KNOWLEDGEWARE
JULY 2018

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Editorial:

Dear Esteemed Readers,

As part of our endeavor to continually share our knowledge, we now present our latest newsletter, covering the direct tax and transfer pricing updates for the month of July 2018.

In this edition, in our Back to Basics section, we carry forward our analysis from the previous edition dealing with vital aspects/ deductions affecting computation of Income from Profits and Gains of Business and Profession. We provide our in-depth analysis and discussion relating to the deductions available to an assessee under section 37 (residuary section) of the Act.

In our tax controversy section, we highlight issues which are confronted in practical life. In the earlier edition, we had analyzed the deductibility of interest expenditure under section 36(1)(iii) of the Act and its non-limitationprior to insertion of section 94B of the Act, ensuring debt funding to be a preferable option over equity. In the current issue we carry on with our discussion with additional issues relating to section 94B of the Act.

In our Case Law analysis, we have analyzed the rulings which have dealt with contemporary issues. We have analyzed the decision of Hyderabad ITAT which has held that Interest expenditure could not be claimed where the loans were not given for purposes in line with the main object of the assessee, an important proposition being laid down being for the purposes of business expediency, any downstream investment had to fit in the first main objects of the investing Company

The Bangalore ITAT in Power and Control Systems held that by virtue of insertion of proviso to section 201(1A) by the Finance Act 2012 wef 1 July 2012, even if any person fails to deduct TDS and is not deemed to be an "assessee in default" under the first proviso to section 201(1), the interest shall be payable from the date on which tax ought to have been deducted till the date of filing of return of income by the payee u/s 201(1A) of the Act.

We have further analyzed recent Kolkata HC judgment which has upheld addition referring to the Tax Audit Report furnished, based on the 'window-dressed' financials prepared for availing bank loan. The Hon'ble HC upheld the decision of the ITAT stating that the financials prepared accompanied by a certificate as to its fairness cannot be tailor-made to make it attractive for bankers and thereafter remove the sheen when it was time to pay tax.

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. Carrying out accurate functional asset and risk analysis is the fundamental principle to arriving at a logical arm's length computation for transactions undertaken. Various courts have emphasized this principle and the Delhi ITAT in the case of Wolters Kluwer (India) Pvt Ltd vs DCIT reiterated that, when the TP analysis was based on wrong FAR analysis then the entire subsequent exercise becomes erroneous, and the same needs to be carried out a fresh.

We hope the analysis would make an interesting reading. As always, we look forward to your feedback and comments which would enable us to enhance the content of the newsletter.

Happy Reading!

Yours Sincerely,

Knowledgeware Team
B. K. Khare & Co.

ARTICLES:

Section 37 - residuary provision for deductions under the head "profits and gains from business or profession" – Part II

In the last issue of Knowledgeware we dealt with the conditions which have to be satisfied before a particular expenditure can be considered eligible for deduction u/s 37. Briefly these are:

- The outgoing should be in the nature of an expenditure
- It should not be covered by sections 30 to 36
- It should have been incurred during the accounting year
- It should not be personal
- It should be laid out or expended wholly and exclusively for purposes of business
- It should not be in the nature of capital expenditure

We dealt with each of these conditions at length and in particular dwelt on the fifth condition- namely, that the expenditure should be for "purposes of business" and analyzed, in general terms what this expression implies. In the present issue of *Knowledgeware*, we deal with actual applications of this concept. We examine in other words to what extent certain types of expenditure- such as that on fines, penalties and interest, litigation related to criminal and quasi-criminal proceedings, secret commissions, payments tainted with illegality, , protection of business and business assets, compensations, damages, political donations, pensions, gratuities , welfare expenses etc.- are deductible u/s 37.

Fines, penalties and interest

The classic proposition on fines and penalties was laid down by the Supreme Court in *Haji Aziz and Abdul Shakoor Brothers 41 ITR 350* in which it was held that infraction of law does not constitute a normal incidence of business. Carrying on of business in modern times however has become much more intricate since this judgment was first delivered. The Supreme Court took cognizance of this complexity in *Prakash Cotton Mills v. CIT201 ITR 684 (SC)* and *Ahmedabad Cotton Mfg Co. Ltd v. CIT 205 ITR 163 (SC),* and indicated that where a fine or penalty is imposed, the A.O. must examine whether it was under the relevant statutory scheme penal or compensatory in nature. If in the nature of the latter it can be allowed as deduction.

Thus a penalty paid under the Customs Act not for infraction of law or as personal penalty but in lieu of confiscation of goods was held as deductible u/s 37 [*CIT v. Parthasarathy 212 ITR 105* (*Mad)*] .

Applying this test to delayed payment of sales tax would involve splitting up the penalty into two components- that which relates to compensation would be allowable, but that which relates to penalty *simpliciter* would not be allowable [*Standard Batteries v. CIT 211 ITR 444(SC); Swadeshi Cotton v. CIT 233 ITR 199 (SC)*]. On this basis,, a penalty paid for under-invoicing of imports and importing in excess of the quantity prescribed under the import license, not involving any infraction of law was held to be an allowable deduction [*CIT v. Tangal 184 ITR 88 (Bom)*]. The same would be the case in respect of penalty paid for purchase of goods from a third party without the assessee realising that they had been illegally imported [*CIT v. Pannalal 67 ITR 667(Bom)*]. Likewise, would be the case where a penalty is imposed for damages for breach or delayed performance of a contract [*Govind v. CIT 79 ITR 493 (Orissa)*; *CIT V. R.D. Sharma 137 ITR 333*].

Interest, being compensatory in nature, is allowable qua delay in payment of a cess because it is part and parcel of the cess or an accretion to it [*Mahalakshmi Sugar Mills Co. v. CIT 123 ITR 429 (SC)*]. Interest for delayed payment to an agent under the Sugarcane Regulation and Purchase Supply Act [*CIT v. Modi Industries 197 ITR 517 (Del)*] or on arrears of tax under various state sales tax Acts (*CIT v. Luxmi Devi Sugar Mills 188 ITR 41 (SC);Lachmandas v. CIT 254 ITR 799(SC)]* is equally an allowable deduction. This principle is also applicable to interest on delayed payment of customs duty [*CIT v. India Pistons 250 ITR 279(Mad*)] as well as delayed payment of power charges under the relevant Electricity Supply Act [*CIT v. Travancore Electro Chemical 211 ITR 775 (Kerala*)].

Interest on delayed payment of income-tax or that component of it as is payable in advance is not admissible as a deduction. This is because such interest is part of tax and since the tax is not deductible, neither is the interest component of it [B*harat Commerce and Industries v. CIT 230 ITR 733 (SC)*].

Criminal and Quasi criminal proceedings

The test to be applied in criminal proceedings is not whether the proceedings ended in acquittal or conviction, but what in essence is the nature of the proceeding itself. If the proceeding is criminal in nature with the possibility of the businessman being sentenced to fine or imprisonment, his mere acquittal will not make out a case for the expenditure being allowed [*CIT V. Hirjee 23 ITR 427 (SC)].* Thus expenditure incurred to fight cases involving infraction of law for breach of customs, excise and other regulations have been held to be disallowable [*J.K. Cotton v. CIT 64 ITR* 444 *(All)* ; *JuggilalKamlapat v. CIT 28 ITR 78 (All)*]. But significantly in the case of *CIT v. Dhanrajgiriji 91 ITR 544 (*SC) the Supreme Court ruled that, irrespective of whether litigation is criminal or civil, what has to be seen is whether it is being carried as a trader. If so, the expenditure in connection therewith has to be allowed as a deduction. In that case, it does not matter whether the litigation is civil or criminal; on the other hand, if it is not incidental to the carrying on of business it cannot be allowed as a deduction. But the Supreme has yet to reconcile this decision with the earlier decisions on the subject.

Expenditure tainted with illegality

S.37(1) lays down that an expenditure incurred for a purpose which is an offence or prohibited by law cannot be allowed as deduction u/s 37(1). Needless to say the last word on whether there was an infraction of law or whether the purpose for which the expenditure was incurred must be pronounced by the appropriate court of law and not the A.O. But if the whole business carried out by the assessee is illegal- as in the case of smuggling, bootlegging or prostitution, the entire expenditure incurred by the assessee cannot be disallowed because what can be brought to tax is only income [*MaddiVenkataramanv.CIT 229ITR 534 (SC)*]. The aforesaid first principles would also prevail in the consideration of business losses in the computation of total income of a doctor who manufactures heroin but from whom stocks of this substance are seized and confiscated in a raid [*Dr. T.A. Qureshi v. CIT 287 ITR 547(SC)].*

Secret Commissions

A number of High Courts have examined the question whether secret commissions can be allowed as a deductionwhen the factum of payment has been proved but the assessee refuses to disclose the names of the parties. The Bombay and Gujarat High Courts have held such payments as allowable when they were established to have been made for business purposes. The Gujarat High Court also ruled that the assessee must be able to establish that the payments were made in line with the practice prevailing in that line of business[*CIT v. GoodlassNerolac 188 ITR 1(Bom*); *Joshi v. CIT 209 ITR 324(Guj*)]. When paid to government officials, such a commission being against public policy and prohibited by law is not allowable as deduction [*CIT v. Kodandarama l44 ITR 195; TariniTarpauline v. CIT 245 ITR 495 (A.P.)*]. Its allow ability must therefore to be taken as limited to private persons. The payment would also have to be subjected to the test laid down in the Explanation to s.37(1).

Expenditure to prevent extinction of businessetc

Expenditure incurred for preservation of business is allowable as any expenditure incurred to safeguard the existence of an asset [*CIT v. MacNeill 158 ITR 385 (Cal); State of Tamil Nadu v. Simpson 197 ITR 237 (Mad); AIR v. CIT 49 ITR 196(Bom)].* On this principle, expenditure incurred to resist a petition for winding up of business filed by some shareholders or to prevent the takeover of business by the Custodian of Evacuee Property are allowable as ordinary revenue expenditure [*Ebrahim v. CIT 81 ITR 664(Bom)*]. Expenditure incurred to prevent change in shareholding however can hardly be justified on this basis and would have to disallowed because it cannot be described as expenditure 'for the purposes of trade' [*Morgan v. Tate 35 TC 367 (HL)*]. But where expenditure was incurred to buy out dissident shareholders so as to facilitate the smooth running of business the same was held as having been incurred for purposes of business [*IR v. Carron Co. 45 TC 18(HL)*].

Expenditure for political purposes

Political donations are not deductible under this section for the simple reason that they cannot be linked to carrying on of business, but when such link specifically exists the expenditure in question would be deductible under this provision [*Ambala Bus Syndicate v. CIT 95 ITR 283]* but not otherwise [*J.K. Cotton v. CIT 62 ITR 813(All)*;*Indian Steel v. CIT 69 ITR379(Cal)]*. It may be noted however that with effect from the assessment year 1979-80, expenditure on advertisements in pamphlets, brochures, souvenir etc is now specifically disallowed u/s 37(2B).

Damages and compensation

The test of capacity is particularly relevant for deciding whether compensation or damages are deductible or not. When either of these are paid to a third party in the ordinary course of business, they are deductible; otherwise, they are not [*Strong and Co Ltd v. Woodifield 5 TC 215* }. For instance, compensation paid by railway or a transport company to an injured passenger is deductible because maintaining the safety of passengers during the course of a journey is very much part of the assessee's business; but this would not be true when the window of a grocer's premises falls on a hapless pedestrian, because the compensation in that case is paid by the grocer not qua trader but as a householder, and the expenditure is not incidental to the carrying on of business [*Strong and Co Ltd v. Woodifield 5 TC 215*].

By the same logic, compensation paid by an assessee for damages caused by his employee on account of negligence [*Annamalai v. CIT 47 ITR 814 (Ker)*]; for breach of warranty [*CIT v. Prafulla 73 ITR 119(Orissa*], failure to perform a trading contract *[Jain v. CIT 91 ITR 557 (Delhi); CIT v. Raj Wool 160 ITR 358(Raj)*], to get rid of an onerous trading obligation to supply goods at a particular price for particular period [*CIT V. Rajaram 208 ITR 503(Bom)*] or to get rid of an employee, director or managing agents [*CIT v. Turner Morrison 68 ITR 147(Cal*); *Noble v. Mitchell 11TC 372; CIT v. Glaxo 114 ITR 110(Bom)*(voluntary termination of a distribution agreement)] are all allowable.

There has been a gradual broadening of judicial thinking in this regard. Thus expenditure which would have been clearly disallowable once may now be considered to be allowable even in cases of misfeasance, because a sum paid in a civil settlement of a charge of misfeasance may not be adequate proof that infraction of law did take place [*CIT v. Rajgopal Transports Ltd. 144 ITR 573(Mad); CIT v. Desiccant Rotors International P. Ltd347 ITR 32 (Delhi*)].

Pensions, gratuities and other welfare expenses

Viscount Cave in *Atherton V. British Insulated and Helsby Cables Ltd. 10TC 155 (HL)*held that pensions, gratuities and other voluntary payments made to employees out of commercial expediency for the purpose of retaining the services of loyal employees are deductible as being wholly and exclusively laid out for purposes of business. The Supreme Court accepted this principle in *ShahzadaNand v. CIT 108 ITR 358(SC)*. The claim has to be examined from the point of view of a prudent businessman and not the revenue [*Abbas Wazir v. CIT 265 ITR 77(All*)]. Provision for liability for gratuity for earlier years is allowable up to the beginning of the current year [*CIT v. Uma Trading 231 ITR 272(SC)]* and remains so allowable even if it in excess of the amount payable under the Payment of Gratuity Act, 1972 [*CIT v. Associated Cement249 ITR 3]*or paid to the relatives of the deceased employee [*Calcutta Landing v. CIT 65 ITR 1(SC)*].

On general principles, gratuity paid directly to an employee even before its transfer to its present owner of the business [*CIT v. Srinivasa 131 ITR 692 (Madras*)] or payments made by the transferor to the transferee for taking over the liability of the transferor's existing liability for gratuity, are allowable *[WT Suren v. CIT 230 ITR 643 (SC*); please see *CIT v. SinnarBediUdyog 257 ITR216* (*Bom*) for payments made directly to the employee- these too are allowable even though they relate to the period prior to the takeover]. However, once deduction is allowed to a contribution made to an approved gratuity fund u/s 36(1)(v), subsequent actual payment to an employee to that extent cannot be allowed again [*CIT v. Anglo India Jute 250 ITR 90].*

Insofar as retrenchment compensation is concerned, it has been held to be allowable where it is paid as part of a continuing business [C*IT v. Simon 187 ITR 302 (Ker)*], on the sale of part of a continuing business [*Jayashree Tea and Industries Ltd. v. CIT 272 ITR 193 (Cal*)],under a scheme of voluntary retirement with view to rationalizing an existing business [*CIT v. Assam Oil 154 ITR 647 (Cal*)], or on temporary cessation of business [*CIT v. Margarine and Refined Oils Co. Ltd. 282 ITR 576 (Kar)*].

Medical expenses incurred on medical treatment of directors or bringing back a dead body have been held to be for purposes of business and are as such allowable [*CIT v. Supreme Motors 84 ITR 1 (Del)*]

Presentation of gifts like wrist watches to employees on the occasion of the anniversary of the formation the company [*CIT v. Aditya Mills 209 ITR 933 (Raj)*] or for such purposes as encouraging punctuality or keeping employees' morale high [*CIT v. Hayward Waldia 209 ITR 159(Cal*)] were all held to permissible under this provision. Similarly, expenditure incurred for repair of recreation club buildings used by employees for their recreation is an allowable deduction *[Assam Brook Ltd. v. CIT 267 ITR 121(Cal)*]. And by this very principle expenditure incurred for obtaining corporate memberships for employees is similarly deductible [*CIT v. Infosys Technologies Ltd. 349 ITR 582 (Kar)*]. Likewise, contributions to labour and employees welfare funds too are deductible, for refusal to make such contributions may lead to labour unrest [*Cheran Engineering Corporation v. CIT 238 ITR 892 (Mad); CIT v. Machine Tools 190 ITR 220 (Cal)*]. Even contributions to an un-recognised provident fund set up under the Provident Fund Act, 1925, is allowable as deduction because the bar u/s. 36(1)(iv) does not cover contributions made under the aforesaid Act.

Conclusion

In the next issue of *Knowledgeware* we will carry forward this discussion and deal with other important issues related to s.37 which we have not covered so far.

Tax Controversy

Interest limitation deduction – a provision of many limitations – Part - II

In our previous Newsletter, we discussed about the provisions of section 94B of the Income Tax Act, 1961 (Act) and certain issues arising therefrom. As a refresher, section 94B limits deduction for interest in relation to a debt given or guaranteed by a non-resident Associated Enterprise (AE) to 30% of EBITDA of the taxpayer.

We discuss certain additional issues relating to section 94B in this edition.

1. Calculation of EBITDA

Section 94B limits deduction of interest to 30% of EBITDA. Determination of EBITDA therefore assumes significance. The primary question for consideration is whether the EBITDA should be considered as per the financial statements or as per the tax laws.

BEPS Action Plan 4 dealing with "*Limiting Base Erosion involving interest deductions and other financial payments"* specifies that EBITDA should be computed based on tax numbers and should be based on the tax rules [Para 23 and Para 88 of BEPS Action Plan 4]. It also recommends that the EBITDA computed as per tax rules should be adjusted for tax-exempt income included in the EBITDA [Para 89 of BEPS Action Plan 4].

Section 94B is silent about calculation of EBITDA. Hence, it remains an open question as to whether EBITDA should be computed as per accounting principles or as per tax laws. The concept of EBITDA is not defined under the tax laws and in the Indian context, it is largely an accounting concept. Furthermore, India has not adopted the recommendations of BEPS Action Plan 4, verbatim. Hence, it may be reasonable to consider that in absence of statutory direction regarding computation of EBITDA, the EBITDA should be based on the financial statements of the taxpayer.

2. Implicit and Explicit Guarantee by the non-resident AE

Section 94B covers cases where the debt is issued by an unrelated party but the AE provides an <u>implicit or explicit guarantee</u> to the lender or deposits a corresponding and matching amount of funds with the lender.

Guarantee, by its very nature, would be a positive act on the part of the AE to the unrelated lender. Furthermore, in organised finance, guarantee would be a formal and documented process. In this context, one wonders what would constitute an implicit guarantee. For instance, where the lender considers the reputation of the AE and the AE's association with the lender for granting a loan to the taxpayer, would such an act constitute an implicit guarantee by the AE? Furthermore, how does one conclude whether the AE has provided an implicit guarantee? As such, the term 'implicit' guarantee requires clarification.

3. Loan from an Indian resident, but guaranteed by the AE

Another issue for consideration is where the taxpayer takes a loan from an Indian resident which is guaranteed by a non-resident AE. The bare provisions of section 94B do not make any distinction between a resident lender and a non-resident lender. Hence, on a plain reading, it appears that interest on loans taken from a resident lender could also get covered by section 94B.

The plain-reading interpretation, however, is not in consonance with the intention of introduction of section 94B of tackling the challenge of base erosion and profit shifting. Where interest is paid to an Indian lender, there is no flight of profit from India and no base erosion. As such, it may be argued that section 94B should not apply to interest paid to an Indian resident. Recently, a taxpayerhas challenged the constitutional validity of section 94B before the Honourable Madras High Court, in so far as it relates to interest on loan taken from a resident lender[Writ petition filed by Siemens Gamesa Renewable Power Private Limited]. The verdict of the High Court is awaited.

4. Effect of section 94B on capitalised interest costs

Where capital expenditure is funded through borrowings, the interest on such borrowings is capitalized to the cost of fixed assets till such time the assets are put to use. While such interest costs are not directly claimed as an expenditure, they are indirectly tax deductible when depreciation is charged on the cost of fixed assets. A question that arises for consideration is whether section 94B apply to such capitalized interest costs.

Section 94B(1) states that *"Notwithstanding anything contained in this Act, where an Indian company… being the borrower, incurs any expenditure by way of interest or of similar nature exceeding one crore rupees <u>which is deductible in computing income chargeable under the head "Profits and gains of business or profession"</u> ….the interest shall not be deductible in computation of income under the said head to the extent that it arises from excess interest, as specified in sub-section (2)*

On the basis of the above, it may be said that section 94B is attracted only where the interest expenditure is deductible. In case of capitalized interest cost, the tax deduction is claimed by way of depreciation. Where the interest cost is capitalized, it loses its nature as interest and is subsumed in the asset cost. Furthermore, it is a settled position that depreciation is an allowance and not an expenditure. Hence, it may be argued that since the taxpayer is claiming deduction by way of depreciation and not as interest expenditure, section 94B cannot be applied.

At present, it appears that the language of section 94B does not prohibit claim of depreciation on capitalized interest cost. However, this position may change in years to come as the change of base erosion still applies.

Concluding remarks:

Section 94B reflects India's intent to adopt the recommendations of the OECD made under the BEPS Action Plans. While India has based section 94B on BEPS Action Plan 4, it has customised the recommendations of Action Plan 4 to meet its intents and requirements.

Considering the practical challenges that could arise from application of section 94B, one could expect certain amendments to the said section in the times to come. In any case, section 94B would significantly influence capital structures and debt push-down strategies and would require careful consideration and planning.

HIGH COURT

The Kerala HC rules that releasing share to other partner upon firm's dissolution amounts to 'transfer'

A recent ruling of the Kerala High Court held that allotment of assets of partnership firm on dissolution being the realization of a pre-existing right, do not amount to 'transfer. However, HC further held that "on the release of the share of the other partner, there is a transfer occasioned and the rightsover that property accrues to the assessee, only on such release being effected by the otherpartner", thus treated the gains with respect to share released by other partneras short term.

Facts and Issue:

Dr.P.N.Bhaskaran ('assessee') was a partner of a firm engaged in the business of running a hospital.On March 31, 1997, the firm, consisting of two partners, i.e., the assessee and his daughter, was dissolved and the daughter released her share in the firm the father i.e. the assessee herein. The assessee also took his share of the assets of the firm and the hospital belonged exclusively to him on such dissolution of the firm and it thus became a proprietorship which was later sold on March 18, 1999 for Rs. 5 Cr. The exact share of each of these partners was not determinable.

The assessee filed return forAY 1999-2000 showing the apportionment of the consideration relating to building, furniture, electric and sanitary fittings, equipments and machinery, land, goodwill and trademark of thehospital and nursing home.

Withrespect to the building, the assessee offered short term capital gainsfor assessment. Consideration obtained for land, goodwill and trademark, which came to Rs.3,75,00,000/-, was offered for taxation as long term capital gains along with claim for exemption as per Section 54EA in so far as having invested in UTI.

The AO allowed the exemption from LTCG. However, CIT suo moto revised the order u/s 263 onthe ground that the assessee became the exclusive owner of the property, therefore, the assetswere 'short term capital assets' since they were held for less than 36 months till date of sale i.e.March 18, 1999.

On reassessment based on suo moto revision, the AO rejected the claim of longterm capital gains for land, trade mark and goodwill and assessed the entire capital gains asSTCG in the hands of the assessee, being the exclusive owner from the date of dissolution offirm, as short term capital gains.CIT(A) upheld the order of the AO.

On further appeal, the ITAT held that where theview adopted by the AO is permissible in law and when the AO adopts one of the two courses oflaw, merely for the reason it has resulted in loss of revenue, invocation of Sec. 263 is not enabled and thus, allowed the assessee's claim on long term capital gains.

Aggrieved, the Revenue preferred an appeal before Kerala HC to decide on the validity of proceedings u/s. 263 of IT Act and determine whether the Tribunal was correct in treating the consideration relating to land, goodwill and trademark as long term capitalgains and allowing exemption u/s. 54AE thereon.

Contentions of the Assessee:

The Tribunal allowing assessee's claim held that on dissolution of the firm there is no separate assignment of ownership to the partners and there is only allotment of the properties in proportionto the shares and therefore, the view taken by the AO in the original assessment proceedings was not erroneous.

The assessee relied on the decision in Sunil Siddharthbhai v. CIT [(1985) 4 SCC 519] to contend that on dissolution of a partnership firm there cannot be a transfer, as held by the Hon'ble Supreme Court. Thus, the consideration for land, goodwill andtrademarkwas rightly taxed as long term capital gains, which was entitledto exemption u/s. 54EA.

Further, decision of the Apex Court in the case of CIT v. Kwality Steel Suppliers Complex [(2017) 14 SCC 548] was relied on, to putin proper perspective the powers conferred under Section 263 and the situations in which such power could be invoked.

Contentions of the Revenue:

The Revenue contended that only after dissolution of firm on **March 31, 1997**, the assesseebecame the exclusive owner of the property, therefore, the assets were 'short term capital assets'since they were held for less than 36 months till date of sale i.e. **March 18, 1999**.

The Revenuefurther contended that when capital gain on building was offered as STCG, there could not beany different claim made for the land or for goodwill and trademark.

As per Section 45(4)- profits or gains arising from the transfer of a capital asset byway of dissolution of firm, is chargeable to tax as income of the firm of the previous year in whichtransfer takes place. Thus, under the IT Act a transfer is effected, which view is furtherfortified by a decision of a Full Bench of this Court in K.I.Viswambharan& Brothers v. CIT [(1973) 91 ITR 588].

Specificreliance was also placed on the decision in AddankiNarayanappa v.BhaskaraKrishnappa [AIR 1966 SC 1300] to urge that when thepartnership subsists, neither of the partners can claim a right on thepartnership assets even to the extent of his share in the business.Only on dissolution and the exclusive rights coming into thepossession of the partner could there be such exclusive rightclaimed, which, again, indicates that the partner so acquiring therights on dissolution could only claim exemptions relatable to thedate of dissolution of the firm.

Observations & Ruling of the Kerala High Court

The Kerala High Court relied on SC ruling in Kwality Steel Suppliers Complex to hold that 2 conditions need to besatisfied for invoking revisionary proceedings u/s 263 i.e. i) the order of AO sought to be revisedis erroneous; and ii) it is prejudicial to the interests of the Revenue and simply because the orderof the AO was prejudicial to the revenue, it cannot be a reason for suo moto revision u/s 263.

Further, HC noted that the Supreme Court in AddankiNarayanappa v. BhaskaraKrishnappa had held that afterdissolution or on retirement, the partner gets an exclusive right to claim the assets to the extent ofthe value of his share and when he takes such share there is no transfer effected and the partneronly takes exclusively what he held in common before dissolution or retirement.

Since the exact shares of partners were not available on record and valuation was also to bedecided, HC remanded the matter to ITAT, before whom the assessee was to produce the deed ofdissolution and release executed in the year 1997-98 and directed ITAT to decide the quantum ofLTCG/STCG, determining the same at the valuation as seen from the dissolution deed, and iflesser than the market value as on the date of release of the share of the other partner in theassets; on the market value.

On facts, it was held that the share of the assessee which he receivedexclusively on dissolution being relatable to a pre-existing right hehad, as one of the partners; to the extent of such share, the assessee's claim for exemption from long term capital gains forreason of the deposit made to UTI under Section 54EA has to beallowed. However, on the value of the shares in which the otherpartner had a pre-existing right; which was released in favour of theassessee, the right over it can be claimed only from the date ofrelease and if subsequent sale falls within the 36 month period,necessarily the assets are to be assessed as short term capitalgains to that extent.

Thus, the High Court did not agree with theTribunal'sview on the acceptance of the claim raised by the assessee forlong term capital gains at least to the extentof the value of the assets released in his favour by the other partneron dissolution. To that extent, the finding of the Assessing Officer inthe original order was held to be an erroneous finding, which was alsoprejudicial to the interest of the revenue. Thus, it was held that the Commissioner was perfectly justified in invoking thepowers under Section 263. To the extent of the share the assesseehad prior to dissolution and the valuation of that share, which wasallotted to his share on dissolution; the order of theTribunal was upheld insofar as allowing the exemption available from long termcapital gains for reason of compliance with Section 54EA. There isno ground for a suomotu revision to that extent since the AssessingOfficer's finding on that count is not erroneous.

Since, the exact shares of thepartners was not known and the valuation was also aquestion to be decided on facts, the matter was remanded to theTribunal, where assessee would produce the deed ofdissolution and release executed in the year 1997-98.

The provisions of sub-section (4) of Section 45 enabled assessment atthe hands of the firm, of the profits and gains arising inter alia fromthe dissolution of a firm. Which, on application of general principlesof partnership, could not be assessed in the hands of the partners whotake away their pre-existing right over the capital assets, which hasbeen held by the various precedents to be not resulting in anytransfer of capital assets.

Citation:

Dr.P.N.Bhaskaran [TS-333-HC-2018(KER)]

Our comments:

In the facts of the given case, since the shares of partners were not determinate on the date of dissolution, treating the assets to the extent of the outgoing partner as not having a pre-existing right with the assessee, could be a debatable issue.

HC held that principle of Real income theory to be adopted for valuation of closing stock of Bank

Facts: During the AY 1984-85 the assessee bank in accordance with the directions of the Reserve Bank of India had invested in securities and shares of various public limited companies. The said investments were treated as stock in trade and valued at cost in books in accordance with the statutory guidelines and accounting policy consistently followed by the assessee bank. However, in the income tax return the assessee valued the stock at net realisable value which was lower than the cost. The AO rejected the assessee 's claim of valuation at lower of cost or net realisable value and valued the shares held as stock at cost for the purpose of computing taxable income. The action of AO was upheld by CIT(A). Tribunal relying on the decision of Calcutta High Court in case ofUCO Bank Ltd (200 ITR 68) held that the assessee was not entitled to claim a different basis of valuation of closing stock from the one adopted in its books of accounts.

Decision: HC noted that the above decision in case of UCO Bank was subsequently reversed by SC. The Hon'ble SC had held that it was open to the assessee to value stock at cost or net realizable value, whichever is lower irrespective of the accounting treatment in the books. It also held that the concept of real income theory should be applied for determining the taxable income. The HC noted that the assessee for last 30 years had been valuing its stock in trade at cost for the purpose of books. However, for the purpose of computing taxable income it had valued the said stock at cost or net realizable value, whichever is lower. **and the said practice had been accepted by the department in the past.** The assessee bank was under obligation as per the statutory provisions to value stock at cost in books and had no option. However, the taxable income is required to be determined on the basis of real income rather than theoretical principle of accountancy. The assessee had been consistently valuing the stock at cost or net realizable value whichever is lower for the purpose of determining the taxable income which is in accordance with the ratio laid down by the Hon'ble SC and had been accepted by the department in the past in respect of other stocks held by the assessee. Thus, HC held that for computing taxable income stock should be valued at cost or net realizable value, whichever is lower.

Citation: United Bank of India, TS-355-HC-2018, High Court at Calcutta

HC confirms addition based on 'window-dressed' Financials certified by CA for availing bank loan

The Calcutta HC held that the AO could have made additions on the basis of the financials prepared on an estimated basis and certified by the CA to avail loan from the bank. The HC has also directed to forward a copy to the Institute of Chartered Accountants of India to take appropriate action against the CA.

Facts & Issue:

The assessee was interested in obtaining credit facilities from a bank and had a balance sheet prepared by a firm of CA for that purpose.

The balance sheet indicated figures which were not commensurate with what was reflected in the books of accounts of the assessee. Nonetheless, a certificate was issued by the CAs in Form 3CB under Rule 6G(1)(b) of the IT Rules.The figures in the balance sheet prepared for availing the loan were at variance with the figures indicated in the balance sheet later on presented by the assessee before the AO.

The AO relied on the figures reported in the audited financials prepared for availing loan and completed the assessment. Aggrieved by the assessment order, the assessee filed an appeal before the CIT(A). The CIT(A) granted relief to the assessee. However, on appeal by the Income-tax Department, the ITAT set aside the order of the CIT(A) and sustained the addition made by the AO. Aggrieved, the assessee filed an appeal before the HC.

Contentions of the assessee:

The AR submitted that the part of CA was based on the information and explanations provided by the Appellant, which were estimated figures and had no relation with the actual figures. Further, the AR highlighted that the report issued by the CA was in Form no. 3CB and not in Form no. 3CD, which provides for the particulars that are required to be furnished under section 44AB of the IT Act.

The AR also contended that it is a usual practice to prepare financials on the basis of estimates at a time prior to when the assessee is statutorily required to complete the annual accounts and hence, addition cannot be made based on such estimated figures.

HC's observations:

The HC observed that the audited balance sheet and profit and loss account nowhere stated that these are on the basis of estimate. The audited profit and loss account and balance sheet prepared for the purposes of availing bank loan did not give any indication that they were only estimated figures. The HC noted that the provisions of section 44AB were applicable in this case. The assessee obtained the tax audit report from the two different auditors. Section 44AB does not require that the tax audit should be conducted twice.

The HC noted that the CA certificate purported to give an impression that it was an exercise of an audit under section 44AB of the IT Act since it was presented in a statutory form and only in the fine print the CA has indicated that the financials were on estimated basis. The HC further noted that the CA certificate even confirmed that the accounts, which were based on estimation, give a true and fair view of the state of affairs.

The HC observed that financials cannot be tailor made to suit a particular purpose or windrow dressed to suit that purpose.

The HC concluded that the doctrine of pari delicto would apply in the present case, which will preclude the assessee from detracting from the figures contained in the earlier balancesheet and profit and loss accounts certified by CA, at any subsequent stage. Any subsequent change in balancesheet figures would rather give an option to the AO to pin the assessee down on the basis of the assessee's representation contained in the earlier balance sheet.

The HC further stated that a CA is governed by certain discipline and he has to conduct audit in accordance with the provisions and rules of the Chartered Accountants Act. Schedule II and Part 1 hold a chartered accountant guilty of professional misconduct if he permits his name or name of his firm to be used in connection with the audit based on estimate. Hence, the HC took a step further by giving a direction to the Registrar to forward a copy of its order to the Institute of Chartered Accountants of India for appropriate steps, if thought fit, to be taken against the CA, upon due notice to such firm of Chartered Accountants.

Citation:

Binod Kumar Agarwala v. CIT [TS-331-HC-2018]

Our Comments:

The decision brings the common conduct adopted by the many taxpayers to avail loans by displaying a rosy picture of its financial position, which in turn may lead to bad loans at a later point of time. The HC highlighted the incorrect approach of the assessee to maintain multiple financials for different purposes to meet their required needs. It further emphasized on the apparent support of the CAs towards abetting in the commission of a colossal act of misrepresentation before other authorities like bank, etc.

The HC has made a very pertinent observation that this is a question of larger than any legal issue under the IT Act and is a matter of public policy.

This decision brings into focus the complacency and connivance that often exists between tax payers and professionals with the object of defrauding the system. That such practices are unethical and as rightly stated by the HC against public policy, are obvious. The CA was guilty of professional misconduct. This decision should be an eye-opener for all professionals. Of course, neither is this case the first such instance nor will it be the last such instance though of course, the tough stand of the Honourable HC merits being saluted.

TRIBUNAL

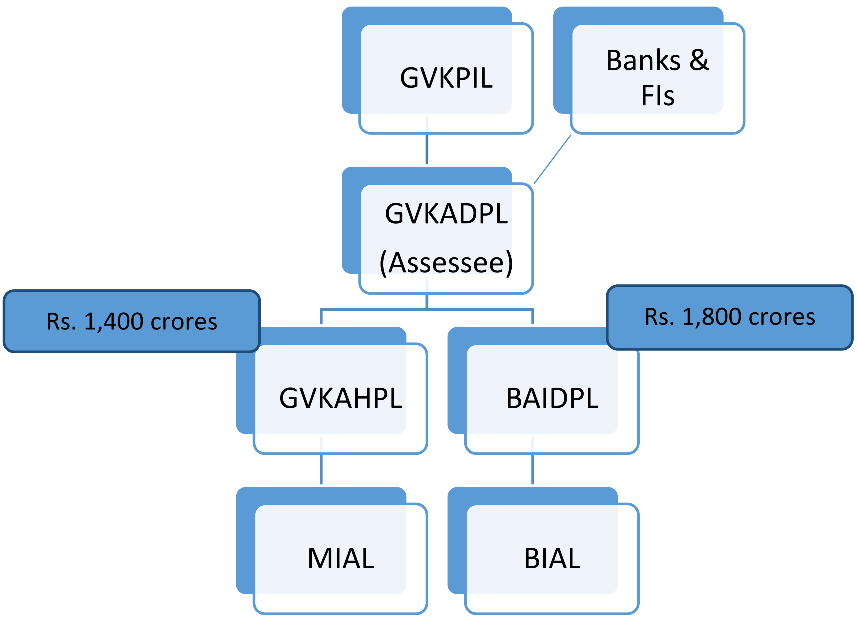
Interest expenditure could not be claimed where the loans were not given for purposes in line with the Main Object of the Assessee

Facts & Reasons for the Appeal:

In the following paragraphs, we are digesting an interesting interpretation by the Hon'ble ITAT, Hyderabad Bench, in relation to an issue pertaining to whether interest expenditure could be claimed for loans advanced in order to acquire controlling stake in downstream investments.

The matter in the instant case related to AY 2012-13. The assessee was the promoter of companies involved in construction, development and operation of domestic/international air ports. Initially, the assessee filed a ROI for this AY declaring Nil income. Subsequently, it revised the ROI by claiming a loss of Rs. 164.12 crores under the normal provisions. During scrutiny assessment proceedings, the AO noted that the loss was owing to a debit of interest cost amounting to Rs. 164.12 crores, which the assessee claimed related to its business.

Basically, the assessee had granted interest-free unsecured loans to its wholly owned subsidiaries ('WOS'), who were engaged in development & operation of domestic airports (Mumbai & Bangalore). These loans were given out of a) interest-free unsecured loans received by the assessee from its parent company and b) interest bearing funds borrowed from banks and financial institutions. It was the latter source of funds, which gave rise to the interest expenditure. The situation can be graphically depicted through the following diagram:



Before the AO, the assessee contended that it was engaged in the development and operation of domestic airports, one at Mumbai and another atBangalore through its ultimate step-down Special

Purpose Vehicles. On facts, the assessee did admit that the deployment of the funds by the WOS was to acquire a controlling stake in the downstream SPVs, which, by itself, provided the business purpose argument for such interest expenditure.

The ld. AO, however, begged to differ. He disallowed the claim of interest expenditure of Rs. 164.12 crores, *inter-alia* on the basis of following key pointers:

- That the assessee wasengaged in the business of advancing the interest-bearing funds to its sister concern as interest-free advances and not in construction andmaintaining the airports;
- That the borrowed money had not been utilised by the assessee in a way that made more commercial sense and helped the assessee in running the intended businessin a more efficient manner;
- That the assessee had diverted the interest-bearing funds to SPVs, which were claiming tax holiday benefits and paying taxes under book profits, thusenabling such SPV’s to create reserves in their hands forthe purpose of utilization of such reserves amongst thegroup companies; and
- That the assessee had not carried out any activities, which enabled the assessee to earn any direct income and also that there was no possibility of earning any income, since the investment has been made by theassessee in the form of interest-free loans.

The ld. CIT(A) agreed with the ld. AO. Hence, the assessee filed an appeal before the Hon’ble ITAT.

Arguments before the ITAT and the decision:

Before the Hon’ble ITAT, the assessee argued that it was commonplace in any infrastructure project to have a SPV structure, since these projects typically require a lot of strategic investors to put their money in. The assessee canvassed the main objects of the Companyto submit that it was engaged in thebusiness ofconstruction and development of airports and further, theobjects also providedthat infrastructure projects could be invested in through SPVs. Therefore, it wascontended that any loan given to fund these SPVs was nothingbut funding its own business operations, that there was commercial expediency involved indeed and hence, anyinterest incurred on such borrowed funds was totally allowable u/s 36(1)(iii) of the Act.

The Revenue, on the other hand, pleaded that the assessee had not carried out anybusiness activity directly to earn any income and going by theinvestment it made in the form of interest-free loans / advances in its subsidiaries, there was also no possibility of earning any income. The Revenue argued that in substance, there was no commercial expediency involved in booking the interest expenditure by the assessee.

The ITAT took note of the facts that a) there were no assets worth mentioning in the assessee’s books and no depreciation was claimed, b) the SPVs viz. MIAL and BIAL were the real operating companies and c) the loans were given to the WOS which was not running any business, but had invested in downstream SPVs, thus there was only a remote connection to the investment and not a direct one. Besides, what seems to have influenced the ITAT is the fact that “investment in all kinds of infrastructure development companies as a promoter…" was not the first main object.

On the basis of the above, the Hon'ble ITAT confirmed the disallowance of interest expenditure ofRs. 164.12 crores claimed by the assessee.

Our Comments:

The important takeaway from this judgement seems to be the proposition that for the purposes of business expediency, any downstream investment had to first fit in the main objects of the investing Company. Now, there can be no quarrel that a Company can have more than one 'Main Objects'. But, perhaps, what would matter more is if the name of the Company included & suggested a particular activity, then it would follow suit logically that the Company was expected to earn its major revenue from that activity. In the instant facts, the assessee 's name indicated that it was in the business of 'airport development', whereas that activity was achieved only in an indirect fashion i.e. through the SPVs which were subsidiaries of the WOS of the assessee.

Viewed from this prism, this judgement would appear to be an appropriate one, considering the facts.

Payee's loss return cannot absolve payer from interest liability u/s 201(1A) for TDS default

The Bangalore ITAT in Power and Control Systems held that by virtue of insertion of proviso to section 201(1A) by the Finance Act 2012 wef 1 July 2012, even if any person fails to deduct TDS and is not deemed to be an "assessee in default" under the first proviso to section 201(1), the interest shall be payable from the date on which tax ought to have been deducted till the date of filing of return of income by the payee u/s 201(1A) of the Act.

Facts & Issue:

Power and Control Systems ("assessee") was a partnership firm engaged in the business of trading in networking cables and equipment's. During the AYs 2011-12 to 2015-16, the assessee made certain purchases from a company incorporated in US. The US company had a branch office in Bangalore to supply items like networking cables and equipment's. Since the non-resident had a PE in India, the income earned in India was taxable both in terms of the Act and under the India-US DTAA.

The assessee did not deduct tax at source while making payments to the US PE and therefore revenue initiated proceedings u/s 201(1) and 201(1A) of the Act and treated the assessee as "assessee in default". Further, interest was levied on tax not deducted from the date on which tax ought to have been deducted till the date on which the non-resident ought to have filed its return of income.

The plea of the assessee in the proceedings initiated under section 201(1) and 201(1A) of the Act was that the payee non-resident suffered losses and had filed returns of income declaring loss, and therefore, assessee could not be treated as "assessee in default" for non-deduction of tax at source because no tax was due to the exchequer. The revenue accepted assessee's plea, however, proceeded to levy interest u/s 201(1A).

The CIT(A) relied on the first proviso to section 201(1A) of the Act inserted y Finance Act, 2012 w.e.f. 1 July 2012 and Punjab and Haryana HC ruling in the case of CIT(TDS) v Punjab Infrastructure Development Board 76 taxmann.com 365(P&H) and held that even in a case where the recipient of income had no tax liability embedded in such payments, the person making payment will be liable to pay interest on tax not deducted at source from the date on which tax ought to have been deducted till the due date of filing of return of income by the payee.
Aggrieved, the assessee filed an appeal before ITAT.

Contentions of the Revenue:

The revenue placed reliance on CIT (A) order and distinguished the cases relied upon by the assessee.

Contentions of the Assessee:

The assessee contended that interest was compensatory in nature and was levied only for the right lost by the revenue for using money due to the Government by way of tax. When no tax was payable, there cannot be any loss to the exchequer and therefore, levy of interest which was compensatory in nature cannot be sustained.

Reliance was placed on Haldia Petrochemicals Ltd. v DCIT (2016) 72 taxmann.com 338 (Kolkata ITAT) wherein the ITAT held that when the primary conditions to be satisfied before treating the payer assessee as "assessee in default" were not met and when no tax at all was payable at any point of time, consequent interest u/s 201(1A) of the Act cannot be levied on the assessee. The computation mechanism itself fails in such a situation.

Observations & Ruling of the ITAT:

The ITAT referred to Madras HC decision in Chennai Metropolitan Water Supply and Sewerage Board (CWSSB)(348 ITR 530) wherein HC took the same view which is now statutorily recognised as a proviso to section 201(1A) of the Act. The HC dealt with the case of the assessee suffering loss and still came to the conclusion that liability to pay interest under section 201(1A) of the Act is mandatory.

The ITAT also observed that Kolkata ITAT in Haldia Petrochemicals (Supra) had made reference to the decision of the Madras HC in CWSSB but had not elaborated on the principles laid down in the decision.

The ITAT noted that the cases relied upon by the assessee were related to AYs prior to AY 2012-13 i.e. prior to the statutory amendments to section 201(1A) of the Act. It was clarified that there is a difference between the case where the amount paid is chargeable to tax but the payee has suffered loss or does not have positive income and a case where the payments made are not chargeable to tax at all. The ITAT stated that the argument made on behalf of the assessee can be considered only where the payment in question is not chargeable to tax at all. However, the ITAT observed that where payment in question is chargeable to tax but the payee has suffered loss or does not have positive income, then the person making the payment is obliged to deduct tax at source. The fact that the payee does not have positive income will absolve the person making payment from being treated as "an assessee in default" for not deducting tax at source but cannot absolve the payer from paying interest u/s 201(1A) of the Act.

The ITAT opined that the above vital distinction was not noticed in the decisions relied upon by the assessee, especially in the case of Haldia Petrochemicals Ltd (supra). Thus, relying on Madras HC (supra) which was later followed by P&H HC in the case of CIT(TDS) v. Punjab Infrastructure Development, 76 taxmann.com 365, ITAT confirmed the decision of the CIT(A) and dismissed the appeal by assessee.

Citation:

Power and Control Systems v. DCIT [TS-371-ITAT-2018 (Del)]

Our Comments:

Legislature has clearly drawn a distinction in section 201 between tax and interest. This is supported by the wordings of sub-section (1) and (1A) which are without prejudice to each other. The deductor cannot unilaterally assess dedicatee's tax liability. The US PE could have obtained a certificate u/s 197 for nil deduction which then would have permitted assessee to make nil tax deduction. Though the taxes paid/ loss return filed by deducted will absolve deduct or from liability to deduct TDS, but it will not absolve him from 'automatic' interest liability under section 201(1A) which should be calculated from the date on which tax should have been deducted to the date on which deducted filed its return.

Loss on shares sold off-market to group-companies allowable. Colourable device plea rejected.

Recently, the Kolkata Bench of ITAT ruled that loss on sale of shares could not be denied to the assessee merely because the loss is incurred on sales made to group companies when price charged in the said off market transactions was the same as quoted in the stock market.

Facts & Issue:

For the year in consideration i.e. AY 2009-10, long-term capital loss of Rs. 13,25,28,636/- was claimed by the assessee on the sale of 7,22,008 equity shares of UM Ltd. Out of the said loss, loss of Rs. 9,83,92,268/- was suffered on sale of 5,25,000 equity shares to a group companies of the assessee. The balance loss of Rs. 3,41,36,368/- was on sale of shares on recognized stock exchange after payment of STT. Further, long-term capital gain of Rs. 1,83,61,185/- was declared on sale of 15,75,000 equity shares of UM Ltd.

The ld. Assessing Officer ('the AO') noticed that the shares sold by the assessee to group companies had not been delivered till March 31, 2009. Therefore, he was of the opinion that such transactions with the group companies were entered into as an afterthought with an intention to claim loss and reduce its tax burden. Accordingly such transactions were treated as a colourable device and long-term capital loss of Rs. 8,00,31,083/- (9,83,92,268/- minus 1,83,61,185/-) was denied relying on the decision of the Hon'ble Apex Court in case of McDowell & Co. Ltd reported in 154 ITR 148.

Contentions of the Assessee:

The counsel representing the Assessee contended that all the transactions of sale of shares entered into by the assessee with its group companies were legal and duly supported by relevant documentary evidence. Even the price charged in the off-market transactions to group companies was the same as quoted in the stock market. In such circumstances, the AO was not justified in treating the transactions as a sham or colourable device merely because it was entered into with the group companies.

On the allegation that delivery of shares sold to group companies have not been made till March 31, 2009, the assessee submitted that instruction were issued to the depository participant to deliver the shares to the demat account of the group companies. The assessee further relied on CBDT Circular No. 704 dated 28.04.1995 which stated that "*in case the transactions take place directly between the parties and not through stock exchanges the date of contract of sale as declared by the parties shall be treated as the date of transfer provided it is followed up by actual delivery of shares and the transfer deed*".

Contentions of the Revenue:

The Revenue strongly relied on the order of the AO that since the transactions were entered into with a group company, and no delivery of shares sold was made till year-end, the transaction was a colourable device. In a riposte to the assessee's contention of the legality of the transactions, the Revenue contended that even if the transaction was considered legal and genuine, it will still remain a colourable device since the purpose of entering into the transaction is to reduce the tax liability.

Observations of the ITAT:

The Hon'ble ITAT noticed that the shares were sold before March 31, 2009 only, it is only the delivery that took place after year-end. Also, instructions to deliver the shares were issued by the assessee on 31st March, 2009 itself. Additionally, the assessee has complied with all statutory provisions relating to sale of shares and information of the same was given to SEBI too. The ld. AO had never doubted the genuineness of the sale of shares.

As per the CBDT circular referred to above, the date of contract of sale, as declared by the parties is treated as the date of transfer provided actual delivery takes place subsequently. In the instant case, the transactions of sale of shares were duly supportedby the required documentary evidence and the fact that deliveryinstructions were also issued by the assessee company to thedepository participant on the date of sale itself. Moreover, the relevant share transactions were effected at the same price as quoted on stock exchange on same date.

Against the reliance placed by the AO on the decision of the Supreme Court in case of McDowells& Co. Ltd (*supra*), the Hon'ble ITAT ruled that the decision of the Hon'ble Punjab & Haryana High Court in case of CIT v Pivete Finance Ltd (192 Taxman 21) is squarely applicable to the facts of the assessee. In the said case, the assessee had continuously resorted to sale of shares to another group company to reduce the tax burden. The High Court held that once it was found that the transactions were genuine and within the realms of the law, then it could not be dubbed with 'colourable device' tag. Reliance was placed on the decision of the Hon'ble SC on case of UOI v AzadiBachaoAndolan reported in 263 ITR 706 wherein it was held that an act, which is otherwise valid in law, cannot be treated as non-est merely on the basis of some underlying motive supposedly resulting in some economic detriment or prejudice to national interest.

Citation:

UMIL Share & Stock Broking Services Ltd [TS-349-ITAT-2018(Kol)]

Our Comments:

This judgement once again throws light on the debate of distinction between tax planning vs tax evasion / avoidance. It is settled law that tax planning may be legitimate provided it is within the framework of law. Colourable devices cannot be part of tax planning and it is wrong to encourage the belief that tax payment can be avoided by resorting to dubious methods. Revenue cannot bring to tax a subject not supported by a statute. Every taxpayer is entitled to arrange his affairs so that his taxes shall be as low as possible. He is not bound to choose a method which will replenish the Government Treasury. The assessee has the right to exercise the most tax efficient manner of disposal of assets through proper and timely sequencing of events / transactions.

The perception is that tax avoidance is legitimate since it did not expressly violate a law even though it may have been the exploitation of lacunae in law. However, the distinction between the tax avoidance & tax planning began to waiver as tax avoidance led to widespread profiteering and fall of government revenue. Currently, the stance is that tax avoidance is as bad as tax evasion, though penalties may not be prescribed yet for the same. However, GAAR has been adopted by several countries including India so as to prohibit transactions with the sole purpose of avoiding tax liabilities. Tax planning on the other hand, refers to the use of tax saving avenues provided by law.

It may be concluded that while the object of both is the same, i.e. to reduce the liability of taxes on a person, they are distinguished based on the means they entail. The methods involved in tax planning are sanctioned by law and the actions taken are not only envisaged by law but supported by it. On the other hand, tax avoidance implies the exploitation of the loopholes in the laws so as to reap benefits which were not intended by the law. Additionally, tax evasion refers to the illegal actions to reduce tax burden which invite stringent legal penalties and punishment. Out of the three, tax evasion is the only means which is illegal though with the implementation of GAAR provisions, the fine line between evasion and avoidance will further disappear into ambiguity.

One may usefully refer to the following passage from the decision in the case of AzadiBachaoAndolan (*supra*) (at Page 762) "if the Court finds that notwithstanding a series of legal steps taken by an assessee, the intended legal result had not been achieved, the Court might be justified in overlooking the intermediate steps, but it would not be permissible for the Court to hear the intervening legal steps as non est based upon some, hypothetical assessment of the real nature of the assessee. In our view the Court must deal with what is tangible in an objective manner and cannot afford to chase a 'will-of-the-wisp'. In an earlier part of the judgement, the Court observed that "These words (sham and device) are not intended to be used as magic mantras or catch all phrases to defeat or nullify the effect of a legal situation".

In present times, the Department might be tempted to call the transaction before the Hon'ble Kolkata Tribunal as an 'impermissible avoidance agreement' as defined in Section 96 of the Act. The law on the subject will however take time to evolve, through the principles discussed in AzadiBachaoAndolan's case would not, in our opinion, be rendered wholly irrelevant.

Gift tax provisions do not apply to buyback transaction

The Mumbai ITAT held that the provisions of section 56(2)(viia) are applicable only in cases where the receipt of shares become property in the hands of the recipient and the shares shall become property of the recipient only if it is shares of any other company. In the instant case, the assessee was in receipt of its own shares and did not satisfy the 'property' test for the purposes of section 56(2)(viia). Hence, these provisions cannot be invoked in the present facts of the case.

Facts & Issue:

The assessee was engaged in the business of trading in shares and derivatives. During the year in question, the assessee made an offer for buy back of 25% of its existing share capital at a price of Rs. 26, which was less than the fair market value. Under the buyback scheme, the assessee bought 12,19,075 shares at Rs.26 per share from one of the directors for which it paid a consideration of Rs.316.95 lakhs.

The AO observed that the book value of shares as on March 31, 2013 was Rs.32.80 per share. However, the assessee hadacquired shares at Rs.26 per share. Accordingly, the AO invoked the provisions of section 56(2)(viia) in the hands of the assessee for assessing the difference between the fair market value and the consideration paid for buyback of shares. The CIT(A) confirmed the stand of the AO. Aggrieved by the CITA) order, the assessee filed an appeal before the ITAT.

Contentions of the assessee:

The assessee relied on the Memorandum explaining the provisions in the Finance Bill 2010, provided that the shares should become a "Capital asset" and property in the hands of recipient. In the instant case, the assessee had purchased the shares under the buyback scheme and the said shares had been extinguished by writing down the share capital. The said shares did not become a capital asset of the assessee and hence, section 56(2)(viia) could not be invoked.

The assessee also relied on the decision of the co-ordinate bench in the case of Sudhir Menon HUF v. ACIT (2014) 148 ITD 260 (Mumbai ITAT), wherein it was held that issue of shares on pro-rata basis did not lead to receipt of any property (shares) in the hands of shareholders. The similar analogy could be applied in the hands of the assessee for shares received pursuant to pro-rata buy back of shares.

Contentions of the revenue:

The assessee had recently obtained the valuation report and the same was not made available before the AO. Hence, the same should be ignored.

The assessee had acquired shares at a price less than the fair market value and hence, the AO had rightly assessed the difference under section 56(2)(viia) of the IT Act.

ITAT's Observations:

A combined reading of section 56(2)(viia) and memorandum explaining the provisions suggests that the provisions of section 56(2)(viia) would be attracted when "a firm or company" receives a "property, being shares in a company (not being a company in which public are substantially interested)". Therefore, the shares should become "property" of the recipient company.Own shares cannot become a property of the recipient company.

Accordingly, the provisions of section 56(2)(viia) would be applicable only in cases where the receipt of shares become property in the hands of the recipient and the shares shall become property of the recipient only if it is "shares of any other company".

In the instant case, the assessee company had purchased its own shares under the buyback scheme and the same had been extinguished by reducing the capital. Hence, the tests of "becoming property" and also "shares of any othercompany" fails in the present case.

Citation:

M/s Vora Financial Services Pvt. Ltd vs. ACIT [ITA No.532/Mum/2008]

Our Comments:

The applicability of section 56(2)(viia) with respect to buy back transaction has been a grey area in the absence of judicial precedents. The above decision would provide an insight to assessee company who receives back its own shares at a price less than the fair market value under the buyback scheme.

INTERNATIONAL TAX

Payments made to non-resident freight forwarders for services rendered outside India not taxable in India

Facts and Issue:

In a recent decision by the Hon'ble Delhi ITAT, it was held that the payments made to non-resident freight forwarders, are not chargeable to tax under section 9(1)(vii) of the Act and hence the payer is not liable to withhold tax under section 195 of the Act. Consequently, there is no question of disallowance of the amounts paid to non-resident freight forwarders under section 40(a)(i) of the Act.

The assessee was engaged in the business of handling cargo, i.e. booking of cargo received by it, mainly from exporters in India and air transportation of that cargo to various countries of the world as per client requirements.

During the year under consideration, the assessee made certain payment on account of freight forwarding functions done by UTI Networks Inc, outside India in respect of cargo exports from India to foreign destinations. During the assessment proceedings, along with certain other disallowances, the AO disallowed the amount paid to UTI Network Inc, for the reason that assessee had failed to withhold tax. According to the AO, services rendered by UTI Network Inc were in the nature of managerial services covered under the definition of "FTS" under section 9(1)(vii) of the Act and hence, liable to tax in India.

Before the CIT(A), the assessee submitted, that the services rendered by UTI Network Inc, were not managerial in nature, but purely commercial services. Reliance was placed on Circular No. 715 dated 8 August, 1995 issued by CBDT, which clarified that payments to resident clearing and forwarding agents for carriage of goods were subject to withholding tax under section 194C of the Act.

Accepting the arguments of the assessee, the CIT(A) held that the services rendered were not managerial services in nature and that these services, were recognized as commercial services and not technical services as understood within the meaning of section 194J of the Act. Furthermore, the CIT(A) also noted that the services had been rendered outside India and hence, were not taxable in India under section 9(1)(vii) of the Act.

The revenue filed an appeal before the ITAT against the order of CIT(A)

Contentions of the Revenue:

According to the AO, services rendered by UTI Network Inc were in the nature of managerial services covered under the definition of "FTS" under section 9(1)(vii) of the Act and hence, liable to tax in India.

During the assessment proceedings, along with certain other disallowances, the AO disallowed the amount paid to UTI Network Inc, for the reason that the assessee had failed to withhold tax

Contentions of the Assessee:

Amount in question was paid purely towards commercial services rendered by UTI Networks Inc

Services are rendered in the field of freight forwarding functions i.e. those functions that are generally done by a freight forwarding agent, which are purely business services.

Managerial services would mean services in the field of managing the affairs or laying down policies, procedures, evaluation of the existing system or evaluation of some new policies or strategies in place of a new system.

Drawing an analogy, with the services of domestic clearing and forwarding agents rendered for carriage of goods, it was contended that just as provisions of section 194C (concerning work and service contract) were applicable and not section 194J (concerning fees for professional or technical services), the services rendered by UTI Networks Inc, could not be considered as managerial services under section 9(1)(vii) of the Act.

Observations & Ruling of the Hon'ble ITAT.

The ITAT decided the appeal in favor of the assessee and held as under.

There was no dispute about the fact that payment was made to UTI Network Inc, outside India for freight forwarding functions.

The payment made to freight forwarding agents was covered by Circular No. 715 (supra), and therefore, the payment could not be treated to be in respect of managerial services. The payment for the said services was not taxable in India under section 9(1)(vii) of the Act.

Such expenditure was in the nature of business expense. As the amount was not chargeable to tax under section 9(1)(vii) of the Act, it was therefore not subject to withholding tax provisions under section 195 of the Act. When the amount is not subject to withholding tax, the provisions of section 40(a)(i) of the Act are rendered inapplicable.

In this regard, the ITAT reiterated the principles as regards the obligation to withhold tax as laid down in the decisions of Eli Lilly Co P Ltd [CIT(A) v Eli Lilly Co P Ltd (2009) 312 ITR 225 (SC)] and Prasad Production Ltd [ITO v Prasad Production (2010) 129 TTJ 641 (Chennai), which has further been approved by the Supreme Court in the case of GE India Technology Center v CIT [(2010) 327 ITR 456 (SC)]

Citation:
ACIT v Indair Carriers P Ltd (ITA No. 605 (Del) of 2018)

Our comments:
It may be noted that, though the ITAT held that the payments made were in the nature of business expenses, it has not examined whether or not there existed a business connection or permanent establishment of UTI Network Inc in India. Nevertheless, in course of payments to such non-resident, the company would always be required to provide tax residency certificate and a no PE certificate to establish the credentials that it does not have a presence in India.

Since the payment were held not to be chargeable to tax in India, under section 9(1)(vii) of the Act, it was accordingly not subject to withholding tax under section 195 of the Act. Consequently, there was no question of disallowance of the amounts paid to non-resident freight forwarders, as the provisions of section 40(a)(i) of the Act were not applicable.

Inspection & Testing charges are not taxable as FTS

The Delhi ITAT held that inspection and testing services are not taxable as FTS under Article 13 of India-UK tax treaty.

Facts & Issue:

The assessee was a company incorporated in the UK and was engaged in the business of providing inspection and testing of wide range of commodities of metal, mineral oils and petro chemicals. The customers in India had appointed the assessee on a principal to principal basis to provide certain inspection & testing services.

During the year in question, the assessee had provided services in relation to (i) inspection and survey of imported/exported cargo and (ii) certificationon quality and price of products. The assessee, while filing the return of income in India, did not offer the payments received from the Indian customers to tax in India, as the same were not characterized as FTS as per Article 13 of the India-UK tax treaty.

The AO held that the Indian customer was in a position to derive an enduring benefit and was in position to utilize knowledge in the future on its own. The AO, therefore, concluded that the services provided by the assessee fall within the ambit of 'making available' technical knowledge under Article 13 of the India-UK tax treaty. The DRP confirmed the AO's stand and the final order was passed against the assessee.

Aggrieved by the final assessment order, the assessee filed an appeal with the ITAT.

Contentions of the assessee:

The assessee had rendered most of the inspection and testing services outside India. The assessee had not provided any technical knowledge, etc. to the Indian customers and hence, the services rendered did not satisfy the 'make available' concept in the definition of FTS as defined under Article 13 of the India-UK tax treaty. Accordingly, the payments received from the Indian customers were not chargeable to tax in India.

***Contentions of the revenue*:**

The DR relied on the DRP directions and submitted that the assessee had made the service available to the Indian customers.

ITAT's Observations:

All the services provided by the assessee were undoubtedly in the nature of technical analysis but the assessee had not made available any technical knowledge, etc. so as to enable the Indian customers to use those services independently. The ITAT while concluding the decision in favour of the assessee, observed that the Revenue had not brought forth any material to show that the Indian customers had performed these services on their own without the help of the assessee.

Citation:

M/s. Inspectorate International Ltd Vs ACIT [ITA No. 6365/Del/2017]

Our comments:

The basic criterion for 'make available concept' under the tax treaty is that the recipient of service should be able to perform the service without any help from the service provider. The same should be backed by documentation so as to prove that the recipient of services is equipped to perform independently without the help of the service provider.

In the given judgement, provision of testing/ services did notmake available technical knowledge, experience, skill, know-how orprocesses, to the Indian customers. Accordingly, payments received from the Indian customers did not fall within the ambit of the term 'FTS' as defined in the India-UK tax treaty.

TRANSFER PRICING

No TP adjustment based on wrong FAR of business support services

The Delhi ITAT ruled that where the entire TP analysis was based on wrong FAR, the entire subsequent exercise became erroneous. While concluding the same, the ITAT emphasised the fact that most of the comparables challenged by the assessee in the year in question, had been accepted by the TPO in the subsequent year. The assessee had not undergone any change in its business model and hence, the rule of consistency was required to be followed.

Facts & Issue:

The assessee was engaged in providing business support services to its AEs and had rendered market support services. These services included development of title, contents of title, printing & publishing, market information & coordination. The assessee had applied TNMM to determine ALP of the transaction of business support services provided to AEs.

The TPO had rejected 13 comparables out of 14 comparables selected by the assessee and had introduced 9 more comparables on the basis of the FAR analysis carried out by him. The TPO also applied a filter of service income to total income greater than 75% to benchmark the transaction of business support services. Accordingly, the TPO determined the ALP at 22.42% as against 8.94% computed by the assessee. Aggrieved by the TPO's order, the assessee filed an appeal before the DRP. The DRP upheld the TP adjustment proposed by the TPO pursuant to which the AO passed the final assessment order. Aggrieved, the assessee filed an appeal before the ITAT.

Contentions of the assessee:

Most of the comparables selected by the assessee had been rejected due to widening of the filter from 50% to 75%. The comparables of assessee were accepted by the TPO in the subsequent year.

The analysis & selection of comparables by the TPO were based on wrong FAR analysis. While selecting the comparables, the TPO had selected companies, which were engaged in providing commission agent services, market research services, business services, HR services, database services, housekeeping services, travel services, accounting services, marketing of telefilms, serials, TV programs etc. However, the assessee had primarily rendered marketing support services for which the FAR was different from the companies selected by the TPO.

The assessee was responsible for limited functions relating to market support services and hence, the entire TP analysis by the TPO was unwarranted.

ITAT's Observations:

When the TP analysis was based upon the wrong FAR of the assessee, the entire subsequent exercise of selecting the comparables became erroneous.

The fact is that the TPO had accepted the comparables of the assessee in the subsequent year and there was no change in the business model. Hence, the ITAT set aside the matter to decide afresh by applying the principle of consistency and in light of the co-ordinate bench of ITAT in case of Adidas Technical services (P.) Ltd. vs.DCIT (2016) 69 taxmann.com 401(Delhi ITAT).

Citation:

M/s Wolters Kluwer (India) Pvt. Ltd. vs DCIT [TS-521-ITAT-2018(DEL)TP]

Our Comments:

Rule 10B of the IT Rules requires a functional analysis to determine whether controlled and uncontrolled transactions are comparable as well as to establish a factual standard on the basis of which adjustments may be made to the results of comparable transactions or companies. A functional analysis in most cases is an essential tool for finding and organising facts about a business in terms of its functions, risk and intangibles. Functional analysis identifies how the economically significant activities undertaken by a MNC are divided between each member involved in the transaction under review, for which respective members should expect to be rewarded. This analysis forms the basis and provides a framework for comparability study and subsequent determination of the most appropriate method. It assists in proper assessment of comparability for the purpose of Arm's length study.

The Supreme Court in the case of *Morgan Stanley and Company Inc. (2007) 292 ITR 416* emphasized on FAR analysis (analysis of the functions performed, and associated resources employed, by the taxpayer in the controlled and uncontrolled transactions) for the benchmarking exercise for determination of arm's length price of an international transaction. The above decision has also laid down the emphasis on a systematic functional analysis for determination of ALP of international transactions.

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