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PARTNERS BEYOND BOUNDARIES

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INDIA TAX

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In this edition of our thought leadership publication, we have tracked the progress of some significant cases decided by the appellate forums across the country along with important press releases issued by the Central Board of Direct Taxes.

TRANSFER PRICING

CASE LAW 1:

Commissioner of Income-tax-8 v. Petro Araldite (P.) Ltd. [2018] 93 taxmann.com 438 [Mumbai]

An adjustment is required to be made to profit margins of the comparable when there is a difference in the level of capacity utilization of the assessee and level of capacity of comparable.

Facts of the case:

The assessee was a joint venture company between Ciba India Limited and Tamil Nadu Petroproducts Ltd. The assessee had been engaged in the business of manufacturing and dealing in basic liquid and solid resins as well as formulations.

The assessee exported finished goods to the associated enterprises ('AE'), imported raw materials from the AEs and paid management charges to its AEs. The assessee had selected Transactional Net Margin Method ('TNMM') as the most appropriate method and the profit level indicator selected was operating profit to operating sales.

The assessee had claimed an adjustment on account of difference in the capacity utilization of the assessee and the comparables which was rejected by the Transfer Pricing Officer ('TPO'). The assessee preferred an appeal before the Hon'ble CIT(A). The Hon'ble CIT(A) ruled in favor of the assessee. Aggrieved, the revenue preferred an appeal in the high court.

Decision of the Hon'ble High Court:

A manufacturing concern has mainly two types of overheads namely fixed and variable overheads. The fixed overheads of the manufacturing concern remain constant irrespective of the capacity utilization.

When the capacity utilization goes up, the rate of allocation or absorption of fixed overheads to sales comes down resulting into higher profit margin. Under-utilization of capacity, would result in allocation fixed costs over a smaller number of final products which reduces the profit. The profitability changes with the change in the level of capacity utilization with higher profitability at higher utilization and lower profitability at lower realization. This happens mainly because of higher allocation or absorption of fixed overheads at lower capacity utilization which comes down as the level of capacity utilization goes up. Accordingly, an adjustment on account of difference in capacity utilization is required to be made.

Also, the Hon'ble High Court stated that the difference in capacity utilization affects the profitability mainly because of the difference in rates at which the fixed overheads are absorbed or allocated depending on the level of capacity utilization. Thus, for making an adjustment to the profitability of the comparables, the fixed overheads allocation or absorption of comparable should be brought at the level of assessee. The adjustment can be made by allocating fixed overheads at the same rate at which fixed overheads are allocated in the case of the tested party.

Therefore, the Hon'ble High Court ruled in favour of assessee and held that if there is a difference in the level of capacity utilization of the assessee and the level of capacity utilization of the comparable, then adjustment would be required to be made to the profit margin of the comparable on account of difference in capacity utilization.

CASE LAW 2:

Principal Commissioner of Income-tax, Bangalore vs. Softbrands India (P.) Ltd. (ITA 536/2015) (Karnataka)

Where the tTribunal, being the final fact finding authority, had given cogent reasons and detailed findings on application of filters and selection of comparables, such findings of Tribunal could not have been perverse in any manner so as to require interference u/s 260-A of the Act. The exercise of fact finding or 'Arm's Length Price' determination or 'Transfer Pricing Adjustments' should be allowed to become final with a quietus at hands of the Tribunal.

Facts of the case:

The Hon'ble High Court of Karnataka was called upon to decide the purported substantial questions of law arising from the order of the Income Tax Appellate Tribunal, Bengaluru. The suggested substantial questions of law under International Taxation issue in the appeal under consideration was whether the Hon'ble Tribunal was right in rejecting comparable companies without appreciating that the reasonings of TPO / Assessing Officer ('AO') for adopting the comparables which have been brought out in the TPO's order, and whether the Hon'ble Tribunal was justified in fixing the related party transaction at 15% of total revenue and deleting comparables without going into specific facts in the case of taxpayer.

Decision of the Hon'ble High Court:

A substantial quantum of international trade and transactions depends upon the fair and quick judicial dispensation in such cases. Had it been a case of substantial question of interpretation of provisions of various laws, such substantial questions of law could be raised before the Hon'ble High Court under Section 260-A of the Act, the Courts could have embarked upon such exercise of framing and answering such substantial question of law. On the other hand, the appeals of the Revenue as to whether the comparables have been rightly picked up or not, filters for arriving at the correct list of comparables have been rightly applied or not, do not in the considered opinion of the Hon'ble High Court, give rise to any substantial question of law. Mere dissatisfaction with the findings of facts arrived at by the Hon'ble Tribunal is not at all a sufficient reason to invoke Section 260-A of the Act before the Hon'ble High Court.

Therefore, the Hon'ble High Court dismissed the appeals filed by the Revenue and ruled that the decision of the Hon'ble Tribunal, being the final fact finding authority, cannot be challenged merely on the grounds of being dissatisfied with the findings of fact arrived at by the Hon'ble Tribunal.

INTERNATIONAL TAX

CASE LAW 1:

Skaps Industries India Pvt Ltd. Vs. ITO [2018] 94 taxmann.com 448 (TAhd.)

Mere non-furnishing of Tax Residency Certificate ('TRC') cannot per se be treated as a trigger to disentitle the treaty benefits to the assessee.

Facts of the case:

During the relevant assessment year, the assessee had made certain payments to a US based entity ('US entity'). These payments are made in consideration for the services rendered by the US entity's personnel for installation and commissioning of certain equipment purchased by the assessee. The AO was of the view, that these payments were for services of engineers in India and are covered by the definition of fees for technical services ('FTS') under the provisions of the Act and accordingly, the assessee was liable for withholding of tax at the time of making such payments.

The assessee sought relief under the India US Double Tax Avoidance Agreement, the same being more beneficial over the domestic tax laws of India. The assessee submitted that the installation and commissioning of the machinery did not result into any transfer of technology or technology being 'made available' to the assessee. However, the AO rejected the assessee's stand stating that the US entity was the only source of obtaining such high degree of technical expertise and irrespective of materials supply, only the US entity had the desired level of expertise is installing and commissioning of the machine.

On account of the above reasons, the AO treated the assessee as an assessee in default for not withholding tax from the payments made and accordingly raised a demand on the assessee.

Aggrieved, the assessee filed an appeal before the Hon'ble CIT(A).

In addition to conforming to the issues raised by the AO, as the assessee was claiming benefit under the DTAA, the Hon'ble CIT(A) further raised queries regarding the absence of TRC of the US entity required for claiming the benefits under the DTAA as per the provisions of the Act.

Therefore, the action of the AO was not only confirmed but further fortified on account of the order passed by the Hon'ble CIT(A).

Aggrieved, the assessee filed an appeal before the Hon'ble Tribunal.

Decision of the Hon'ble Tribunal:

In the absence of TRC, the assessee submitted Form W9 (which is used in the context of domestic tax withholding requirements in the US) claiming it to be equivalent to a certification from a US authority.

At the outset, the Hon'ble Tribunal clarified that as per the provisions of the Act relating to obtaining TRC, in the absence of a non-obstante clause, it could not be construed as a limitation to the treaty superiority over domestic law. The condition to obtain TRC can only be pressed into service as a provision beneficial to the assessee. The Hon'ble Tribunal was of the opinion that an eligible assessee cannot be declined the treaty benefits on the ground that the said assessee is not able to furnish a valid TRC.

However, the Hon'ble Tribunal stated that there has to be reasonable evidence about entitlement of treaty benefits to the US entity. The onus to give sufficient and reasonable evidence of satisfying the requirements of the DTAA is on assessee. The Hon'ble Tribunal was of the view that the requirements under the DTAA are far more onerous than furnishing of TRC.

Further, with respect to Form W9 submitted by assessee, the Hon'ble Tribunal observed that the said form is merely a declaration to provide inputs to the tax-deductor for fulfilling reporting obligations to the US IRS. Accordingly, the said form had no relevance in the present context. The Hon'ble Tribunal, considering that, at no stage, the assessee was asked to submit evidences in support of the residential status, remanded the matter back to the Hon'ble CIT(A) on the fundamental aspect of treaty entitlement and also on other issues for fresh adjudication

Therefore, the Hon'ble Tribunal remanded the matter back to the Hon'ble CIT(A) for fresh adjudication.

CASE LAW 2:

Ernst & Young Ltd. Vs. ACIT (International Taxation) (ITA Nos.6561 & 6562/Del/2016) (TDel.)

In a case where, the assessee, a UK based company having branch office ('BO') in India, claimed deduction under section 44C of the Act on account of head office ('HO') expenditure, it was not justified to disallow the claim merely because it was not debited in profit & loss account of the assessee considering that:

- *Such expenses were actually incurred by the HO for the BO;*
- *Genuineness of such expenses was not doubted;*
- *The assessee had claimed deduction in computation statement.*

Facts of the case:

The assessee was a UK based company which had a BO in India which provided professional services in nature of technical assistance/advice in relation to expatriate tax and business tax compliance services. During the relevant assessment years, the assessee claimed deduction under section 44C of the Act on account of HO expenditure. The AO, on finding that assessee had not claimed such expenditure in profit & loss account of Indian BO, disallowed the said expenditure.

The assessee clarified that there were certain general & administrative expenses incurred by the HO outside India which are attributable to some extent of the operations of the BO. Even though these expenses are not recharged/ debited in the profit & loss account of the BO, the same have been claimed as deductible in accordance with and within the limits prescribed under section 44C of the Act.

The assessee submitted a certificate from the HO stating that such expenses had actually been incurred. The AO was not satisfied by the explanation given by the assessee and therefore, disallowed the said expense.

Aggrieved, the assessee approached the Dispute Resolution Panel ('DRP'). The DRP ruled against the assessee.

Aggrieved, the assessee filed an appeal before the Hon'ble Tribunal.

Decision of the Hon'ble Tribunal:

The assessee submitted that although the expense has not debited the amount to the Profit & Loss Account, however, the same has been claimed as expenditure in the return of income and the expenditure is within the permissible limit as per the provisions of section 44C of the Act. The assessee placed reliance on the decision rendered by Hon'ble Mumbai Tribunal in the case of British Bank of Middle East Vs. Jt. CIT [2005] 4 SOT 122, wherein it was held that with regards to non-claim of expenditure in the Profit & Loss Account, the entries in the books of account are not decisive.

The revenue, on the other hand, heavily relied on the order of the AO and DRP. The revenue submitted that since the expenditure has not been claimed by the assessee in the Profit & Loss Account on account of HO expenditure, therefore, the same could not be allowed.

The Hon'ble CIT(A), on considering the rival contentions, was of the view that as long as the expenditure is really incurred and is otherwise deductible, the deduction cannot be declined on the ground that it has not been debited in the books of account.

Therefore, the Hon'ble Tribunal ruled in favour of the assessee.

DOMESTIC TAX

CASE LAW 1:

Principal Commissioner of Income Tax – 8 Vs. M/s Quest Investment Advisors Pvt. Ltd. ITA No. 280 of 2016 (Mumbai)

Where if an expense is accepted by the AO for few years preceding the year under assessment, the AO is bound to allow the same for the year under consideration.

Facts of the case:

The assessee was engaged in the business of equity research, investment advisory services and running portfolio management services. The assessee had income from capital gains and professional income. As a consistent practice, the assessee claimed the expenses incurred against the professional expenses for computation of income.

The AO however, allocated the expenses on proportionate basis between capital gains and professional income.

The assessee appealed the order of AO at Hon'ble CIT(A), however the same was dismissed.

Aggrieved the assessee appealed at the Hon'ble Tribunal, wherein the Hon'ble Tribunal held that considering the facts of the case **Radhasoami Satsang Vs. Commissioner of Income Tax, 193 ITR 321** the assessee could not be disallowed certain expenses if the assessee has been allowed the same for years prior and subsequent to the year under consideration in case the revenue was not able to point out any distinguishing facts in the subject assessment year, which would warrant a different view to be taken by the officer.

On being aggrieved, the revenue appealed the order of Hon'ble Tribunal with the Hon'ble Bombay High Court.

Decision of the Hon'ble High Court.

The Hon'ble High Court, after connecting to the case law referred by the Hon'ble Tribunal referred the case law of **Bharat Sanchar Nigam Ltd. Vs. Union of India 282 ITR 273.** In the following case law it is clearly stated that Where facts and law in a subsequent assessment year are the same, no authority whether *quasi-judicial* or judicial can generally be permitted to take a different view. Accordingly, the Hon'ble High Court stated that the principal once accepted by the revenue, and the same was consistently applied by the assessee without any changes in the facts of the case, the revenue was bound to accept the same.

Thus, the Hon'ble High Court decided in the favour of the assessee and upheld the order of the Hon'ble Tribunal and dismissed the appeal of the revenue.

CASE LAW 2:

Principal Commissioner of Income Tax (Surat) Vs. Tejua Rohitkumar Kapadia (Supra)

Purchases made by the assessee are treated to be legitimate if they have proper supporting, and the party from whom the purchases are made authorizes the same.

Facts of the case:

The assessee is in the business of trading of goods. The AO has treated purchases amounting to INR 5.19 cores as bogus purchases and disallowed the same.

Aggrieved the assessee appealed the order of the AO at the Hon'ble CIT(A). The Hon'ble CIT(A) allowed the following purchase and stated them to be legitimate since the assessee held all supporting for the purchase, the details of sales made from the following purchases and the seller had also acknowledged making sales to the assessee.

Aggrieved, the revenue preferred an appeal before the Hon'ble Tribunal.

Decision of the Hon'ble Tribunal:

The Hon'ble Tribunal noted the following:

- *The assessee had made all the payments for the purchases by account payee cheques, the assessee ad all relevant records pertaining to sales made from the above purchases.*
- *The seller had acknowledged sales made to the assessee and paid the amount of tax liable to be paid for the sales transaction.*

The Hon'ble Supreme Court stated that the purchases could not be disallowed merely based on findings of the investigation wing stating that the entire amount fir purchases were remitted back to the assessee in cash as there were no evidences available to back the same. On the other hand, the assessee had all relevant records and documents stating the genuineness of the purchases made.

The Hon'ble Tribunal thus held in favour of the assessee and dismissed the appeals preferred by the revenue.

CASE LAW 3:

M/s. Vora Financial Services P. Ltd. vs. ACIT 2(3)(1) ITA No. 532/Mum/2018

The buyback of own shares cannot become property of the recipient company and therefore, the AO cannot invoke section 56(2)(viia) of the Act.

Facts of the Case

The assessee is engaged in the business of trading in shares and derivatives. During the AY under consideration, the assessee made an offer to the existing shareholders for buyback of 25% of its existing share capital at a price of INR 26 per share. The book value at the time of buyback was INR 32.80 per share. One of the directors had applied for the buyback of shares amounting to INR 316 lakhs. Since the buyback price was less than the book value of the company at the time of buyback, the AO invoked section 56(2)(viia) of the Act. Further, the amount that was given to the director for the shares which were bought back, were understood to be reinvested as a loan given to the assessee companies only. The entire transaction was perceived as an exercise to reduce the liability of the company by purchasing shares below the fair market value.

Accordingly, the AO assessed the difference between the book value of shares and the buyback price of shares as income of the assessee u/s 56(2)(viia) of the Act.

Aggrieved by the order of the AO, the assessee preferred an appeal with the CIT(A).

The Hon'ble CIT(A) confirmed the order of the AO. On further appeal with the Hon'ble Bombay Tribunal, the Hon'ble Tribunal held as under;

Decision of the Hon'ble Tribunal:

Provision of section 56(2)(viia) of the Act read with the memorandum explaining the provisions would show that the section 56(2)(viia) of the Act would be attracted when a firm or company (not public company) receives property being shares of some other company. Therefore, it was noted that the shares of the own company bought back cannot be considered as capital asset or property u/s 56(2)(viia) of the Act. Since the shares once bought back shall be extinguished by writing down the share capital. Therefore, those shares would not be capital asset of the assessee company u/s 56(2)(viia) of the Act. Further, the AO had relied on the difference between the book value of the shares and the buyback / purchase price of the shares. However, the terminologies used in the section 56(2)(viia) of the Act is 'Fair Market Value'.

The assessee highlighted that the Fair market value of the shares were INR 25.42 per share i.e. lower than the buyback price. Further, the Assessee submitted the valuation report of shares done by an registered independent valuer.

Relying on the supportings and submissions made by the assessee, the Hon'ble Tribunal decided to take the view that the AO was not justified in invoking the provisions of Section 56(2)(viia) of the Act for buyback of own shares. In view of the foregoing discussions, the Hon'ble Tribunal had decided to set aside the order passed by CIT(A) on this issue and had directed the AO to delete the addition made u/s 56(2)(viia) of the Act.

The Hon'ble Tribunal decided in the favour of the assessee

RECENT IMPORTANT CIRCULAR AND PRESS RELEASE ISSUED BY THE CENTRAL BOARD OF DIRECT TAXES ('CBDT')

1. Press release dated June 19, 2018 – Amendment in Rule 10CB of the Income tax Rules, 1962 (the Rules') in respect of computation of interest income pursuant to secondary adjustment.

In order to tackle the difficulties that had been noted in the implementing the provisions of sub-rule (1) of rule 10CB in respect of primary adjustment that arises on account of agreement for advance pricing (APA) entered into by the assessee, or on account of an agreement reached under the mutual agreement procedure (MAP), the CBDT has proposed to amend Rule 10CB and a draft notification has been prepared.

The link to visit the press release is provided hereunder:
https://www.incometaxindia.gov.in/Lists/Press%20Releases/Attachments/718/Amendment-Rule-10CB-IT-Rules-1962-PressRelease-20-6-2018.pdf

2. Circular 3 of 2018 dated July 11, 2018 – Revision in the monetary limits for filing of appeals by the department before the Tribunal, High Court and Supreme Court.

In order to reduce litigation, CBDT vide circular 3 of 2018 came with a revised monetary limit for filing of appeals by the department before the higher tax and regulatories. The link to visit the circular is provided hereunder:
https://www.incometaxindia.gov.in/communications/circular/circular_3_2018.pdf

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