NEWS CRUNCH

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DIRECT TAX

1. Stock Appreciation Rights taxable as perquisites, even if received from parent company

Facts of the case

The Assessees were employees of M/s Cognizant Technologies India Pvt. Ltd. During the relevant assessment years, the assesses had participated in an Incentive Compensation Plan offered by the parent company of M/s Cognizant Technologies India Pvt. Ltd whereby the employees were provided Stock Appreciation Rights ('SAR'). SAR is the right to receive bonus in cash, equivalent to the appreciation in the value of the company's share price over a specified period.

This right is generally conferred on the employees so as to motivate the employees to perform their best at work and link the company goals to individual employee goals.

Ruling

In this decision, the Chennai High Court has laid down principles for taxation of SARs as below:

- SAR is a right conferred upon the Assessee in his capacity of an employee and accordingly, though the option is provided by parent company, the rights will be considered as perquisite or benefit in lieu of salary

- The said rights are not capital in nature, hence, the same is liable to tax as revenue receipt

- Residential status of the employee at the time of vesting is irrelevant for taxation in India

- If taxes have been deducted on the said rights as per the laws of another country, then credit for such taxes will be available as per applicable laws and on production of evidence of payment of such taxes in another country

Nangia's Take

Share based employee benefit schemes are slowly taking a strong hold in India especially among new start-ups wherein talent acquisition is a major concern. Keeping this in mind, the Securities Exchange Board of India (SEBI) had notified New Regulations in October 2014 for share based employee benefit schemes. The terms and conditions for SAR were laid down in this New Regulation. While SEBI has introduced SARs, no specific changes were made in the budget for taxation of these rights. The decision of the Chennai ITAT is in line with the decision of special bench of ITAT Mumbai and will now give guidelines for taxation of SARs.

Source:[TS-252-ITAT-2016(CHNY)]

2. Offshore supply of equipment is not taxable even if installation, commissioning and testing was done in India by a separate group entity

The Assessee is a foreign company incorporated in USA. During the year, Nortel India (a group company of the Assessee) entered into three different contracts ('main contracts') with Reliance for (i) supply of equipment; (ii) installation, commissioning and testing and (iii) software contract. Nortel India then subcontracted the contract for supply of equipment to the Assessee.

Under the terms of the subcontract, the Assessee assumed all rights and obligations of Nortel India to sell, supply and deliver equipment wherein right to the equipment passes on to Reliance outside India. Reliance placed purchase orders directly with the Assessee and made all payments for the said supply directly to the Assessee.

During the course of assessment, the tax officer held that the main contracts constituted a single turnkey contract which had been artificially divided into three separate contracts. As the contracts were indivisible and the installation, commissioning and testing was performed in India by Nortel India on behalf of the Assessee, Nortel India would constitute PE of the Assessee and profits arising to the Assessee have to be attributed to India.

The said decision of the tax officer was upheld by CIT(A) and ITAT.

Aggrieved the Assessee filed an appeal before the High Court. After a thorough reading of the contracts and placing reliance on the decision of Ishikawajima-Harima Heavy Industries[1], the High Court concluded that even in case of turnkey contract, it is not necessary that for the purpose of taxability, the entire contract be considered as an integrated one. Further, the High Court observed that the consideration received by the Assesse was only for supply of equipment and Nortel India received separate consideration for the service part of the contract performed by Nortel India. Accordingly, Nortel India was not acting on behalf of the Assessee or any other group entity and an independent tax entity would not constitute a PE..

Nangia's Take

The High Court's decision will help mitigate PE exposure especially for multinational companies executing diverse scope of work under different contracts through different entities. It may be noted that the High Court's observations and conclusion are based on a complete review of the contracts and the terms and conditions therein. Accordingly, it can be concluded that where the scope of work has been clearly defined in the agreement, taxability should be examined at entity level and not group level.

Source: [TS-241-HC-2016(DEL)]

[1](2007) 288 ITR 408 (SC)

3. ITAT holds that income from certification of oil & gas reserves is not taxable under Indo-US DTAA

Facts of the case

ONGC had entered into a tax protected contract with DeGloyer & McNaughton, USA (hereinafter referred to as D&M) for the third party certification of oil & gas reserves. The scope of work was executed in the USA wherein personnel of D&M visited India for only 2 days for collection of data.

ONGC applied for a tax order u/s 195(2) pursuant to which the assessing officer held the income payable to D&M to be in the nature of *fees for technical services* subject to tax at the rate of 10 per cent.

ONGC filed an appeal with the Commissioner (Appeals) claiming that under the Indo-US DTAA, payments made to D&M could not be taxable in India by virtue of the facts that (a) in the absence of a permanent establishment in India its business income would be taxable only in the US; and (b) the payments could not be fees for included services under the DTAA since ONGC was not passed on any technical knowledge, experience or skill.

The Commissioner (Appeals) ruled that the payments made by ONGC to D&M were in respect of activities pertaining to 'mining' and accordingly excluded from the purview of section 9(1)(vii) of the Act.

The CIT(A) ruled that the income of D&M would be chargeable to tax in India u/s 44BB. Both ONGC as well as the tax authorities filed appeals with the ITAT against the ruling of the CIT(A).

The ITAT held that the third party certification of oil & gas reserves cannot be construed as fees for technical services under the India-USA DTAA as no technical knowledge, skill, knowhow, etc. was made available to ONGC. Further, the ITAT noticed that it was not disputed by the assessing officer that D&M did not have a PE in India. In this background, the ITAT held that payments made by ONGC to D&M were not subject to tax in India under the Indo-US DTAA, notwithstanding the provisions of section 44BB.

Nangia's Take

This is an important ruling for the oil & gas service providers whose incomes are sometimes deemed by the tax authorities to be taxable as fees for technical services given the technical input and complexities involved. The ITAT has reiterated the view that unless technical knowledge, skill, etc. is transferred, such services will not be taxable as fees for technical services under the Indo-US DTAA.

TRANSFER PRICING

4. Broad based findings of Transfer Pricing Officer/ Dispute Resolution Panel in relation to the development of intangibles on account of location saving is unwarranted; Appropriate characterization of taxpayer based on its functional profile is crucial to determine the arm's length price

Facts of the Case

Best Seller United India Private Limited ["the taxpayer"] was incorporated in 199 and is a wholly owned subsidiary of Best Seller AS ("BSAS"). It is engaged in the business of providing buying agency services, i.e. sourcing of finished goods from India to its Associated Enterprise ["AE"] (i.e. BSAS). For the aforesaid international transaction, the taxpayer was compensated by way of commission (i.e. 2.5% on the cost of the goods sourced from India by the AE of the taxpayer). For determining the arm's length price ["ALP"], the taxpayer had applied Transactional Net Margin Method ("TNMM") and selected eight comparables

with their weighted average of three years' margin (OP/OC) of 12.72% as against the 437% margin earned by the taxpayer.

During the course of the assessment, the Transfer Pricing Officer ["TPO"] rejected the taxpayer's TP study treated it as a 'contract manufacturer. The TPO further concluded that the remuneration model used by the taxpayer cannot be accepted as the same did not capture the compensation to be earned by the taxpayer from development and use of intangibles (on account of location savings). He was also of the view that cost of goods sold has not been reflected while computing the compensation payable to the taxpayer. Accordingly, choosing a set of six comparables with average margin at 8.07% and proposed a TP adjustment of INR 31 crores. Aggrieved with the same, the taxpayer filed its objections before the Dispute Resolution Panel ["DRP"] which directed the TPO to compute ALP at 5% of the value of goods sourced by the taxpayer's AE from India and thereby, reduced the amount of additions to INR 14 crores. Aggrieved with actions of DRP, the taxpayer filed an appeal before the Income Tax Appellate Tribunal ["the ITAT"/"the tribunal"].

Verdict of the ITAT

The ITAT categorically held the actions of TPO and DRP as irrational and accordingly, set-aside the entire additions made in this connection. While doing so, the ITAT observed the following:

- The taxpayer is neither entitled to have the title of goods nor possessed them. Its role is confined to facilitator who performs liaison services in order to ensure that the goods qualify the standards as prescribed by the AE;
- The taxpayer performs under the standard code to get the goods manufactured for its AE and there exist no agreement between the taxpayer and the manufacturer of the goods for the taxpayer's AE and as such, the question of bearing significant risks and performing critical functions do not arise in case of the taxpayer;
- The taxpayer neither possesses any plant/ machinery nor had incurred any expense in relation to the manufacturing of goods;
- The DRP although set aside the findings of TPO of considering the taxpayer as manufacturer, but also directed that the taxpayer cannot be compared with support service provider companies. Thus, the DRP failed to pin-point the functional profile of the taxpayer;
- The findings of Hon'ble High Court Ruling in case of ***Li & Fung India Private Limited (ITA No. 5156/Del/2010)*** is not applicable in the instant case of the taxpayer

Nangia's Take

To ascertain the functional profile of the taxpayer, it is necessary to have the understanding of the commercial realities. Further, the broad based findings of the lower tax authorities without application of mind and understanding the business realism of the taxpayer is inadequate and thus, unsustainable.

Source: Bestseller United India Private Limited Vs Addl. CIT, Range 2, New Delhi [I.T.A. No. 6140/Del/2012]

5. The Tribunal allows appeal of the taxpayer; considers amendment to Section 92B to be read as prospective in case of outstanding receivables

Facts of the Case

Rusabh Diamonds ("the taxpayer") is engaged in the business of manufacturing, import and export of cut and polished diamonds. During the year under consideration, the taxpayer entered into had international transaction with its associated enterprise ("AE") which was benchmarked on the basis of transactional net margin method ("TNMM"). Transfer pricing officer ("TPO") noticed that the AE owed INR 35.76 crores to the taxpayer amounting to approximately 40% of the total exports.

In addition to the same, the taxpayer had paid interest of INR 0.27 crores that could have been avoided had the export proceeds been realized within time. Hence, the TPO made an adjustment of INR 4.47 crores at cost plus 3% mark up and refused taxpayer's contention of non-applicability of section 92B of the Income Tax Act ('the Act") in the instant case.

Additionally, dispute resolution panel ("DRP") partially upheld the TPO's contention directing the assessing officer ("AO") to remove the mark up and restrict the interest on receivables at SBI PLR.

Aggrieved taxpayer as well as revenue appealed before the Income Tax Appellate Tribunal ("ITAT/the Tribunal").

ITAT Adjudication

The taxpayer submitted before the Tribunal that a continuing debit balance cannot be considered as a separate international transaction. Reliance was also placed on the decision placed by the Tribunal in the following cases:

1. ***Kusum Healthcare Pvt. Ltd. Vs. ACIT [(2015) 62 taxmann.79 (Del)];***
2. ***Micro Ink Ltd. Vs. ACIT [(2014) 63 taxmann.353 (Ahd)];***
3. ***Nimbus Communications Ltd. Vs. ACIT [(2011) 139 TTJ 214 (Mum)]***

It was also submitted by the taxpayer that the amendment made in 2012 cannot be applied retrospectively since transfer pricing ("TP") amendments can only be prospective in effect. Accordingly, reliance was placed on the observations made by the Tribunal in the case of ***Bharti Airtel Ltd. Vs. ACIT [(2014) 63 SOT 113 (Del)].***

The Revenue, on the other hand, contended that as per the amendment in Section 92B of the Finance Act, 2012 w.r.e.f. 1st April, 2002, international transactions shall include outstanding receivables. In this regard, reliance was placed on the decision of the Hon'ble Bombay HC in case of ***i-Gate Computer Systems Ltd. Vs. ACIT and vice versa (ITA No. 2504/PN/2012).*** The Revenue also suggested application of comparable uncontrolled price ("CUP") (direct method) method instead of TNMM.

The Tribunal opined that even though the amendment to Section 92B was with retrospective effect, it was held that as long as sale is benchmarked on TNMM basis, no separate adjustment is required for delay in realization of debts. In this regard, reliance had been placed on

the HC decision in case of ***Sony Ericsson Mobile [TS-96-HC-2015(Del)-TP].***

Based on the same, the Tribunal held that in cases where interest relating to sales is a part of operating income (considered reasonable under TNMM), no adjustment would be required for notional interest on outstanding receivables.

Additionally, the Tribunal noticed that in the instant case, there was nothing on record to show exclusion from other income and hence, setting off interest expenses with interest on account of delay in realization of debts was an uncommon occurrence and thus, deleted the arm's length price ("ALP") adjustment w.r.t. delay in realization of sale proceeds.

Applicability of amendment in Section 92B in the present case

The explanation added to Section 92B is clarificatory in nature and does not expand the scope of the term "international transaction". The Tribunal was of the opinion that even though the 2012 amendment increases the scope of international transaction, it cannot be implemented for period prior to the date law came in force unless it is reversed by a higher judicial assembly hence, it could not implemented for the period prior to this law coming in force. In this regard, reliance had been placed by the Tribunal on SC decision in ***Krishnaswamy S Pd. vs. Union of India [(2006) 281 ITR 305 (SC)].***

Reliance in this regard had also been placed in HC guidance in ***DIT vs. New Skies Satellite BV [TS-64-HC-DEL(2016)]*** wherein the amendment with regard to continuing debit balance had been considered beyond the scope of international transaction and could not be taken retrospectively.

Therefore, the amendment to section 92B of the Act in case of outstanding receivables shall be effective from April 1, 2012. While the present case related to AY 2009-10, the Tribunal removed the TP adjustment and allowed the taxpayer's appeal.

Nangia's Take

The Tribunal in the instant case clarified that if an amendment does not add anything or expand the scope of an international transaction defined under section 92B of the Act, the matter rests then and there itself unless it is overruled by a higher judicial forum. Further, uee to the conflicting positions taken by ITAT as discussed above, the issue whether the levy of interest on delayed realization of the AEs' outstanding receivables remains unsettled. Therefore, as the Indian Government is pacing up to settle the various persistent TP issues, it becomes equally significant to unclutter the ambiguities in relation of levy of interest on delayed realization of the AEs' outstanding receivables as well so as to gain the confidence of the multinational groups in Indian tax regime.

Source: Rusabh Diamonds vs. ACIT [I.T.A. No.2840/Mum/2014]; ACIT vs. Rusabh Diamonds [I.T.A. No.2497/Mum/2014] AND Rusabh Diamonds vs. ACIT [C.O. No.110/Mum/2014 arising out of I.T.A. No.2497/Mum/2014]

INDIRECT TAX

6. Staff deputation to group Companies constitute Joint employment, not liable to service tax

M/s Franco Indian Pharmaceutical Private Limited [‘Assessee‘] is a manufacturer of pharmaceutical products, having its own marketing network. The Assessee’s three group companies are also engaged in manufacturer of pharmaceutical products, but they do not have any marketing network. Thus, in order to sell their products, group companies use Assessee’s network for which, Assessee recovers the expenses incurred from its group companies.

In this case, Authorities were of the view that expenses recovered by the Assessee from its group companies are in the nature of services rendered under the category of Business Auxiliary Service [i.e. promotion or marketing or sale of goods produced or belonging to the client] and issued a show cause notices].

Subsequently, order was issued against the Assessee confirming demand of service tax along with interest and penalties on value of expenses recovered by the Assessee. Aggrieved by the same, Assessee filed an appeal before the Mumbai Tribunal.

The Mumbai Tribunal observed and ruled as under –

- The Agreement inter alia indicates that Assessee is only deputing the employees to the group companies and said employees are called back after the job is completed. Agreement does not indicate that the Assessee is rendering service of promotion or marketing of the goods manufactured by the group companies.

- In terms of the service tax provision, services rendered in the course of employment have been kept outside the purview of service tax. Whether such service is rendered by an employee to one employer or to many, as in the case of joint employment, cannot make any difference to the tax treatment of the emoluments earned by employee.

- An employee can legitimately refuse to work for another company, either on deputation or on secondment, if employer contract is silent on the employer’s right to depute or second the employees. However, if such employee consents to such deputation or secondment to another company for long period, knowing that emoluments are being paid by such other companies, transform the arrangement into a contract of joint employment with several employers.

- Even otherwise, by its very nature, a situation where the employer-companies have a preexisting agreement to hire employees on joint basis and agree to share the cost of employment on actual by dividing it amongst themselves in such a manner that each employer bears only his part of the cost indicates that there was no intention amongst the employer companies to render any service to each other.

- In the absence of any mark-up to the cost, the payment received against debit notes by one employer company from another would not partakes the character of consideration for service, but merely represents reimbursement of shared costs.

Nangia's Take

In view of the above, raising a debit note on group companies for recovering the employee related cost, without markup, for services of employees would not amount to consideration for a service.

[Source: Appeal No. ST/368/12-Mum in the case of M/s Franco Indian Pharmaceutical Private Limited vs. Commissioner of Service Tax, Mumbai]

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