NEWS CRUNCH

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NANGIA & CO
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DIRECT TAX

1. Income of non-resident that is not attributable to PE in India shall still be taxable in India as FTS

Recently, Delhi Income Tax Appellate Tribunal ("Tribunal") in the case of International Management Group (UK) Ltd. ('the assessee') dealt with the issue of taxability of income received by the assessee, which is not attributable to its Permanent Establishment ('PE') in India. The assessee had entered into a contract with the Board of Cricket Control in India ('BCCI') for providing services related to assistance in establishment, commercialization and operation of the Indian Premier League ('IPL') events. The assessee rendered services through its employees in India and, thus, triggered a Service PE under the India-UK Double Taxation Avoidance Agreement ("India-UK Treaty"). However, a part of the services was rendered in South Africa, as certain IPL matches were relocated to South Africa. The issue under consideration was on taxability of the amount received from the BCCI for furnishing of services in South Africa.

The Tribunal held that profits, only to the extent of the activities carried on by the assessee through its Service PE, shall be taxable as business profits under the India-UK treaty and the balance activities, which are not at all connected with the activities of the Service PE, shall be taxed

as Fees for Technical Services ("FTS") under the India-UK treaty. Under the provisions of the Income-tax Act, 1961 ("the Act"), the Tribunal ruled that the whole amount was taxable as FTS as the services provided by the assessee were utilized by the BCCI for carrying on business in India and the source of income of the BCCI was in India. Accordingly, the services did not fall under the source rule exclusion applicable to FTS under the Act.

Nangia's Take

This decision deals with the issues relating to taxation of FTS, as also business profits taxation, and rules that in cases where the income is effectively connected to a PE in India, it shall be governed by the Business Profits Article and, hence, shall be taxable on net basis (i.e., income less expenditure). However, the balance amount which is not connected to the PE can continue to be governed under the specific income Article i.e., FTS in the current case, and can be taxable in India on a gross basis.

This ruling also provides that there is no difference between the terms "effectively connected with" and "attributable to" as these have been used interchangeably in India's DTAA. Accordingly, if a particular receipt is not taxable under the specific FTS Article of the DTAA on account of being effectively connected with the PE, the same will be taxable under the Business Income Article.

Source:[TS-545-ITAT-2016]

2. Withholding tax non-applicable on lump sum lease premium payable on long-term leases – CBDT clarifies

The High Courts have debated this issue and have adjudicated that no withholding is required on payments pursuant to long-term leases, as the payments are capital in nature/in the nature of deemed sale. Further, all the rights pertaining to the property would stand transferred to the lessee and, moreover, there is no provision in the lease arrangement to adjust the lump sum payment against any rent payable by the lessee.

In this background, Central Board of Direct Taxes (CBDT), has issued clarification on the applicability of tax withholding provisions on lump sum lease premium payable on long- term leases. The CBDT noted that in various favorable judicial precedents, it has been held that such payments which are not adjustable against periodic rent payable are not in the nature of rent for the use of land or any property and are not subject to withholding. Accordingly, CBDT has issued the Circular clarifying non-applicability of withholding on lump sum premium or one-time lease charges paid for acquisition of long-term leasehold rights.

Nangia's Take

This is yet another Circular issued by the CBDT to provide clarity and certainty on the issue which, as noted by the CBDT, is covered by many of the judicial precedents. The Circular provides much needed certainty and avoids litigation. However, what would one mean by "long-term lease" has not been clarified and, hence, there can be certain ambiguity in this regard.

CBDT Circulars are binding on revenue authorities and applies to all pending proceedings including pending appeals.

Source: [Circular No. 35 of 2016 dated 13 October 2016]

TRANSFER PRICING

3. Extending corporate guarantee by Indian entity its overseas subsidiary is a 'shareholder activity'; Restores the matter in respect of intercompany loan

Facts of the case

Tega India ("the taxpayer") had set up Tega Investment Ltd., Bahamas, an associated enterprise ("AE") ("TIL") as a special purpose vehicle for undertaking acquisition of Beruc equipment Pty Limited and Bentod Manufacturing Limited. In order to acquire the aforementioned companies, the taxpayer provided a interest free shareholder loan to TIL and a corporate guarantee to ICICI Bank UK to fund the taxpayer's AE (i.e. TIL). The Transfer Pricing Officer ("TPO"), during the assessment proceedings, proposed upward adjustment by levying interest on interest free loan advanced by taxpayer to its AE and determining a charge @2.5% towards the for providing corporate guarantee.

Aggrieved, the taxpayer challenged the orders of the TPO before the Dispute Resolution Panel (“DRP”). The DRP upheld the orders of the TPO. Subsequently, the taxpayer challenged the actions of DRP before Income Tax Appellant Tribunal (“ITAT”/ “the Tribunal”).

The Tribunal’s Ruling

1. On interest free inter-Corporate loan

The taxpayer’s contentions: The taxpayer contended that it had benchmarked the captioned transaction using Comparable Uncontrolled Prices (“CUP”) method and determined the interest rate of LIBOR plus 100 bps as the arm’s length rate (“ALP”). The taxpayer suo-moto offered to tax such notional income on interest free loan to TIL and to its other AEs. However, the TPO, by downgrading the credit rating of the Australian and US AEs of the taxpayer, arrived at 300 bps as credit spread to make TP adjustment. The taxpayer argued that the loan was provided as a substitute to equity funding to TIL for furthering its own intent of acquiring the two South African entities and hence, it should be classified as ***loan performing shareholder function***, thus, warranting no charge. The Taxpayer reiterated the fact that it never had an expectation to earn interest income from its subsidiary but to benefit itself. The taxpayer further stated that the funds were provided as a means to mitigate its own risks vis-à-vis infusion of additional funds in the form of equity and hence they were *quasi- equity* in nature.

The Tribunal’s Findings: The ITAT agreed that the loan was advanced by the taxpayer to its subsidiary company on account of commercial expediency i.e. in order to expand its business globally. Also, since TIL had a low capital, therefore, without injecting funds, it was not possible for it to run the business for benefit of the taxpayer. The Tribunal also found merit in taxpayer’s submissions and pointed out that the loan granted was indeed a kind of *quasi-equity*. The ITAT further stated that the mechanism adopted by TPO to determine the credit rating of the taxpayer and its AEs is erroneous and held that the captioned issue required fresh examination. Accordingly, the matter was restored to TPO in order to determine the ALP of the loan.

2. On Corporate Guarantee

The taxpayer’s contentions: The taxpayer ingeminated that his expectations from the corporate guarantee provided were never to earn a guarantee fee but to benefit itself. This was evident from the skewed debt-equity ratio of TIL since no other independent entity would have lent any funds to it. Thus, it was clear that the intent of the taxpayer was that of the investor and not that of a lender.

The Tribunal’s Findings: The Tribunal was completely in agreement with the taxpayer’s contentions and stated that the taxpayer opted for providing a guarantee tête-à-tête blocking its own funds to facilitate furtherance of its own business and get return in terms of appreciation in value and dividends. The ITAT also supported the taxpayer relying on judicial precedents wherein it was held that corporate guarantee by an Indian entity to its overseas subsidiary is a shareholder’s activity and hence, no TP adjustment is required. Based thereon, the ITAT ordered to delete TP addition on account of subject transaction.

Nangia’s Take

ITAT ruling confirms that providing corporate guarantee in respect of a loan extended to an AE cannot be covered under the ambit of TP provisions without placing emphasis upon the aim of the guarantor. If the intent of the taxpayer is furtherance of his own business objective, it will be wise to classify it as a shareholder activity.

Source: Tega Industries Ltd. Vs DCIT [TS-780-ITAT-2016(Kol)-TP]

4. The Tribunal affirmed the re-characterization of the refunded share application money (advanced by taxpayer to its associated enterprise) as loan transaction and subjects the same for levy of interest

Facts of the case

Taurian Iron & Steel Co. Private Limited, ["the taxpayer'] during previous year relevant to the assessment year under review, advanced share application money to its wholly owned subsidiary in South Africa i.e. Taurian CISA [associate enterprise ("AE") of the taxpayer] of USD 0.86mn, to be used by the later for obtaining mining contract in Africa.

As against the total remittance, 31,120 shares worth USD 0.66mn were allotted to the taxpayer and balance amount of 0.20mn was refunded.

The Transfer Pricing Officer ("TPO"), during assessment, referring to and taking cognizance of manifold factors partake that the color and character of said remittances is in the nature of loan advanced by the taxpayer to the AE, thereby proceed to charge interest @ 14% p.a. making an upward TP adjustment of INR 1.58mn. On appeal Commissioner of Income Tax (appeals) ["CIT(A)"] partly confirm the action TPO's by directing to charge interest on the basis of six month LIBOR plus 150 basis points.

Tribunal's Ruling

1. On the nature of Share application money refunded

The ITAT is of impression that *re-characterization of a transaction is permissible only where the economic substance of a transaction differs from its form*. Referring to the present case, it was arbitrated that remittance made by the taxpayer to the extent of allotment of 31,120 shares is permissible in the eye of law.

The Tribunal however did not persuaded with the similar treatment for the refunded amount of 0.20mn. It was pronounced that factum of advancing the amount and its repayment by the AE would fall within the ambit of awarding simpliciter advance, which consequently would render the color and character to transaction under review, as that of being a 'loan transaction. Articulating the never so crystallized allotment of shares for 0.20mn as absolutely misconceived, the ITAT set aside the order of ld. CIT(A) and directed the AO to continue to levy the interest (based on LIBOR) on the amount of share application money refunded to the taxpayer.

Nangia's Take

This ruling may create a trend of charging interest on share application money advanced by Indian taxpayer to its AE and subsequently refunded to the taxpayer. This ruling is different from the earlier rulings of the Tribunal wherein the ITAT, in many cases has disregarded the traditional view of re-characterization of share application money as loan by the lower tax authorities and thereby charge interest on inordinate delay in share allotment or even no allotment.

Source: Taurian Iron & Steel Co. Pvt. Ltd. Vs. ADCIT [TS-768-ITAT-2016(Mum)-TP]

INDIRECT TAX

5. GST Council meet : Centre proposes four tier structure under GST with two standard rates Ministry of Finance has released draft rules and formats of registration, invoice, payment, return and refund under GST

- As the first day of council meeting concluded on Tuesday, the GST council managed to arrive at a consensus on how to compensate the state for losses they incur on account of tax reform that subsume various state and central levies.

- However, Council has not yet arrived at a conclusion on the crucial GST rate structure. As per Finance Minster Arun Jatiley, the proposal for four tier structure was discusses.

Rate structure under GST:

The Basic structure: The center proposes four-slab GST tax structure:

Particulars	Proposed GST rate
Lower Rate	6%
Standard 1 Rate	12%
Standard 2 rate	18%
Higher Rate	26%

However, there is also proposal to impose an additional cess.

- Food item will continue to exempt from tax. As much as 50% of the common use goods will either be in the exempt category or lower band.

- Also, 70 percent of the items is proposed to be governed by 18 percent of lower GST rate. However, ultra-luxury items such as high-end cars and demerit goods like tobacco, cigarettes, aerated drinks, luxury car and polluting items would attract an additional cess on top of the 26 percent GST rate.

- On gold, the GST rate suggested was 4 percent. FMCG and consumer durable products would attract 26 percent GST rate, against the current incidence of around 31 percent.

- Taxation of services would, however, be only in the 6 percent, 12 percent and 18 percent range, with the higher rate being 18 percent.

Virtues of the proposed structure:

- The overall impact on the consumer price index is likely to be (-)0.6%.

- Estimate of inflation impact on health services is 0.56 percent, fuel and lighting 0.05 percent and clothing 0.23 percent, transport (-)0.65 percent, education (-)0.08 percent and housing (-)0.09 percent. It also says the Centre's estimated revenue collection is Rs 8.72 lakh crore as per this structure.

- The proposal to impose a cess will help create a fund of Rs 50,000 crore, which can be used to compensate the states.

Nangia's Take

GST council is moving ultra-fast towards the timely implementation of GST from 1st April 2017. GST council also finalized the compensation formula for states for calculating compensation for states in the first five year of implementation. With this speed of GST council, April 2017 is a doable target. Government has proposed a slab rate structure under GST, it would also increase the revenue of government in comparison to current tax scenario of indirect taxation, which is still under discussion in GST Council.