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DIRECT TAX

1. Capital gain not taxable in India as per India Mauritius tax treaty

Authority for Advance Ruling ("AAR") in the case of Shinsei Investment Ltd. ('the Assessee") dealt with the issue of availing benefit under the India-Mauritius Double Taxation Avoidance Agreement (DTAA) from capital gains arising on transfer of shares of Indian companies. The Assessee is a company incorporated in Mauritius and a wholly owned subsidiary of a Japanese company. Further, the Assessee owns major equity in two companies incorporated in India.

During the relevant assessment year, the Assessee proposed to sell its entire shareholding (75%) in the said Indian companies to a third party in Japan. The Assessee's parent company was a party to the Share Purchase Agreement ("SPA") in its capacity as sponsor and in order to comply with mutual fund regulations. As per the terms of the SPA the said parent company had various rights and responsibilities as a sponsor.

Based on the above facts, the Assessee filed an application with the AAR to determine if capital gains will be taxable in India. As per Article 13 of the DTAA, capital gain arising from alienation of a specified property are taxable only in the state of residence.

However, the tax department placing reliance on ***Aditya Birla Nuvo Ltd 342 ITR 308,*** argued that the Assessee had merely given its name to the SPA and the effective control of the transaction was with the parent company and accordingly, the beneficial provisions of DTAA were not applicable to the transaction.

After considering both submissions, the AAR observed that the Assessee's parent company was a part of the SPA merely in its capacity as a sponsor and in order to comply with mutual fund regulations. Accordingly, it could not be said that the Assessee was a 'permitted transferee'. Further, the shares proposed to be sold were subscribed by the Assessee in its own name and the bank statements filed show that the Assessee had paid for such subscription. Therefore, the AAR allowed the Assessee benefit under Article 13 of the DTAA and held that capital gain arising to the Assessee will not be taxable in India. Further, the AAR also concluded that since income is not taxable in India, the Assessee will not be required to file income tax return in India or will not be liable to tax under the provisions of section 115JB of the Act.

Nangia's Take

Interestingly distinguishing the present case from the High Court ruling in the case of Aditya Nuvo, deciding favorably, the AAR duly noted that the Assessee had funded the investment and the involvement of Parent company was mainly due to the statutory requirement under the regulations, and concluded that the Assessee earned capital gains in its own right and hence is eligible for the DTAA benefit. Though the DTAA has been amended, by way of the 2016 Protocol permitting source taxation in respect of gains arising from transfer of shares of an Indian company, this ruling is relevant for grandfathered investments made before 1 April 2017 and the investments made between 1 April 2017 to 31 March 2019.

[Source: AAR No 1017 of 2010]

2. AMC does not tantamount to make available of technical knowledge, not taxable as FTS

HCL Comnet Ltd. ("the Assessee"), a company incorporated in India is engaged in the business of designing, delivering, installation and commissioning of networking solution and providing professional services for management and maintenance of networking solution. During the relevant assessment year, the Assessee made payments under annual maintenance contracts (AMC) to various foreign companies without deducting taxes at source.

The payment for AMC contract comprised payment for warranty charges and extended warranty charges, which were in the nature of repair/ replacement of equipment. As per the terms of the contract, equipment was sent outside India for any repair/ replacement and was re-imported in India after the repair work was done.

During the course of assessment, the Assessing Officer held that deduction of the said payment could not be allowed to the Assessee as no taxes were withheld by the Assessee on the said payments. The decision of the Assessing Officer was dismissed by the CIT(A) stating that no taxes were required to be deducted and accordingly, the payments should be allowed as a deduction. Aggrieved the Assessing Officer filed an appeal before the Tribunal. In this decision, the Tribunal has stated that routine maintenance repair will not tantamount to 'make available' of technical knowledge, skill, experience, know how etc and hence, would not be taxable in India in the absence of a permanent establishment.

Since the amount is not taxable in India, no taxes are required to be deducted by the Assessee.

Nangia's Take

In this decision, the Tribunal has examined India Israel treaty and provided benefit of limited definition of 'fees for technical services' as per the most favored nation clause in the Protocol to India Israel treaty. By virtue of the said clause, the scope of definition of 'fees for technical services' was restricted to 'make available' of technical knowledge, skill, experience, know how etc which proved to be beneficial in case of the Assessee.

[Source: ITA Nos 321/Del/2002]

3. Foreign amalgamation eligible for tax exemption in India by applying non-discrimination clause

Recently the AAR in the case of Banca Sella SPA ("the Assessee"), dealt with the issue of tax implications arising on amalgamation of two Italian companies, which resulted in transfer of a branch office in India to the amalgamated company, under the Income-tax Act, 1961 ("the Act") and the India-Italy Double Taxation Avoidance Agreement ("Tax Treaty") and held that in the absence of consideration flowing to the amalgamating company, the transfer cannot be taxed as capital gains in India.

The Assessee together with its Holding company and other Group companies, holds another Italian company, SSBS. The Assessee holds 15% in SSBS (prior to its amalgamation) and the balance is held by other Group entities. The Group was carrying out business in India through one of its subsidiaries (SSIPL) incorporated in India. On 15 February 2010, SSIPL transferred the information technology business to the Indian branch of SSBS (set up in January 2010) on a going concern basis, for a fair consideration. The Assessee approached the AAR for a ruling on tax implications that may arise from the amalgamation.

Under the Act, "transfer" cannot be taxed as capital gains in the absence of any consideration flowing to the amalgamating company i.e., SSBS. Applying the non-discrimination clause of the Tax Treaty in the present case, AAR held that the exemption in respect of amalgamation available under the Act shall be available to SBBS.

Further, on the issue "whether BSS and other shareholders would be liable to tax on extinguishment of 15% holding in SSBS", AAR held that in the present case, "transfer" is in the hands of the Assessee, and since the Assessee has not received any consideration, there would be no taxability in their hands. In respect of other shareholders, though they have received consideration in the form of shares of BSS, what these shareholders have transferred are shares in SSBS, an Italian company, and not assets in the PE of SSBS. Since gains arising on transfer of shares of an Italian company would be taxable only in Italy, the same is not taxable in India.

Nangia's Take

This favorable ruling reiterates the settled principles of tax in the case of amalgamations under overseas restructuring within a group, that capital gain tax exemption available to Indian companies under the Act shall be available to foreign companies under the provisions of the non-discrimination clause of the Tax Treaty.

[Source: TS-468-AAR-2016]

TRANSFER PRICING

4. Expenses incurred by Indian entity for setting up its overseas subsidiary (pre-incorporation expenses) cannot be relegated as "international transaction" and shall consider being a "shareholder activity"

Facts of the case

New Delhi Television Ltd. ("the taxpayer") is engaged in the business of Television, News Broadcasting to its two channels namely NDTV 24x7 and NDTV India. During the financial year 2006-07, the taxpayer assisted its overseas subsidiary i.e. NDTV Net Works Plc. [associated enterprise ("AE")] to set up its business operations in England. For this purpose, the taxpayer incurred certain expenditure prior to incorporation of its overseas subsidiary, as a part of its plan to diversify into various domains of the media.

These expenses were subsequently reimbursed to the taxpayer at cost by the AE. The taxpayer also rendered certain management services to its AE post incorporation, towards which the taxpayer again did not charge any markup.

During the course of transfer pricing ("TP") assessment, the TP Officer ("TPO") spurned the taxpayer's contention of treating its activities as "shareholder activity" and proceeds to benchmark both the transactions under the head "management services". Accordingly, he proceeded and made an upward adjustment. At the appellate proceedings, the Commissioner of Income Tax (Appeals) upheld the order passed by the TPO to the extent of levying mark-up on the services rendered post incorporation of the AE.

Aggrieved with the same, both taxpayer and revenue decided to move to the Income Tax Appellant Tribunal ["the ITAT"/ the Tribunal"].

Tribunal's Ruling

1. On Pre-Incorporation Expenses

The ITAT, in relation to taxpayer's contention of considering its expenditure incurred prior to incorporation of its AE as "shareholder's activity", relied on OECD TP Guidelines which define the term 'shareholder activity' as "*an activity which is performed by a Member of an MNE group (usually the parent company or a regional holding company) solely because of its ownership interest in one or more other group members i.e. in its capacity as a shareholder*".

The ITAT held that the taxpayer had incurred expenses solely because of its ownership interest and is different transaction from the one of provision of managerial services after incorporation. Thence classifying it as a shareholder activity, the tribunal upheld the action of taxpayer of not charging any mark-up on reimbursement of expenses incurred before AE come into existence.

2. On Post-Incorporation Expenses

The ITAT clarified that the expenditure incurred by the taxpayer before incorporation of its AE cannot be a deciding factor to determine the arm's length price of international transaction between the taxpayer and its AE post incorporation. Accordingly, the ITAT held that the reimbursement of other managerial costs by the AE to the taxpayer, post its incorporation, is considered to be the serviced rendered by the taxpayer and thus, should be subjected to an arm's length mark-up. The Tribunal further observed that the taxpayer itself has worked out the arm's length margin of 12.29% in its TP report.

Nangia's Take

The Indian TP regulations do not have any specific guidelines for identification and treatment of consideration paid/received for shareholder activity or of any other nature. The instant case, however, specifically brings out a distinctive feature between "shareholder activities" & "services provided under normal course of business" and with additional mark-up policy in the former case.

Source: New Delhi Television Limited vs. ACIT [TS-613-ITAT-2016-(DEL)-TP]

5. The High Court allowed the TP assessment proceedings to carry on further despite keeping the debate open on analyzing shareholding pattern of the directors and their relatives for examining the applicability of Domestic TP provisions

Facts of the case

DB Corp Ltd ("the taxpayer") is a company registered under the Companies Act. During the course of scrutiny assessment for assessment year ("AY") 13-14, the Assessment Office ("the AO") referred the case to Transfer Pricing Officer ("TPO") under section 92CA (1) of the Income Tax Act ("the Act") to determine the arm's length price ("ALP") of specified domestic transactions of the taxpayer.

The taxpayer raised objections against the reference made to TPO and subsequent notice issued by the TPO in this respect. The AO made a report to Principal Commissioner of Income Tax ("Principal CIT") stating why such objections are not valid. Upon considering AO's report, the taxpayer's objections against reference to TPO as well as further objections were rejected by Principal CIT. Following which, the taxpayer challenged before Gujarat High Court ("HC"), the reference made by AO to TPO and notice issued by the TPO. He also challenged the orders rejecting taxpayer's objections against TPO reference.

Proceedings before the HC

The issue before the court was to examine the applicability of domestic Transfer Pricing ("TP") provisions in the taxpayer's case.
During the assessment year under review, the taxpayer incurred expenditure pertaining to advertisement, rent and purchase of investment (exceeding INR 5 crore), for which payment was made to the entity, viz. Writers & Publishers Pvt. Ltd ("WPPL"). The Taxpayer's directors and their relatives held 25.98% of the shareholding of WPPL, but their individual holding was less than 5%.
The tax authorities was of the view that since the aggregate holding of Directors and their relatives of the taxpayer was more than 20%, therefore, the entity would qualify as a ***specified person*** defined under Section 40A(2)(b) in terms of clause (vi)(B) of the Act.

The taxpayer was of the contrary view and relied on the ratio drawn from the case of ***Octave Apparels vs. Commissioner of Income Tax-1, Ludhiana [(2014) 45 Taxmann.com 370],*** where it was held that when shareholding of each partner of the firm was less than 10% though their cumulative shareholding was more than 10%, Section 2(22)(e) of the Act would not apply. Accordingly, the taxpayer contended that since none of the directors and their relatives held more than 20% of the holding WPPL, hence, the provisions of clause (vi) of Section 40A (2)(b) of the Act will not be applicable in the instant case. It was further claimed that aggregate holding of the directors (including their relatives) could not be taken into consideration for examining the applicability of domestic TP provisions provided in Section 92BA read with Section 40A(2)(b) of the Act. With this, the taxpayer emphasized upon the fact that for the purpose of Section 40A(2)(b) of the Act, the reference of holding director must be understood in its normal grammatical meaning i.e. holding of an individual director, without resorting to aggregation of the holding of the directors.

Adjudicating in favour of the Revenue, the HC dismissed the taxpayer's petition. The HC noted observations from ***Veer Gems vs. Assistant Commissioner of Income Tax [TS-670-HC-2011(GUJ)-TP]*** and stated that the AO must be completely satisfied that it is expedient to make reference to the TPO and such opinion of the AO must be backed by the Commissioner's approval. The HC further observed that requisite evidences suggesting that directors (including their relatives) of the taxpayer, in aggregate held more than 20% of the shares in WPPL; and also since the aggregate expenditure incurred by the taxpayer to WPPL exceeded INR 5 crores, therefore, the HC would allow TP procedure to carry on further without disrupting it at intermediary stage.

With reference to appealing before the HC, the HC mentioned that the taxpayer would have one more opportunity to contest (i.e. AO's reference to the TPO) before the Dispute Resolution Panel under Section 144C of the Act who would have the powers to nullify the variations arising out of the order of the TPO, had it been concluded that the reference to the TPO was invalid.

The HC, however, kept open the legal issues regarding the question whether Clause (vi) of Section 40A(2)(b) of the Act would cover only the holding of the director(s) on individual or on aggregated basis (i.e. by considering the holdings of their relatives).

Nangia's Take

As the first year of TP audit of transactions covered in Indian DTP provisions has embarked on, it is expected that the same will navigate the Indian TP regime towards new set of challenges with significant TP additions. In the instant ruling, the HC has kept the debate open for one of crucial aspects of examining the shareholding pattern (i.e. individual vs. aggregated) to analyze the applicability of DTP provisions. It would be interesting to see the construction of the appellate authorities (later during the course of proceedings) while analyzing provisions of Clause (vi) of Section 40A(2)(b) of the Act.

Source: D B Corp Ltd. Vs DCIT [TS-607-HC-2016(GUJ)-TP]

INDIRECT TAX

6. CBEC issues clarification on transaction of hiring, leasing or licensing of goods

In terms of Article 366 of the Constitution of India, hiring, leasing or licensing of any goods with transfer of the right to use is deemed to be a sale, thereby subject to VAT/ CST. Further, in terms of Section 66E(f) of the Finance Act, 1994, transfer of good by way of hiring/ leasing/ licensing of goods without transfer of right to use is a 'declared service', thereby subject to service tax.

Vide the Circular, Central Board of Excise and Customs ['CBEC'] has clarified that in any given case involving hiring, leasing or licensing of goods, it is essential to determine whether, in terms of the contract, there is transfer of right to use the goods, as per the principles laid down by the Supreme Court in the case of **BSNL vs. Union of India [2006 (2) STR 161 SC]**. In the said case, the Supreme Court held that a transaction involves transfer of right to use goods, in case it fulfills the following criteria:

- There must be goods available for delivery;
- There must be consensus *ad idem* as to the identity of the goods;
- Transferee should have legal right to use the goods;
- Such right should be to the exclusion of the transferor i.e. it should not be merely license to use the goods, and
- During the period of transfer, owner cannot again transfer the same right to others.

Circular further states that:

- The term of contract must be studied *vis-a-vis* the criteria laid down by the Supreme Court in order to determine whether a transaction involves transfer of right to use goods.

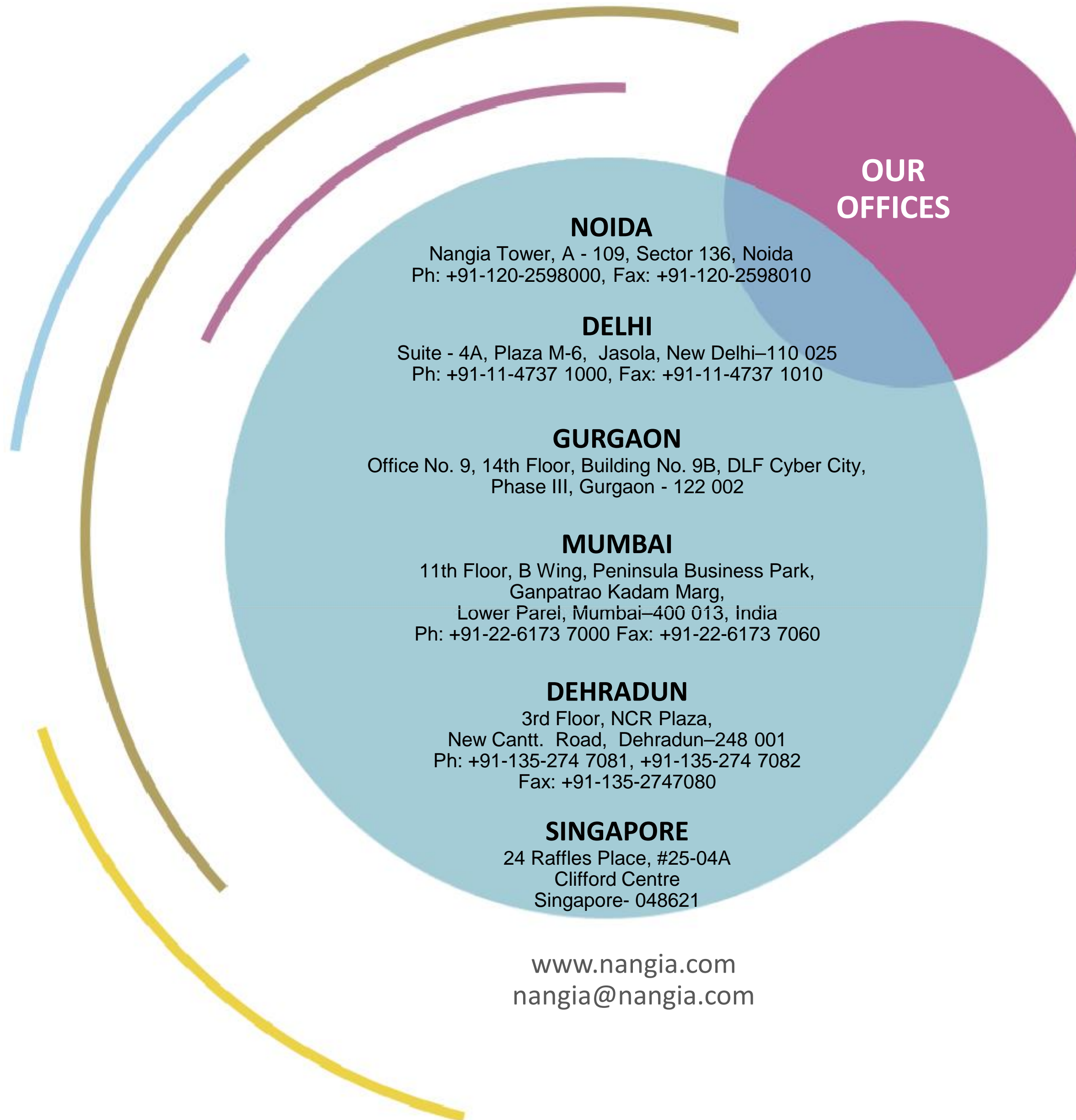
- The cases decided under Sales Tax / VAT legislations should not be applied mechanically but applicability of the said cases in a given case should be examined in view of the facts and terms of the contract of the given case.

- Circular also cites examples of 'financial lease' & 'operating lease', as well as 'dry leases' & 'wet leases' for aircraft industry, to emphasize the diverse nature of transactions and clarifies that in all these cases, no presumptions/ assumptions about service tax liability should be made and terms of the contract should be examined in view of the criteria laid down in the BSNL Judgment and other judicial pronouncements.

Nangia's Take

Circular merely emphasis that in transactions, involving hiring, leasing or licensing of goods, criteria laid down by the Supreme Court must be followed and applied to determine applicability of service tax viz a viz the contractual terms. Although concepts of finance lease, operating lease, dry lease and wet lease are discussed briefly, the Circular does not bring about clarity with regard to applicability of service tax on the said transactions.

[Source: Circular No. 198/8/2016-Service Tax dated 17 August 2016]



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