALP cannot be Nil : The assessee reimbursed it's share of the common cost incurred by the AE in respect of certain support services, without any mark-up. The TPO determined the ALP of the transaction at Nil stating that the necessity of cost sharing was not explained and actual rendering of the services had not been proved properly. The Tribunal held that the TPO has to determine the ALP of a transaction as per the provisions of Section 92C and cannot determine ALP at Nil, particularly when there was no dispute regarding the agreement and absence of mark-up on reimbursement. [*ACIT* v. *Koch Chemical Technology Group*, ITA No.7236/Mum/2010, order dated 30-9-2015, ITAT, Mumbai]

Payment to obtain status as 'exclusive vendor' - Capital expenditure: The assessee, a manufacturer of seating systems was appointed as the exclusive supplier seating systems for an automobile major. The payment was effected in the form of reduction in the invoice amount as and when the assessee raised invoices. The assessee contended that this was in the nature of a volume discount and an item of revenue expenditure. However, the ITAT held that the payment was made for protection acquired by the company for its business as a whole and hence capital in nature. The Tribunal stated that though the payment was spread over a period of time, it would retain its essential character. [*Lear Automotive India (P) Ltd* v. *DCIT*, ITA No. 5256/Del/2012, Order dated 9-9-2015, ITAT, Delhi]

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News Nuggets

MAT issue comes to rest as Government accepts Shah Committee's report

The issue of applicability of Minimum Alternate Tax (MAT) provisions to FIIs/FPIs which do not have a permanent establishment (PE) in India, has seen much debate over the past years. The AP Shah Committee on Direct Tax Matters had recommended amending Section 115JB of the Income Tax Act to specifically provide that MAT would not be applicable to FIIs/ FPIs not having PE in India. The Government has accepted the said recommendation and has expressed its desire to amend the section to clarify that FIIs/ FPIs not having a permanent establishment in India would not be subject to tax for periods prior to 01.04.2015. The assessing officers were advised *vide* Instruction No 9/2015, dated 2-9-2015, not to proceed with any pending assessment already initiated or to recover any tax demand raised on this ground. Recently, the revenue authorities [*Castleton Investment Ltd .v DIT [2015] 62 Taxmann.com 43 (SC)*] urged before the Supreme Court that the Government now having accepted the recommendations of the Shah Committee, and having come out with a Circular directing the field formations accordingly, the issue stands resolved. The Court, accepting the submission, has put a formal closure to the issue.

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