KNOWLEDGEWARE
DECEMBER 2017

B.K.KHARE & CO
CHARTERED ACCOUNTANTS

Head Office: Mumbai

706-708, Sharda Chambers |
New Marine Lines | Mumbai 400 020
Phone: +91 (0) 22 2200 0607 | 7318 | 6360
Phone: +91 (0) 22 6631 5835 | 5836
Telephone:+91-22-22006360

Bengaluru

101, Money Chambers | 1st Floor
6 K.H. Road | Shanthinagar
Bengaluru 560027
Phone: +91 (0) 80 4110 5357

Pune

4th floor|Hotel Swaroop|Lane No. 10 |
Prabhat Road| Pune - 411 004
Phone:+91 (0) 2032926341
Phone:+91 (0) 2064019743 |25666932

New Delhi

A-4, Westend,
Rao Tula Ram Marg,
New Delhi – 110 021, India.
Tel: 011-49057624

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Editorial:

Dear Esteemed Readers,

Welcome 2018*!!* We take this opportunity to wish all our dear readers a very happy new year 2018. As the pastor and life coach, Jason Soroski says, *"There is nothing magical about the flip of the calendar, but it represents a clean break, a new hope, and a blank canvas."* Let us all rise to this new hope and the blank canvas of new opportunities over the next *365* days, draw our best sketch and leave our finest imprints for the future generations to emulate. Happy new year once again!!

We are once more pleased to share our latest newsletter, covering the direct tax and transfer pricing updates for the month of December 2017.

In this edition, in our Back to Basics section, we carry forward our analysis from the previous edition of Income from Profits and Gains from Business and Profession. In this part, we have dealt with the issue relating to depreciation, which being a non-cash expenditure represents the diminution in the value of an asset, being a legitimate a charge on the profit and loss account without which a businessman cannot know his true worth. We have provided our analysis on the issue of depreciation and the intricacies and challenges thereon on its allow ability under various scenarios.

In our tax controversy section, we endeavor to bring to light the challenges faced by the tax payers. In the recent past, one such issue which became a season's flavor of sorts during the tax assessment season pertained to the propriety of the proposition put forth by the AOs as to whether education cess and surcharge did not form part of income-tax and hence, could not be considered as part of Minimum Alternate Tax ('MAT') credit. The direct fallout of this narrow view propounded by the tax office was that the amount of eligible MAT credit would get reduced to the extent of surcharge and education cess paid for earlier AYs and consequently, leading to a higher tax outflow for the subsequent years. We have lucidly analyzed this controversy provided our forthright views on how the same should be handled by the tax office.

Guarantee fees is now fast becoming a source of litigation before the Indian tax authorities. In a globalized world where operations are carried out simultaneously across numerous countries, it is commonplace for a global parent to enter into global corporate guarantee agreements with established multi-national banks. The parent may also recover the guarantee fees paid by it to these banks from its subsidiaries, by following a defined appropriate transfer pricing plan. We have analyzed the decision of Delhi ITAT, which has treated such guarantee fees received by overseas parent as "*Other Income*", notwithstanding the ruling of Mumbai ITAT, wherein it was held that guarantee commission received by a foreign company did not accrue in India nor can it be deemed to be accrued in India, therefore, is not taxable in India

Transfer pricing cases always draw significant litigation. Be it choosing correct comparables, allowing various adjustments or undertaking correct benchmarking analysis. There is increased focus on ensuring profits are taxed in India.

Granting of Inter-company loans has always drawn the ire of transfer pricing authorities. Every transaction is viewed with microscopic suspicion, and adjustment is proposed on account of interest free loan provided by the assessee to its associated enterprise ('AE') and interest charge on outstanding receivables from the AE. We have analyzed a unique decision by the Ahmadabad ITAT, which while passing a speaking order, studied the facts in detail and upheld the proposition of *substance over form* by treating the transaction of loan given by the assessee to its AE in the nature of quasi capital contribution and deleting the unjust addition made by the AO.

We hope you find our newsletter of interest. As always, we look forward to your feedback and comments which would enable us to further enhance the content of the newsletter.

Happy Reading!

Yours Sincerely,

Knowledgeware Team
B. K. Khare & Co.

ARTICLES:

Income from business or profession: Depreciation

Introduction

In accordance with well-established principles of accountancy, depreciation represents the diminution in the value of an asset on account of wear and tear during the course of carrying on business or profession. Such an outgoing is as legitimate a charge on the profit and loss account as any other revenue expenditure incurred for purposes of business. This is because without taking cognizance of depreciation in his final accounts, a businessman cannot know his true profit or loss. The Income-tax Act has taken cognizance of this principle right from its very inception.

Scheme of depreciation

The scheme of granting depreciation allowance under the Act underwent a radical modification with effect from the assessment year 1988-89.Rates of depreciation have been provided for in Rule 5 read with Appendix 1. For purpose of depreciation, assets are divided into two categories: (a) tangible and (b) intangible. Tangible assets are again divided into three parts: buildings; plant and machinery; and furniture and fixtures. Each of these parts is further sub divided into blocks of assets for which different rates of depreciation have been prescribed:

i. Written down value (WDV) is computed separately for each block of assets and not for individual assets;
ii. The actual cost of a new purchase is added to the existing WDV of the asset;
iii. The value realized for an asset discarded, sold, or destroyed together with its scrap value is deducted from the existing WDV of the block, but only to the extent of the existing WDV of the block; the balance consideration is treated as a short term capital gain;
iv. The new scheme ensures that total depreciation never exceeds the actual cost of an asset; it has an inbuilt scheme for balancing allowance and balancing charge; the provisions related to these two concepts now stand deleted from the Act.
v. Extra shift allowance stands deleted because generally the rates of depreciation have been enhanced
vi. The straight line method for ocean going ships has been deleted.

Allowance limited to buildings, plant and machinery and furniture and fittings

The new scheme, effective from 1st April 1988 is applicable only to buildings, plant and machinery and furniture and fittings. There is a well established distinction between a building on the one hand; and plant and machinery on the other. The latter enjoys a higher rate of depreciation because it wears out faster and has a shorter life span. The term 'building' includes within its ambit approach roads [*CIT v. Gwalior Rayons 196 ITR 149(SC); CIT v. Tata Robbins [236 ITR 206 (Patna)]* , driveways and compound walls[*CIT v Gujarat State Fertilizers 219 ITR 550 (Guj); 255 ITR 594 (Guj)*] , fences, drains [*CIT v. Gwalior Rayon 196 ITR149 (SC)*]and culverts [*CIT v Gujarat State Fertilizers 219 ITR 550 (Guj); CIT v Gujarat State Fertilizers 2240 ITR 536 (Guj)*] . Within buildings residential buildings are entitled for depreciation of 5%; other buildings for 10%

Plant- meaning of:

Under the Income-tax Act, the word "plant" has been held to have a very wide meaning [*CIT v. Taj Mahal Hotel 82 ITR 44 (SC)*. Anything which helps the assessee to carry on his business falls within the ambit of the term [C*IT v. Elecon 166 ITR 66(SC*); *CIT v. Saurashtra Bottling232 ITR 270 (Guj); Siemens v. CIT 217 ITR 622 (Bom)*]. U/s 43(3), it includes ships, vehicles, books, scientific apparatus and even surgical equipment meant in the case of a doctor. This provision, however, has been amended w.e.f. 1st April 1962 to exclude tea bushes and livestock. It includes knives and is expected to last for three years [*Hinten v. Maden 38 TC 391 (HL*)], bottles and shells used by a soft drink manufacturer [*CIT v. Krishna Bottlers 175 ITR 154 (AP*)], gas cylinders(*CIT v. Steel Rolling Mills 164 ITR 633 (Cal*)], diesel tank embedded in the earth [*CIT v. Salem Textiles 237 ITR 662(Mad*)], sanitary and pipeline fittings in a hotel [*CIT v. Taj Mahal Hotel 82 ITR 44(SC*)], thermocole or fiberglass insulation in a cold storage plant [*CIT v. Yamuna 129 ITR728*(P&H)], shuttering material used in construction [Harijan Nigam V. CIT 229 ITR 776(All)], wells, tube wells and oil wells [*CIT v. Warner Hindustan117 ITR 15 (All)*; *CIT v. Hindustan Motors 170 ITR 431 (Cal)*; *CIT v. OIL India 198 ITR 701 (Cal)*] etc.This list is only illustrative and not exhaustive. In a land mark judgement the Gujarat High Court in *CIT v. Elecon Engineering Co Ltd 96 ITR 672 (Guj)* held that drawings and patterns constituting knowhow were plant. The Supreme Court affirmed this judgment in *Scientific Engineering House Ltd. v. CIT 157 ITR 86 (SC*).

Functional test

In order to decide whether a particular apparatus is plant or part of a building, the courts have sometimes applied the functional test. Where the apparatus is one with the help of which business is carried on it would constitute plant; where it comprises the setting or premises for the business it would be part of the building. In *CIT v. Karnataka Power Corporation 247 ITR 268*, the Supreme Court held that whether a building can be held as a plant is a question of fact which would depend upon whether it has been planned and constructed to meet the assessee's special requirement. With effect from 1st April 2004, however, s. 43(3) has been amended so as to provide that 'plant' does not include buildings or furniture and fittings. Nonetheless a doubt does lurk in the minds of some commentators as to whether the amended definition overrules the full bench decision in the case *CIT v. Karnataka Power Corporation (supra)*.

There is a controversy with regard to shuttering material. The Allahabad High court in HarijanEvamNirbalVargAvas *Nigam 229 ITR 776(All)*; the Madras High Court in CIT *v. Alagendran Finance Ltd 264 ITR 269 (Mad)*; and The Rajasthan High Court in *CIT v. Mohta Construction 273 ITR 276 (Raj)* have held that the word 'plant' was broad enough to include such material; the A.P. High court in CIT *v. Vijaya Enterprises 332 ITR 235 (AP)* has however expressed a contrary view.

User in accounting year

A sine qua non for the grant of depreciation is that the asset should have been used during the relevant previous year. If the asset is not put to use [*Dinesh Kumar Aggarwal v.CIT 267 ITR 768(Bom)*] or is incapable of being put to use during the relevant previous year [*CIT v. Air Travel Enterprises 265 ITR 537(Ker)*] , depreciation cannot be allowed.

Under rule 5 depreciation is allowable if the asset is used at any time during the relevant previous year, but if the user is less than 180 days, the assessee can claim only 50% of the depreciation to which he is entitled at the prescribed rate [2nd proviso to s. 32(1)]. The assessee would be eligible for the allowance even if the asset is used during trial production [CIT*v. AshimaSyntex 255 ITR 133( ); CIT v. Union Carbide 254 ITR 488(Cal*)]. The word '"use" includes not only active use but also passive use- That is to say even if it is not actually used, but is ready for use, that too would meet the requirements of the law [CIT v. *Southern Petrochemical Industries Corporation 311 ITR 202 (Mad*); *CIT v. Dalmia 13 ITR 415 (Pat); CIT v. Visvanath 5 ITR 621 (Bom)*]. Even if the asset is used illegally and a fine was imposed, the assessee would still be eligible to claim depreciation [Anil *Bulk Carriers V. 276 ITR 625 (All)].*He can also claim it in respect of a temple built inside the factory premises [*Atlas v. CIT 134 ITR 458 (P&H)]*.

The asset in question may be worked by a licencee or lessee; the owner of the asset would, none the less be entitled to claim depreciation on such an asset, if the grant of the lease or licence took place in the ordinary course of business { *Rieta Biscuit Co 320 ITR 521 (P&H); CIT v. Shaan Finance 231 ITR 308(SC); ICDS v. CIT 350 ITR 527 (SC)]*. In the business of leasing once the assessee has leased the asset, the requirements of the section are met; there is no additional requirement to the effect that the lessee too should have used the asset in his business [CIT *v . Kotak Mahindra ltd. 317 ITR 236(Bom*)]. This principle would not apply where the lease deed is not genuine and transaction is a sham [*Mcorp Global v. CIT 309 ITR 434(SC)*].

Valid sale and lease back transactions which have legal incidents of sale and lease back in the transaction would satisfy the tests of grant of depreciation to the legal owner of the property and a deduction for rental payable to the lessor in the hands of the lessee [*CIT v. Cosmos Films Ltd. 338 ITR 266 (Del), CIT v Zuari Finance Ltd. 271 ITR 538(Bom), CIT v. Gujarat Gas Co. Ltd. 308 ITR 243 (Guj*)].

Ownership

Another important condition laid for the grant of deduction under this section is that the assessee should be the owner of the asset on which he claims depreciation. Depreciation is not allowable to an assessee if he has only hired or leased out an asset for his use [*Atlas Cycle IndustriesLtd . v. CIT 270 ITR 108 (P&H*)] unless during the course of the hIre purchase agreement, the ownership of such asset is considered to pass on to him [*CIT v. General Industries 155 ITR430*(*Del)*].

The test then is of present ownership. If the assessee owns a building built on leased land, and the lease deed provides that on the termination of the lease, the building will revert back to the lessor along with the land, the lessee will nonetheless be entitled to claim depreciation on the building which currently belongs to him (Srinivasamurthy v. CIT 64 ITR 242 (Kar); CIT v. Chandra 117 ITR 251 (*All*)].

Even more importantly, a claim for depreciation can be made so long as a person exercises the rights of an owner and is entitled to the income that it generates, even though a formal deed of conveyance or registration may not have been executed in his favour [*Mysore Minerals v. CIT 237 ITR 775(SC); Podar Cement 226 ITR 625(SC*)].Ownership then, in the context of s. 32, must be understood in a broader rather than a restrictive sense. Thus a company can claim depreciation on the buses which it plies and the income from which it shows in its books, even though these may be registered in the names of its directors [CIT *v. FazilkaDabwali Transport Co. Pvt. Ltd 270 ITR 398 (P&H)].* On the same score depreciation is allowable on a motor vehicle owned by the assessee and used by him for purposes of his business, even if is not registered in his name under the Motor Vehicles Act [CIT v. Saikia 143ITR 39 (Cal)].

From the assessment year 1971-72 onwards, the assessee is also competent to claim depreciation – in respect of capital expenditure incurred by him on a leased building which he occupies as a lessee or as a licensee and in which he carries on his business or profession [Explanation 1 to s32(1)(ii)].

Conclusion

We shall carry forward our discussion in the next issue of *Knowlegeware* during the course which we will discuss the remaining issues related to this important deduction.

Tax Controversy

Whether Surcharge and Education Cess was includible while computing MAT Credit?

Often, it has been observed that during tax assessments, the Assessing Officers tend to raise an issue in case of a few assessees and this fast becomes one of the common issues of the assessment season. One such issue which became a season's flavor of sorts during the tax assessment season, especially for the AY 2012-13 pertained to the propriety of the proposition put forth by the AOs as to whether education cess and surcharge did not form part of income-tax and hence, could not be considered as part of Minimum Alternate Tax ('MAT') credit. The direct fallout of this narrow view propounded by the Department was that the amount of eligible MAT credit would get reduced to the extent of surcharge and education cess paid for earlier AYs and consequently, leading to a higher tax outflow for the subsequent years.

The AO's view is right indeed, felt the Delhi ITAT

One of the earliest rulings on this vexed subject emanated in August 2012. The Delhi ITAT had the occasion to consider this issue in its ruling in the case of the Richa Global Exports Pvt. Ltd. vs. ACIT, CPC Bengaluru [ITA No. 2303/Del/2012].

The assessee contended that due credit of MAT including surcharge & education cess ought to be considered u/s 115JAA of the Income-tax Act, 1961 ('the Act') and in support, relied upon Explanation 2 of section 115JB which was inserted by Finance Act, 2008 with retrospective effect from April 1, 2001. This Explanation was inserted to define the meaning of tax (which of course, included education cess and surcharge) for the purpose of calculating book profits liable to tax u/s 115JB. It is submitted that this definition should be extended to section 115JAA of the Act as it was*pari-materia*.It was pointed out that Chapter XIIB of the Act had four sections and definition of tax was given in one section i.e. 115JAA vide Explanation (2) and therefore, it was argued that the said explanation would apply to all the four sections, which were covered under Chapter-XIIB and particularly to section 115JAA. In view of the above, the assessee submitted that benefit of surcharge and education cess paid in the earlier AY ought to be given as part of tax credit and the amount of surcharge and education cess should not be considered as a separate levy. Finally, the assesse argued that education cess and surcharge were included in the definition of 'Income-tax' per Section 2(43) of the Act.

The Department, on the other hand, drew support from the fact that the scheme of computer software which processed the income-tax returns was designed to exclude surcharge and education cess from the ambit of MAT credit, which was the correct interpretation. Section 115JAA & section 115JB talked of only income-tax and nowhere surcharge and education cess was included for the purpose of these sections.

The ITAT noted that section 115JB clearly meant that the book profit shall be deemed to be total income of the assessee and tax payable by the assessee on such total income shall be the amount of income-tax at specified rate of tax, which was 15% for the relevant year under consideration. The ITAT agreed that the section did not talk about the income-tax as increased by surcharge & education cess. It talked only about income-tax. The ITAT remarked that wherever statute has required income-tax to include surcharge and education tax, it had specifically done it like in Explanation 2 to section 115JB. Similarly, Form 29B, which was to be filed along with return of income ('ROI') where MAT was applicable, at point 14, it stated that the amount of income-tax payable by the company would be 15% of column (of the ROI) 12 i.e. book profits, it does not state surcharge or education cess. Therefore, the ITAT concluded that it emerged that MAT payable u/s 115JB was only income-tax and did not include surcharge or education cess. Therefore, if only income-tax was to be paid under the provisions of section 115JB, it was natural that tax credit u/s 115JAA would only be of income-tax and not of surcharge and education cess.

No, the Surcharge and Education Cess did form part of the eligible MAT credit

Juxtaposing the view adopted by the Delhi ITAT, various Tax Courts across India have upheld the principle that theamount of MAT credit should also be inclusive of surcharge and education cess and hence, the allowability of MAT credit against the tax payable ought to be inclusive of surcharge and education cess. The latest ruling to join this increasing and consistent trend is the Hyderabad ITAT's ruling in case of ACIT vs. Divi's Laboratories Ltd. [ITA No. 596/Hyd/2017 which was pronounced on November 29, 2017].

Upon a reading of the sub-section 2A of section 115AA of the Act, the ITAT observed that the tax credit to be allowed shall be the difference of tax paid for any AY under sub-section (1) of 115JB and the amount of tax payable on his total income computed in accordance with the other provisions of this Act. The important word used is 'tax paid' and as per the Hon'ble Apex Court decision in the case of CIT vs. K. Srinivasan [83 ITR 0346], the term 'tax' included surcharge. The 'set off' in respect of brought forward tax credit shall be allowed for any AY to the extent of difference between tax on his total income and the tax, which would have been payable u/s 115JB, as the case may be for that AY. On a careful reading, the term used are 'tax' and not income-tax or any other term. Thus, the ITAT concluded that the term 'tax' did include surcharge. Distinguishing the Richa Global Exports decision (supra), the ITAT remarked that perhaps, the Apex court decision in the case of K. Srinivasan (supra) may not have been brought to the knowledge of the Delhi ITAT.

Our Comments

When the definition section [s. 2(43)] has defined 'tax' to include surcharge and education cess, it seems convincing to us that the eligibility for MAT credit also should follow suit. It would be absurd to deny MAT credit of the portion representing surcharge and education cess, especially when the liability does include the same. Though, of course, there is no equity in tax, yet a liberal interpretation of the situation would go a long way in fostering a non-adversarial atmosphere.

Even in the scheme of the Form ITR-6, the MAT credit has to be given against the gross tax payable exclusive of surcharge /cess and only after the MAT credit tax liability, the surcharge and cess has to be calculated for the purpose of working out the grand tax liability. In the alternate, if the MAT credit is taken into account without including the surcharge and education cess, then the surcharge and education cess on the tax liability has to be calculated only after allowing the MAT credit.

It may be pointed out that the assessee's interpretation has been supported even at the High Court levels. For instance, this aspect has been squarely covered in the decision of the Hon'ble Kolkata

High Court in case of SREI Infrastructure Finance Limited vs. DCIT, Kolkata [reported in 395 ITR 291 & 289 CTR 412], wherein the Hon'ble Court had clearly held MAT Credit under section 115JAA brought forward from earlier years is to be set off against tax on total income including surcharge and education cess, instead of adjusting the same from tax on total income before charging such surcharge and education cess. The Allahabad High Court had, in the case of CIT Vs. Vacment India [reported in 349 ITR 304] upheld this proposition. In fact, the jurisdictional Mumbai ITAT had, in its decision in the Wyeth Limited vs. ACIT, LTU, Mumbai [ITA No. 6682/Mum/2011] quoted from the Vacment decision (supra) and held that the allowability of MAT credit against the tax payable ought to be inclusive of surcharge and education cess.

Various benches of the Hon'ble ITAT have applied the favorable ratio of the Wyeth judgement (supra). For the benefit of our readers, we have presented a tabulation below:

ITAT Bench	**Appeal Number / Relating to AY**	**Case Details**
Mumbai	5098/Mum/2013 AY 2011-12	DCIT vs. Godrej Oil Palm Ltd.
Hyderabad	146/Hyd/2015 AY 2012-13	Virtusa India Pvt. Ltd. vs. DCIT
Pune	151/PN/2015 AY 2012-13	Dar Al-Handasah Consultants (Shair and Partners) India Pvt. Ltd., vs. ACIT
Chennai	449/Mds/2016 AY 2011-12	Value Source Technologies Private Ltd
Hyderabad	596/Hyd/2017 AY 2011-12	ACIT vs. Divi's Laboratories Ltd.
Vishakapatnam	2122/Mds/2015 AY 2013-14	DCIT vs. Saint Gobain Gyproc India Ltd.
Bengaluru	1304/Bang/2016 AY 2012-13	TriconInfotech Pvt. Ltd. vs. ACIT

Having said this, in a completely different context, the Mumbai ITAT has held that the education cess was not required to be included in the tax while calculating the tax effect. This was, of course, in the context of CBDT Circular No. 21 of 2015 dated December 10, 2015, which dealt with the maintainability of appeals filed by the Department before the Hon'ble ITAT. This Circular did not specifically require inclusion of surcharge and education cess& the ITAT has now interpreted to say that one need not include these items, which makes a difference in borderline cases. Whether the Revenue would make use of this ratio to pursue their narrow interpretation in the context of MAT credit is something which only time will tell.

It is felt that in such borderline cases, where two views are reasonably possible, applying the golden rule that the view in favor of the assessee should be taken, CBDT should issue a benevolent circular to put an end to this needless controversy and resultant litigation.

SUPREME COURT

Tax holiday benefit denied to small scale industries in subsequent years due to non-satisfaction of eligibility conditions

The Supreme Court in the case of Ace Multi Axes Systems Ltd. reversed the Karnataka HC decision and held that the assessee would not be eligible to avail tax holiday benefit under section 80IB of the Act meant for small scale industries due to non-satisfaction of eligibility conditions in subsequent years even if the eligibility criteria were satisfied in the initial year.

Facts & Issue*:*

Ace Mutli Axes Systems Ltd.(hereafter referred to as "assessee") was a company engaged in manufacture and sale of components/parts of CNC lathes and similar machines. The assessee was a Small Scale Industrial Undertaking (SSIU) in its initial year and fulfilled all the conditions stipulated under section 80IB of the Act. The assessee availed tax holiday under section 80IB of the Act for 8 consecutive assessment years. During the ninth year of claim of benefit under section 80IB(3) of the Act, the assessee ceased to be a SSIU.

The AO completed the assessment by allowing the claim of the assessee after making certain adjustments. Subsequently, the CIT exercised his review powers conferred under section 263 of the Act and directed the AO to disallow the benefit of deduction for AY 2005-06 as the assessee no longer continued to be SSIU. The assessee preferred an appeal before CIT(A) and ITAT and the AO's order was upheld.

However, the HC reversed the said orders and observed that merely because the SSIU stabilised early, made further investment in its business and exceeded the value of plant and machinery of Rs.1 crore during the said AY cannot deprive the assessee of benefit under section 80IB of the Act.

Aggrieved, the department filed an appeal before the SC.

Contentions of the Revenue:

SSI in addition to the four conditions provided in section 80IB(2) of the Act was also required to be categorised as SSI as per section 11B of Industries (Development & Regulations) Act, 1951. The requirement of manufacturing article or things, minimum number of employees and categorisation as an SSI under section 11B of the IDR Act were dynamic and required to be fulfilled year-on-year. The eligible undertaking had to show in each subsequent year of claim that these three conditions had not been violated.

Each assessment year was separate and independent; and the revenue authorities had every power to examine and analyse the facts and figures as well as relevant law points of each year to find out whether all the conditions were fulfilled or not. In the case of the assessee, though it was a SSIU in the initial assessment year, but in the AY 2005-06, it was not a SSIU and therefore, deduction sought under section 80IB(3) of the Act had to be denied.

Contentions of the Assessee:

The assessee contended that once the conditions stipulated under section 80IB of the Act are satisfied in the initial year, the benefit of claim of deduction was available for 10 consecutive years. Even if the assessee was no longer an SSIU in accordance with section 11B of the IDR Act on account of increase in limit of investment in plant and machinery, such a relief could not be denied as the provisions of section 80IB of the Act did not require the fulfilment of eligibility condition in the subsequent years. It was also contended that the provisions relating to incentive were to be construed liberally to advance the objective of the provision.

Observations& Ruling of the SC:

The SC observed that the scheme of the statute does not indicate that the incentive provided has to continue for 10 consecutive years irrespective of continuation of eligibility conditions. Applicability of incentive is directly related to the eligibility.

SC was unable to appreciate the logic of HC's observation that the object of the legislature is to encourage industrial expansion which implies that the incentive should remain applicable even where on account of industrial expansion; the SSIU ceases to remain SSIU. SC observed that incentive is given to a particular category of the industry for a specified purpose and the same cannot be availed if it no longer falls in the specified category. Construing an incentive provision liberally does not mean ignoring conditions for exemption.

Further, SC observed that the intention of the legislature is not defeated by not allowing the incentive to the assessee that ceases to be SSIU, even if it was eligible in the initial assessment year. Had that been the logic, the incentive ought to have been given irrespective of any condition as the incentive certainly helps further expansion of industry by reducing the tax burden.

SC emphasised on the concept of vertical equity which provides that all the assessees need not be taxed uniformly. Progressive taxation is a well-known element of tax policy. Higher tax burden on the assessees having higher income or higher capacity cannot be considered unreasonable.

SC in the case of Bajaj Tempo Ltd v. CIT 196 ITR 188 (1992) had observed that provisions granting incentive for promoting growth and development should be construed liberally. However, SC in the present case distinguished the Bajaj Tempo decision and held that construing liberally does not mean ignoring conditions for exemption. The principle of law considered in Bajaj Tempo was held to be a valid principle of interpretation where there is ambiguity or absurdity or where conditions of eligibility are substantially complied. In the present case, the scheme of the statute is clear that the incentive is applicable to a SSIU. Therefore, intention of the legislature is in no way defeated by not allowing the said incentive if the assessee ceases to be the class of undertaking for which the incentive is provided even if it was eligible in the initial year.

As the assessee no longer retains the character of SSIU, it was not eligible for claiming the incentive meant for that category. Permitting incentive in such a case will be against the object of law.

Citation*:*

DCIT v. Ace Multi Axes systems Ltd (TS-571-SC-2017)

Our Comments:

Whether eligibility conditions for SSIU is required to be fulfilled only in initial assessment year or during the entire tax holiday period has been matter of debate before the courts. The above decision has reaffirmed the position that formation. Further, SC has clearly laid down that incentive provisions should be construed liberally only when there is valid principle of interpretation and where there is ambiguity or absurdity or where conditions of eligibility are substantially complied. The liberal reading of incentive provisions does not mean that stipulated conditions can be ignored.

Judges split over non-discrimination benefit, requirement to examine PE-status for TDS u/s 195

The Apex court in case of S.R.M.B. Dairy Farming (P) Ltd held that CBDT circular specifying monetary limit for appeal filing is applicable even to pending matters i.e. retrospectively.

Facts & Issue:

CBDT issued an instruction no. 3 of 2011 dated 9.2.2011, providing for appeals not to be filed before High Courts where the tax impact was less than Rs. 10 lakhs, which was in supersession of the earlier instruction no. 1979 of 2000 where the limit of tax effect was Rs. 4 lakhs. The revenue contended that the circular should have a prospective effect whereas the assessee appealed otherwise.
Due to diverse views on this aspect by the High Courts and certain decisions of the Supreme Court which have divergence of opinion, the Apex Court consider it necessary to examine the issue so as to avoid conflicting orders by the High Court.

Revenue's Contention:

The CIT was of the opinion that the Circular has to be applied prospectively which would not grant relief to the pending cases not exceeding the specified monetary limits.

Assesee's Contention:

The assessee was pleading that the CBDT Circular would be applicable retrospectively even for the matters pending as on date of the circular.

Observations & Ruling of the Tribunal:

The Karnataka High Court in case of CIT vs Ranka&Ranka had addressed the issue of recognizing the concept of providing monetary limit. It was held that the CBDT circular no 3/2011 was applicable retrospectively. The Karnataka HC considered the CBDT circular in conspectus of the National Litigation Policy.
On the other hand, the Bombay HC, Madhya Pradesh HC, Delhi HC had taken the view that was sought to be taken by the Karnataka HC. The reason being the value of money went down and cases of the tax department increased, the choking docket required such an endeavour and there was no reason why the same policy should not be applied to old matters to achieve the objectives of the policy laid down by the CBDT. Further, an earlier circular dated 5 June 2007 issued by the CBDT was also taken note of, which required all appeals referred to HC was of recurring nature and therefore required to be settled by HC.
Various courts held that the instruction issued by the CBDT specifying the monetary limit for filing of appeals would apply only prospectively. The view adopted by Delhi HC holding the circular applicable to pending matters came up before a 3 Judge bench of the Supreme court in case of Surya Herbal Ltd and the Supreme Court held that the Circular dated 9 February 2011 should not be applied ipso facto particular when the matter has a cascading effect. For cases with common principles in subsequent group of matters, HC would not apply circular ipso facto.
The Apex court also considered its decision of Suchitra Components Ltd. on the general principle of application of Circulars. Reliance was placed on the view expressed in Mysore Electricals Ltd observing that a beneficial circular has to be applied retrospectively while an oppressive circular has to be applied prospectively.

The Supreme Court ruled in favour of assessee that the Circular would apply even to pending matters subject to the two caveats provided in the case of Surya Herbal Ltd viz.

i. circular should not be applied by HC ipso facto when the matter had a cascading effect and
ii. where common funds may be involved in subsequent group of matters or a large number of matters

The SC observed that this larger bench ruling "actually should have laid the controversy to rest."

Citation:

S.R.M.B. Dairy Farming P Ltd [TS-549-SC-2017]

Our comments:

The Supreme Court in the instant case considered the issuance of Circular in conspectus of the National Litigation Policy document released which lays down in its visions the focus on the efficiency & responsibility of the litigant, like ensuring good cases are won, bad ones are not needlessly preserved and litigation is not resorted for the sake of litigating. With this background, the Apex court took a decision that the Circular would apply retrospectively as the monetary limit for filing of appeal was increased to Rs. 10 lakhs from Rs. 4 lakhs.

HIGH COURT

Karnataka High Court holds protocol an integral part of DTAA, no separate notification required to make applicability effective for MFN clause

Recently, The Karnataka HC has held that protocol is an integral part of the DTAA and no separate notification is required to make the MFN clause of the protocol effective

Facts and Issue:

Apollo Tyres Limited (the Company) had made certain payments to non-residents without deducting tax at source by relying on the Most Favoured Nation (MFN) clause in the protocol to the India-Netherlands Double Taxable Avoidance Agreement (DTAA) read with India-Finland DTAA.

The AO denied the aforesaid benefit stating that no separate notification existed allowing applicability of MFN clause in the protocol to the India-Netherlands DTAA, read with India-Finland DTAA. In the absence of the same, the AO held that tax was required to be deducted at source under section 195 of the Act.

Aggrieved by the order of the AO, the Company preferred to file a revision application under section 264 of the Act before the CIT. The CIT relied on the decision of the Authority for Advanced Rulings (AAR) in the case of Steria (India) Limited [(2014) 45 Taxman 281 (AAR New Delhi)] upheld the order of the AO.

Aggrieved by the aforesaid decision of the CIT, the Company filed the petition(s) before the Karnataka High Court (Karnataka HC).

Contentions of the Revenue:

The departmental representative argued that a separate notification is required expressly allowing applicability of MFN clause in the protocol to the India-Netherlands DTA, read with India-Finland DTAA.

As there was no notification issued by the CBDT, the provisions of the protocol for availing benefit of MFN clause are not applicable. The payments made by the Company to non-residents attracted provisions of section 195 of the Act and tax had to be deducted at source.

Contentions of the Assessee:

The Counsel for the Company specifically relied on the following and argued that no separate notification is required to make the MFN clause of the DTAA applicable.

Divisional Bench of the Delhi High Court (Delhi HC) in the case of Steria (India) Limited [(2016) 386 ITR 390(Delhi)] had set aside the order of the AAR in the case of Steria (India) Limited (supra) as relied upon by the CIT;

The Delhi HC had concluded that the text of the protocol to the India-Netherlands DTAA makes it self-operational and that protocol forms an integral part of the DTAA;

Language of Article 12 of the India-Netherlands DTAA along with the protocol makes it clear that no separate notification is required to make the protocol effective;

Accordingly, the payment was not taxable considering the beneficial Fees for Technical Services (FTS) clause of the India-Finland DTAA.

Observations & Ruling of the Karnataka High Court:

The Karnataka HC after considering the arguments of the tax department and the Company decided in favour of the Company, holding that the protocol was an integral part of the DTAA and no separate notification was required to make its applicability effective.

While doing so, the Karnataka HC has inter-alia observed as under:

The protocol itself provides for automatic application of subsequent DTAA, to the India-Netherlands DTAA and therefore, no separate notification was envisaged to be issued for enforcing such subsequent DTAA with another OECD country, i.e., Finland (in the present case), to be made applicable.

The decision of the AAR in the case of Steria (India) Limited (supra) cited by the Revenue authorities, cannot be relied upon in light of the decision of the Delhi HC in the case of Steria (India) Limited (supra).

Citation:

Apollo Tyres Limited v/s. Commissioner of Income-tax (International Taxation) [WP Nos 31737 & 31738 of 2016 & 32300 & 32301 of 2016]

HC held that Non-Compete fees paid towards competitive threats is illusionary, treated as capital in nature.

Facts and Issue:

The assessee is engaged in the manufacture and sale of front wheel drive axle assembly for vehicles. According to assessee, it was the market leader in manufacturing of these products.

In the process of expanding the manufacturing capacity, the assessee acquired assets and liabilities if a newly set-up factory, established by the Company namely, Shriram Mobiles Limited ("SML"), Madras. The consideration was paid in two parts; Rs. 1.30 crores towards net asset value and Rs. 70 lacs on account of non-compete clause. The MD of SML became the corporate director of the Madras Division of the Assessee Company.

In the assessment proceedings, AO contended that since this expenditure is to keep competitors out of the market and increase sales, its long term enduring benefit and hence could not be treated as revenue in nature. CIT(A) held that since non-compete fees was for short term period of 5 years, same shall be allowed as revenue expenditure.

However, ITAT allowed the appeal of revenue and held non-compete fees was capital in nature, the Assessee eliminated its only competitor after acquiring the factory, thereby perpetuating its exclusivity in the market. Assessee filed the appeal before HC.

Contentions of the Revenue:

The Revenue contended that assesse had obtained a benefit of enduring nature by ensuring that competition was eliminated at inception itself. Hence, non-compete fees is capital in nature. They relied on Sharp Business Systems (*Sharp Business System V. CIT [254 CTR 233 (Delhi) 2012*] To justify this contention, they pointed out certain clauses in the agreement entered between the assesse and SML.

In the agreement, it was stated that Rs. 1.30crs was towards net asset value and Rs. 70 lacs were for *Obligations and Covenants set out in the Agreement.*

There were many obligations and promises made in the agreement which included warranty and representations, indemnification, prompt execution of the agreement, obtaining approvals from the financial institutions confirming the release of charges, maintenance of confidentiality including confidentiality for intellectual property, approval from tax authorities, obligation of SML to obtain necessary sanctions and approvals and agreement also included non-compete clause.

The revenue counsel argued that consideration of Rs. 70 lacs was not only for non-compete fees but also for these obligations and this had direct impact on final execution and implementation of the agreement. Even non-compete fees clause in the agreement appeared illusionary in nature and restricted. There were no non-compete obligations on promoters and directors. As stated above, MD of SML became corporate director of the Assessee Company's Madras Division.

The Counsel also distinguished the applicability of Delhi HC judgement of Eicher Ltd in this case stating that facts were not comparable. Hence, it was contended that the said expenditure is revenue in nature.

Contentions of the Assessee:

The Assessee contended that the said expenditure was revenue in nature. The assesse was sole manufacturer and market leader of these products. The operations of SML had yet not commenced hence there was no serious threat to the market leadership position of the Assessee.

Assessee relied upon Delhi HC judgement of Eicher Ltd (*CIT vs. Eicher Ltd [2008] 302 ITR 249 (Del*)), wherein non-compete fees was treated as revenue in nature.

Observations & Ruling of the Delhi High Court:

The Court observed that the consideration of Rs. 70 lacs was for non- compete fees and also towards smoothening the process of acquisition of the unit. There were many obligations and covenants upon the SML i.e. obtaining permissions and approvals from various authorities, maintaining confidentiality and thus ensuring smooth process of acquisition. The Court also noted that the acquisition of SML's unit was for expansion purpose so as to increase the production capacity. There was no serious threat to the assesse as SML has not started its manufacturing process. The non-compete clause appeared to be illusory in nature. Based on the facts of the case, the impugned expenditure is treated as Capital in nature.

In view of the above, the question of law was decided in favour of Revenue and against the assessee. The appeal remains dismissed.

Citation:

M/s GKN Driveline India Ltd vs. CIT [TS 533 HC 2017(Del)]

Our Comments:

To determine whether a particular expenditure is revenue in nature or capital in nature, test is laid down by Supreme Court in case of Empire Jute Co. Ltd vs. CIT [124 ITR 1 SC (1980)]. The test includes testing of enduring benefit and other on distinction between fixed and circulating capital.

In the case of Eicher Ltd(Supra), this test of enduring benefit was applied and it was concluded that non-compete fees was revenue in nature. However, based on the present facts of the case, it was concluded by CIT(A) that since fees was for 5 years hence should be treated as revenue in nature.

However, ITAT reversed the order of CIT (A) and restored the findings to the AO. But the authorities failed to see the agreement clauses which was bought to the notice of court by the revenue counsel.

The facts stated that non-compete fees was not only towards non-competency clause but it was also for other obligations as laid down in the agreement without which the complete execution was agreement and takeover of the unit was not possible. Hence, the fees are treated as Capital in nature, dismissing the assessee's appeal.

TRIBUNAL

Delhi ITAT holds that Section 56(2)(viib) applies to all classes of shares and the proposition that AO can challenge the valuation report submitted for the computation of income if it is not based on relevant material

Facts & Issue*:*

The assessee was engaged in the business of investment and financing and had allotted 2,05,000, 0.1% redeemable non-cumulative preference shares (RNCPS), with face value of Rs. 10 each, at a premium of Rs. 1,990 per share. These shares were partly allotted to a group company and partly to an independent third party.

The RNCPS were redeemable on expiry of 10 years from the date of allotment at a redemption price of Rs. 5200 per share and could also be redeemed at any time before that with mutual consent. The RNCPS were valued at INR 2000 per RNCPS as per the valuation report from a chartered accountant (CA) obtained under Rule 11UA(c) of the Income Tax Rules, 1962. The CA had used discounted cash flow method and used a discounting factor of 10% to arrive at the present value of the RCNPS.

The AO accepted the discounted cash flow method used in the valuation report. However, he applied discounting rate of 15% (being the prime lending rate of housing companies) instead of 10% adopted by the CA. The AO thus determined the market value of RNCPS at Rs. 1285.41 per share as against Rs. 2000 in the valuation report and made an addition of Rs. 14.64 [i.e. 2,05,000 shares * (Rs 2,000.00-Rs. 1,285.41)] crores under section 56(2)(viib) of the Act.

The CIT(A) upheld the addition made by the AO, but reduced the quantum of addition made by the AO, by changing the discounting rate of 15% used by the AO to 12.5%.

Contentions of the Assessee:

The assessee contended that Section 56(2)(viib) was introduced with an objective to deter the generation and use of unaccounted money through infusion of funds from shareholders at a substantial premium. It was stated that the RNCPS are *quasi* debt instruments and not shares per se, and hence, these RNCPS are not covered by the provisions of section 56(2)(viib) of the Act, which was introduced to deal with equity shares. Further, the said section (read with applicable rules) requires that the valuation of RNCPS should be supported by a report of an expert. The AO, not being an expert in the matter of valuation could not interfere and tamper with the fair market value determined by the valuer. Thus, in case the AO was not in agreement with the report, the only option available to him was to refer the matter to an expert.

The assessee contended that the discounting rate of 15% adopted by the AO was based on home loan rates, which was not appropriate since the investors had no chance of investing in housing loans, as they were regulated by the authorities. It further contended that rate of return on RNCPS ought to have been higher than the post-tax return on debt instruments which was prevailing at about 8.78%. Further, the assessee contended that the AO had ignored the prevailing rate of return on preference shares of other companies that ranged from 8-10%.

Moreover, on the AO's observation that the assessee had issued the shares on a premium since it was facing a liquidity crunch, the assessee stated that there was no question of liquidity crunch since the assessee had readily sellable investment in equity shares whose market value was much higher than the value of the RNCPS. The assessee contended that the finding of the AO was not based on facts but merely on prejudiced presumptions.

Contentions of the Revenue:

On the contrary, the Revenue contended that Section 56(2)(viib) of the Act uses the word "shares," and hence, was applicable to RNCPS. Further, there was no provision in law to refer the valuation of shares to another expert by the AO for valuation and hence the AO had the right and was duty bound to examine whether the valuer had based his valuation on relevant material and whether the valuation was properly done.

It was contended that the assumptions made by the valuer were not based on facts. The Assessee's profit had dipped over the years. The Assessee would not have an assured and ascertainable cash flow in the future which was likely to lead to liquidity crunch for the Assessee.

The Revenue defended the adoption of 15% as discounting rate stating that home loan rates were very conservative, as they were given at concessional rates and that too with full security backing the loan. It was further contended that tax was not a factor to be considered while determining the discounting rate since the burden of tax on dividend in the hands of the Assessee was minimal. Even if tax rate was considered a relevant factor in the determination of discount rate, the tax rate in the hands of the assessee needs to be considered and not the tax rate in the hands of the investor.

Observations & Ruling of the Tribunal:

The Tribunal rejected the contention of the assesse that provisions of section 56(2)(viib) are not applicable to RNCPS being quasi debt. It held that all classes of shares were covered by section 56(2)(viib) and RNCPS could not be excluded from the ambit of section 56(2)(viib) of the Act.

It further held that the AO was empowered to interfere with the valuation report which since it was not based on relevant material.

In regard to AOs power to challenge the valuation, it held that the AO was duty bound to examine the valuation report and record his findings on the same. It was not necessary for the AO to refer the matter to another expert and the AO could replace the irrelevant material in the report and modify the valuation on the basis of relevant material and a rational view.

The Tribunal also noted that the Assessee had a good investment portfolio that had grown in value and could be easily liquidated. Accordingly, it also held that the revenue’s findings in relation to cash flow crunch was incorrect and was merely based on presumptions.

In respect of appropriate discount rate, the Tribunal observed that the rate of return for an investor should have been considered and such rate should be the rate of return for instruments in which the investor could deploy his funds. The assessee could not have invested in home loans considering the regulations governing the loans, and hence, use of home loan rate was highly erroneous. Thus, the rates of return on preference shares issued by other companies for the relevant period were relevant for arriving at the discount rate.

The Tribunal noted that an independent investor had invested in RNCPS on the same terms. The Tribunal held that the valuation done by the Chartered Accountant in accordance with applicable Rules was based on relevant facts and the discount factor of 10% was based on appropriate comparable’s and thus the fair value was considered to be at arms’ length price.

Citation:

Microfirm Capital Pvt. Ltd. [TS-587-ITAT-2017]

Our Comments:

This decision upholds applicability of section 56(2)(viib) to issue of all types of shares and the right of the AO to challenge the valuation report.However, it also confirms that if the valuation is based on appropriate material facts the same need not be disturbed.

INTERNATIONAL TAX

Guarantee Fee Income from Indian subsidiaries arising to foreign holding companies is taxable as 'Other Income', not 'Interest Income'

The Delhi Tribunal has held that guarantee fee paid by an Indian subsidiary to its Foreign holding company is accrued and received by the holding company in India and such income is taxable as 'Other Income' and not as 'Interest Income'.

Facts & Issue:

The assessee is the ultimate parent company of two companies incorporated in India, namely Johnson Matthey India Private Limited (JMIPL) and Johnson Matthey Chemicals India Private Limited (JMCIPL). During the AY 2011-12, the assessee provided guarantees to banks in India for supporting the credit facilities extended by the banks to JMIPL and JMCIPL. It also provided guarantees to certain global banks outside India for facilities extended to its subsidiary companies in India.

While filing its return of income for AY 2011-12, the assessee treated the guarantee fees received from Indian subsidiaries to be in the nature of interest income under Article 12 (Interest article) of the India – UK tax treaty (the 'tax treaty') and offered the same to tax at the beneficial rate of 15 per cent.

The AO, however, rejected the beneficial rate adopted by the assessee under Article 12 of the tax treaty and in his final assessment order, treated the guarantee fee to be taxable under Article 23(other income article) of the tax treaty and charged it to tax at 40 per cent. Aggrieved, the assessee filed an appeal with the Tribunal.

Contentions of the Assessee:

During the course of appeals, the assessee raised an additional ground stating that since the source of guarantee fee received for providing a guarantee for its Associated Enterprises (AEs) to foreign banks is outside India, it cannot be held to be taxable in India. The assessee contended that since it does not have a Permanent Establishment (PE) in India, the income earned in the form of fees charged for providing bank guarantee/corporate guarantee, in the normal course of business, would not be chargeable to tax in India. In its submissions, the assessee relied upon the case of Capgemini S.A. (ITA No. 7198/Mum/2012) where it was held that the guarantee commission received by the foreign parent from its Indian subsidiaries does not accrue nor does it deem to have been accrued in India and, therefore, not taxable in India under the Act.

Contentions of the Revenue:

The Revenue argued that the additional ground should not be admitted because the authorities below never had an opportunity to examine the said issue, in as much as the only issue that was under consideration was whether the receipt was in the nature of interest or other income. It further placed reliance on the order of the lower authorities.

Observations& Ruling of the Tribunal:

The Tribunal examined the issue of corporate/bank guarantee income with reference to Article 12(5) of the treaty and Section 2(28A) of the Act. It ruled in favour of the Revenue for the following reasons:

A. <u>Guarantee Fee accrued or arose in India, and hence is taxable in India</u>

Section 5(2) of the Act states that the total income of any previous year of a person who is a non-resident shall include all income from whatever source derived which is received or is deemed to be received in India in such year by or on behalf of such person; or accrues or arises or is deemed to accrue or arise to him in India during such year.

The Tribunal observed that it was not the entering of the global corporate agreement outside India that occasioned the assessee to charge the guarantee commission, but it was the act of the subsidiary in availing the loan that accrued the guarantee commission to the assessee. Relying on the decision of the Apex Court in the case of Kanchanganga Sea Foods Pvt. Ltd. ([2010] 325 ITR 540), the Tribunal held that it was not open for the assessee to contend that no income accrued to them in India as long as there is no denial that the loan transaction took place in India.

Thus, the guarantee commission was accrued and received by the assessee in India and hence such a receipt is taxable in India.

B. <u>Guarantee fee is not in the nature of interest</u>

The definition of interest under the provisions of the Act and the treaty should be interpreted in the context of the usage and with reference to other words and phrases used in the definition. Although the definition includes the words "claims of any kind" or "service fee or other charges," such terms need to be understood in relation to the transaction or contract of loan.

Under the Act, the term "interest" is defined as any payment pursuant to a loan transaction, if it is made in the context of a loan and in relation to the contract between the parties, even in the absence of a debtor-creditor relationship.

However, a payment made to a person not a party to the loan transaction or contract cannot be treated as an interest payment even though the payments are incidental to the loan.
If the definition of interest under the Act or the Treaty were expanded, it would also cover other payments incidental to the actual loan agreement, which would not reflect the true intention of the legislature or treaty policy.

The assessee is not a party to the loan transaction, and the guarantee contract is different from the loan contract; accordingly, a guarantee fee does not fall within the definition of interest under the provisions of the Act and the Treaty.

C. Guarantee fee is not in the nature of business income

The Tribunal observed that the assessee is manufacturing technologically advanced chemicals known as catalysts used in automobile and other industries. It manufactures a variety of precious metal containing catalysts and chemical products which are used in a wide range of industrial applications. From the facts of the case, it indicates that the assessee was not involved in the business of providing corporate/bank guarantees to earn income on a regular basis. The global corporate guarantee that was entered into by the assessee is only for the limited purpose of securing loans to its subsidiaries, and the income derived from the issue of corporate/bank guarantees is only an incidental one. In these circumstances, the Tribunal observed that it is difficult to accept the argument that the income from issue of corporate/bank guarantee would be a business profit, for the application of Article 7 of the tax treaty.

D. Guarantee fee is not in the nature of fees for technical services (FTS)

With respect to the contention of the assessee that the corporate/bank guarantee income could be regarded as FTS, the Tribunal observed that the payment does not relate to the tendering of any technical or consultancy service and the question of making available any knowledge, experience, skill know-how or process or consist of any development or transfer of a technical plan or a technical design. At the same time, it does not also meet the requirement of Explanation to Section 9(1)(vii) of the Act. Therefore, the Tribunal observed that guarantee recharge amount is not FTS.

Citation:

Johnson Matthey Public Ltd. Company vs. DCIT [ITA No. 1143/Del/2016]

Our Comments:

In a globalised world where operations are carried out simultaneously across numerous countries, it is commonplace for a global parent to enter into global corporate guarantee agreements with established multi-national banks. The parent may also recover the guarantee fees paid by it to these banks from its subsidiaries, by following a defined appropriate transfer pricing plan.

This decision of the Delhi Tribunal is in complete contrast to an earlier ruling of the Mumbai Tribunal in the case of Capgemini S.A. (supra), wherein it was held that guarantee commission received by a foreign company did not accrue in India nor can it be deemed to accrue in India, therefore, is not taxable in India under the Act. Even though the Delhi Tribunal did take note of the earlier ruling of the Mumbai Tribunal, interestingly, it has neither distinguished nor dissented from the said earlier ruling.

This decision has thus opened up a Pandora's Box for the taxability of guarantee fee income, with divergent views being expressed by the two benches of the Tribunal.

Until there is pronouncement given by High Court on this very issue, assessees would need to factor in this conflict of opinions while making tax compliances, based on the distinct facts and circumstances of their respective cases.

Shipping company incorporated and liable to tax in UAE eligible for treaty benefits

The Rajkot Bench of ITAT in the case of Martrade Gulf Logistics FZO-UAE held that a shipping company liable to tax in UAE by virtue of its incorporation in UAE is eligible to avail India UAE tax treaty benefits. The treaty benefits cannot be denied to an assessee considering that its directors and shareholders were not UAE residents and its AGM was held outside the UAE. The tie-breaker rule with respect to residential status of assessee was held not applicable as the assessee was not resident of both India and UAE. The tax treaty benefits could be denied only when the creation of an entity was part of manoeuvring, wholly or mainly, to obtain the benefits of the India –UAE tax treaty which were otherwise not available.

Facts & Issue:

Martrade Gulf Logistics FZCO-UAE (hereafter referred to as "assessee") was a shipping company incorporated in UAE. The entire share capital of the assessee company was held by German entities.

The assessee had claimed benefit under Article 8 of the India UAE tax treaty. The return was assessed under section 172(4) of the Act.

The AO declined the tax treaty benefit on the ground that the assessee had not actually been taxed on his income in UAE. The AO took a stand that the effective control and management of the assessee was situated out of UAE since, most of the directors and shareholders of the Company were other national and therefore, assessee could not be treated as resident of UAE.

Aggrieved, assessee filed an appeal before CIT(A) who in turn reversed the action of AO and observed that the assessee was a resident of UAE. The CIT(A) considered the Residency Certificate, Incorporation certificate , Trading License and other documents and observed that place of effective management of the assessee was UAE and therefore assessee was resident of UAE and eligible for India-UAE tax treaty benefits.

Aggrieved, revenue filed an appeal before ITAT.

Contentions of the Revenue:

The AO observed that the place of effective management was not situated in UAE as the directors and shareholders were of different nationalities other than UAE i.e. India, German and Portuguese. Further, the annual General meeting of the assessee was also not held in UAE.

The AO also observed that the assessee was not subjected to tax in UAE. Further, Article 29 of the tax treaty dealing with Limitation of Benefit provisions was invoked and AO contended that the assessee shall not be entitled to the benefits of the India-UAE DTAA as the main purpose or one of the main purposes of the creation of such entity was to obtain benefits of the tax treaty which would not have been available otherwise.

Contentions of the Assessee:

The assessee contended that though the shareholders and directors of the UAE Company are non-UAE residents, the company is managed and controlled wholly from UAE.

Since the business is carried on from the UAE, the provisions of Article 29 are not at all applicable to the facts of assessee.

Observations & Ruling of the ITAT:

The ITAT observed that for the purpose of being treated as a resident of a contracting state, it is necessary that the person should be liable to tax in that state by virtue of its domicile, residence, place of management, place of incorporation, etc. It is not at all necessary that to be treated as liable to tax in UAE, the person should have actually paid tax in UAE.

The tie breaker rule with respect to residential status of the assessee is applicable only when the assessee is resident of both the states i.e. India and UAE. Therefore, tie breaker rule as provided in Article 4(4) of the tax treaty is not relevant in the present case.

The ITAT observed that CIT(A) had given reasoned and elaborate finding that the place of effective management of the assessee company was from UAE.

The ITAT viewed that in order to invoke Article 29, what was to be established was that if the assessee was not to be formed in the UAE, the assessee would not have been entitled for such benefits. The entire share capital was held by the German entities but then, in the India-Germany tax treaty also, similar benefits with regard to taxability of shipping profits only in the state of residents are available. Therefore, whether the company was to be formed in UAE or in Germany, it would not have made material difference so far as non-taxability of the said income in India is concerned.

The ITAT observed that it was undisputed that the assessee was liable to tax in UAE by virtue of its incorporation in UAE and therefore it was covered by the definition of "resident of contracting state" under Article 4(1) of the Indo- UAE tax treaty.

Citation:

ITO v. Martrade Gulf Logistics FZCO-UAE (TS-575-ITAT -2017)

Our Comments:

The issue with respect to benefits of India-UAE tax treaty and the applicability of Limitation of Benefit provisions have been a matter of debate for long time. The above decision has made it clear that the nationality of the shareholders and directors is not a decisive factor while determining the residency of a company. Tax treaty benefits cannot be denied to a person merely because it has not actually paid the taxes. The above decision would also assist assessees in analysing the applicability of Limitation of Benefit provisions under the tax treaty.

TRANSFER PRICING

Multiple year data cannot be used as a matter of right

The Bangalore ITAT in DCIT v.Softbrand India Pvt Ltd (Now IN fore Bangalore Pvt. Ltd, has held that, multiple year data cannot be used as matter of right. Influence of market conditions/ business cycles of earlier years on current year pricing is an important factor to be considered.

Facts & Issue:

During AY 2009-10 Softbrand India Pvt Ltd rendered software development services to its holding company Softbrand International Inc, USA.

The assessee had filed TP study in support of its contention that the price received for its international transaction was at arm's length. The TPO made certain observations with regards to TP study and proceeded to make an adjustment on the basis of the addition made in the assessee's own case in previous year.

TPO considered similar comparables and Arithmetic Mean (AM) of margin as per previous year and determined ALP for the current year.

Being aggrieved the assessee filed an appeal before CIT(A). The CIT(A) deleted the addition made by the AO, on the ground that, action of the AO in adopting the data of AY 08-09 in AY 09-10 was erroneous. CIT(A) held that, prior year or multiple year data can be utilized only on the condition wherein it is established that such data revealed facts which could have influence on the determination of transfer pricing of the impugned year.

Aggrieved, revenue filed an appeal before Bangalore ITAT.

Contentions of the Revenue:

Revenue contended that, the Ld. CIT(A) erred in striking down the addition made by TPO/AO in determining ALP, on the ground that the AO failed to establish relevance between pricing of impugned year and market conditions/ business cycle/ product life cycle of the previous years without considering / appreciating the fact that Rule 10B(4) provides that, data relating to period not less than two years prior to such FY may also be considered if such data reveals facts which could have influence on the determination of arm's length prices in relation to the transaction being compared.

Contentions of the Assessee:

The assessee contended that, it is mandatory to use contemporaneous data while arriving at arm's length price. Prior year or multiple year data could be used only on the condition that it is established that such data revealed facts which could have an influence on the determination of arm's length prices of the transaction being compared.

The assessee further contended that the Ld. AO in his order u/s 92CA of the Act simply stated that there was no pressing reason to deviate from the arm's length mean margin on cost that was determined last year.

Observations & Ruling of the ITAT:

The Hon'ble ITAT heard the rival contentions and perused the material available on record. It dismissed the revenue's appeal against CIT(A)'s order deleting the TP addition.

It held that, the Ld. AO had not established that assessee's pricing was influenced by the market conditions/ business cycle etc. of earlier years and had not provided fresh working of ALP utilizing current year data which could have been put forth before the assessee.

The Hon'ble ITAT further held that, according to Rule 10B(4), the data for comparability of an uncontrolled transaction with International transactions should be the data relevant to the financial year in which international transaction had been entered into and stressed that, "Multiple data cannot be used as a matter of right", it further opined that, since there were no circumstances justifying the use of previous year data in the present case, CIT(A) had rightly rejected the method and the basis of addition by the AO.

Citation:
DCITvsSoftbrands India Pvt. Ltd (TS-934-ITAT-2017(Bang)-TP)

Our Comments:
The decision taken in impugned case is favourable for cases where additions are made by the TPO by using previous year comparables without applying fresh search analysis. Use of Multiple year data is permissible only when, the pricing of the international transaction or domestic transaction is influenced by earlier year's marketing conditions or situations.

Central Board of Direct Taxes (CBDT) on October 20, 2015 issued the final rules to give effect to the use of 'multiple year data' and 'range concept' which were introduced by Finance Act, 2014. As per the said Notification, when using multiple year data, data for each comparable shall be the weighted average of the selected years. In the present case the AO had just selected '*previous year*' set of comparables and had not provided any fresh working of ALP.

GLOSSARY

ABBREVIATION	MEANING
AAR	Hon'ble Authority for Advance Rulings
ACIT	Learned Assistant Commissioner of Income Tax
ACT	Income Tax Act, 1961
AO	Learned Assessing Officer
AY	Assessment Year
CBDT	Central Board of Direct Taxes
CIT	Learned Commissioner of Income Tax
CIT(A)	Learned Commissioner of Income Tax (Appeals)
DCIT	Learned Deputy Commissioner of Income Tax
DRP	Dispute Resolution Panel
DTAA	Double Tax Avoidance Agreement
FTS	Fees for Technical Services
FY	Financial Year
HC	Hon'ble High Court
INR	Indian Rupees
IRA	Indian Revenue Authorities
ITAT	Hon'ble Income Tax Appellate Tribunal
IT Rules	Income Tax Rules, 1962
Ltd.	Limited
PE	Permanent Establishment
SC	Hon'ble Supreme Court
TDS	Tax Deducted at Source
TPO	Transfer Pricing Officer