NEWS CRUNCH

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CHARTERED ACCOUNTANTS

What's inside . . .

DIRECT TAX

1. Software development expenditure is allowable as revenue expense, considering the nature of business.

Background

- Differential Technologies Ltd. ("assessee") is a company engaged in the business of development of software and sale of software products.

- During Financial Year ("FY") 2003-04 [relevant to Assessment Year ("AY") 2004-05], the assessee incurred an expenditure for carrying out in-house development in relation a software project,

(hereinafter referred to as "SMIS"). The cost incurred by the assessee on in-house development of software are accumulated and deferred until the completion of development, due testing and validation of such software product.

- During AY 2009-10, the whole expenditure incurred on SMIS as a business expenditure was written off by the assessee, for the reason that the software was not commercially viable and had become obsolete due to fast change in the technology and software programme.

- The assessee's case was scrutinized under section 143(3) of the Income tax Act, 1961 ("the Act"), wherein the Assessing Officer ("AO") partly disallowed expenditure claimed on SMIS. On appeal the action of the AO was sustained by the Ld. Commissioner of Income Tax (Appeal) ("CIT(A)"). Thereafter the assessee filed an appeal before the Ld. Income Tax Appellate Tribunal ("ITAT") in this regard.

Assessee's Contentions

- The assessee intended to write off the said expense matching with the revenue realized from the sale of such software, as per his consistent accounting policy. However, the said expenditure was fully written off during the relevant period, as the said software became obsolete.

- It also submitted that similar write offs for the other software were made in the earlier years and the same were accepted by the department during the assessment proceedings u/s 143(3) the Act.

Revenue's Contentions

- As per the Ld. AO, the expenditure was incurred 5/4 years back and is expected to be spread over the number of years, thus, is of capital nature. Also, the expenditure is not be allowed u/s 37(1) of the Act, because it has not been incurred during the relevant previous year.

- Further, the assessee has an in-house software development, therefore, the said expenditure will be allowed under the provisions of section 35D of the Act i.e. 1/5th of the total expenditure during the relevant period.

ITAT's Ruling

The Ld. ITAT observed and held as under:

- It is an undisputed fact that the assessee incurred an expenditure for development of software amounting to Rs. 24,65,578 in A.Y. 2004-05 and such development of software was meant to be sold as a part of its core business activity.

- The assessee is a software developer and develop software for the sale selling the same. Therefore, software developed are the inventories held for sale by the assessee and the moment it is felt that the inventory cannot be sold, the same needs to be written off at realizable value, being Nil in this case.

- The said product could not be sold over a period of time and has become obsolete, due to fast changing technologies and software programme. Thus, it has to be left to the prudence of the businessman to write it off in the year in which it considers that the said product cannot be sold at all or it has become scrap.

- If the software for which the expenses are incurred is for sale, then definitely it is of revenue nature and the same is allowable as business u/s 28 of the Act while computing the income chargeable as business income.

2. Supreme Court rules that fess paid for technical know-how for setting up of a manufacturing unit is capital expenditure

- Honda SIEL Cars India Ltd. **("Assessee")** was a Joint Venture company incorporated by Honda Motors Company Ltd., Japan ("HMCL") and SEIL Ltd., India.
- HMCL, Japan entered into a **Technical Collaboration Agreement ("TCA")** with Assessee wherein different kinds of know-how and technical information were to be provided by HMCL (as a licensor) to Assessee (as a licensee) for a lump sum fee to be paid in 5 equal installments commencing from third year of commencement of commercial production along with royalty for internal sales and exports.

Apart from this, three memoranda were also executed for providing necessary guidance for setting up of a plant.

- Assessee filed its return of income for AY 1999-2000 classifying such payments for TCA as "revenue expenditure" and payments for memoranda as "capital expenditure".
- Notice u/s 148 was issued stating that payments for TCA were capital in nature and later, orders were passed treating the same as capital expenditure.
- While, ITAT gave decision in favor of the Assessee, High Court agreed with the view of the Assessing Officer **("AO")**.
- Assessee contended that ownership rights in the know-how continued to remain with HMCL. It had merely acquired right to use technical information provided by HMCL. Thus, payments made were to be treated as revenue expenditure. For this, Assessee relied upon the Delhi High Court judgement in case of **CIT V. Hero Honda Motors (2015) 327 ITR 481 (Delhi)**
- As per Revenue, the technical know-how and royalty payments were of **"enduring nature"** and therefore, they would qualify as capital expenditure. A new asset in the form of setting up of a new company had come into existence with the aid of technical know-how.

Ruling of the Supreme Court:

- The Supreme Court affirmed decision of the Allahabad High Court stating that admittedly, there was no existing business and thus, question of improvising the existing technical know-how by borrowing the technical know-how of the HCML, Japan did not arise.
- The very purpose of the Agreement between two companies was to set up JV company with aim and objective to establish a unit for manufacture of automobiles & parts thereof. This technical collaboration not only included transfer of technical information, but, complete assistance, actual, factual and on the spot, for establishment of the unit.
- Though Supreme Court acknowledged that tenure of the agreement is limited and rights of Assessee as licensee were limited. However, the Supreme Court further noted that in case of termination of the Agreement, JV itself would come to an end and there may not be any further continuation of product with technical know-how of foreign collaborator.

- The Supreme Court found ITAT's opinion incorrect which said that only other three memoranda were necessary for setting up the manufacturing facilities and the payment for this Agreement was not in connection with setting up of a plant.

- Referring to the Delhi High Court judgement in case of **CIT V. Hero Honda (2015) 327ITR481(Delhi),** Supreme Court said that it should be noticed that in that case, technical know-how was obtained for improvising scooter segment, which unit was already in existence. On the contrary, in the present case, the agreement was for setting up a new plant for the first time to manufacture cars. The aforesaid distinction between the two agreements has made all the difference in the results and as a consequence, the Supreme Court agreed with the views of High Court and dismissed the appeal of the assessee with costs.

NANGIA'S TAKE

By this decision, Supreme court has laid down a principle that the "purpose and the objective" of the agreement regarding technical know-how would determine the character of the expenditure, i.e., whether capital or revenue. An expenditure incurred to acquire or bring into existence an asset or an advantage of enduring benefit of the business is a capital expenditure. The Supreme Court appears to have not given much importance to the rights granted to licensee under and tenure of the technical assistance agreement, by way of which technical knowhow is provided. The Supreme Court has also highlighted a very fine distinction between setting up a new asset/ business and improving upon an old asset/ business and held that while the expenditure incurred for latter can be considered as revenue expenditure, any expenditure for creating new asset/ business would qualify for being a capital expenditure. This decision has also again re-emphasized the principle that overall conduct of parties and viewing transaction on a holistic picture is important to characterize nature of any transaction or item of income/ expenditure. In our view, this decision will change the way such agreements are interpreted by tax authorities and their tax treatment.

3. Central Board of Direct Taxes (CBDT) clarifies trade advances are not "deemed dividend"

CBDT vide its Circular (Circular) No. 19/2017 dated 12 June, 2017 clarified that trade advances in the nature of commercial transactions will not be deemed as dividend under a specific anti-abuse provision (deemed dividend provision) of the Income Tax Act, 1961 ('the Act'). This is a significant development because the deemed dividend provision, *inter alia,* deems advance or loan to a substantial shareholder or a concern in which such shareholder has substantial interest as a dividend.

The Circular also provides illustrative circumstances of trade advances/commercial transactions which are not covered under the deemed dividend provision as upheld in the following favorable HC judgements:

- Advances made by a company to its sister concern for job work done by the sister concern

- Advances made by a company to its shareholder for installing plant and machinery at shareholder's premises to enable the shareholder to do job work for company's export orders.

- Floating security deposit given by a company to its sister concern for use of latter's electricity generator.

Accordingly, the CBDT has directed the Tax Authority not to file any further appeal on this issue and, furthermore, appeal already filed should be withdrawn or not pressed.

NANGIA'S TAKE

The Circular provides much needed certainty and avoids further litigation on the issue of treating trade advances made by companies for bonafide commercial transaction as deemed dividend. The CBDT Circular will apply in a case where the parties are able to establish the bonafide nature of commercial transaction for which advances are made by companies. The Circular is binding on all lower Tax Authorities and will apply to all pending proceedings including pending appeals.

INTERNATIONAL TAX

4. Ireland keen to woo Indian startups, offers tax benefits

- The Investment and Development Agency (IDA) wants to triple the number of startups, IT services organisations, entrepreneurs from various sectors in India in the next three years to set up base in various parts of Ireland. IDA along with sister firms like Enterprise Ireland is looking forward to helping Indian startups and enterprise companies focusing on the European market.

- IDA Ireland is engaged with organisations in IT services, fintech, pharmaceuticals and medical devices among others. Currently, six out of the top 10 Indian IT services companies in Ireland include TCS, HCL, Wipro, Mindtree, and Tech Mahindra who had started with a BPO operation and have also set up a Centre of Excellence in the telecom space.

5. India, Germany plan pact to help startups thrive

Italy sought to boost revenue from multinational internet companies on Monday by offering them the chance to agree on their future tax bills rather than risk disputes. The amendment stipulates that multinationals with total revenues of more than 50 billion euros ($56 billion) per year and sales worth more than 50 million euros in Italy can fix their tax bill in advance. Companies that sign up to the scheme will not only be able to agree their tax bills in advance for future years but will also have outstanding tax claims from previous years halved.

6. Thailand has become the 98th jurisdiction to join the Inclusive Framework on BEPS

It will participate on an equal footing with all other Inclusive Framework ('IF') members. The IF was established in January 2016, after the G20 Leaders urged the timely implementation of the BEPS package released in October 2015 and called on the OECD to develop a more inclusive framework with the involvement of interested non-G20 countries and jurisdictions, including developing economies. The programme will assist Thailand to implement new international tax standards with a focus on Country-by-Country Reporting and the other BEPS minimum standards, and the standards for exchange of information on request and for the automatic exchange of financial account information (the "Common Reporting Standard").

TRANSFER PRICING

7. The Tribunal seems to be in dilemma while confirming the bundling of transactions approach on one hand and subsequently, directing the TPO to examine one of the intra-group transactions of the taxpayer on standalone basis

Facts of the case

The Yokogawa India Limited ["the taxpayer"] is engaged in the Business of industrial automation and control, test and measurement, Information System and Industry Support. The taxpayer's business is divided into three segments namely System, Trading and Products & software development services. During Assessment Year under review, the taxpayer reported various international transactions including the Global Sale and Marketing Activity Fees paid by the taxpayer to its associated enterprise ["AE"]. In course of transfer pricing ["TP"] proceedings, the TP Officer ["TPO"] applied the benefit test and observed that the services rendered to the taxpayer under Global Sale and Marketing Activity Fees is already covered under Management Service Fees.

and thus, concluded that no separate payment was required or necessary by the taxpayer to its AE on account of procurement of Global Sale and Marketing services. Based thereon, the TPO held that the Arm's Length Price ["ALP"] of Global Sale and Marketing Activity Fees is NIL and consequently proposed an adjustment of INR 5.73 Crores.

The taxpayer challenged the action of the TPO before the Dispute Resolution Panel ("DRP"). The DRP held that the TPO was not justified in examining the necessity and commercial expediency of the payment made by the taxpayer as Global Sale & Marketing activity fees. Further, the DRP did not give any concluding findings on the issue of Most Appropriate Method adopted by the taxpayer as Transaction Net Margin Method ["TNMM"] whereas TPO applied Comparable Uncontrolled Price ("CUP") method. However, TPO did not give effect to the directions of the DRP properly. Therefore, both, the aggrieved taxpayer and Revenue filed cross appeals before the Income Tax Appellant Tribunal ["the ITAT"/ "the Tribunal"].

The ITAT Ruling

The Tribunal observed that The taxpayer carried out multiple & diversified international transactions in different segments which comprised of revenue receipts from the AE as well as revenue payment to the AE. In the light thereof All the international transactions having receipts from the AE and payment to the AE shall be clubbed together and analysed under TNMM rather than testing of single transaction of fee payment under TNMM. However, the Tribunal further held The DRP correct in directing to determine the ALP of Global Sale & Marketing Activity fees instead of considering its ALP at Nil.

In addition to the same, the Tribunal further held that the payments in respect of Management Service Fee as well as the Fee towards Global Sale & marketing Activity should be considered as operating cost & allocated in the ratio of turnover of the other international transactions of the taxpayer.

In the light of the above, the ITAT remanded back the entire matter of fresh determination of ALP of Global Sale & marketing Activity fee paid by the taxpayer and set aside the TP adjustment made by the TPO.

NANGIA'S TAKE

There are diverse ITAT rulings which support the aggregation of transaction approach on one hand and the others that support the ALP determination of international transaction on standalone basis. However, the ITAT, by referring back the matter of ALP determination of payment of Global Sale & Marketing Activity fee on standalone basis, contradicts its stand of confirming the taxpayer's approach of aggregating its international transactions with its AEs. Further, the instant ruling lack clarity in respect of outlining the approach adopted by taxpayer while segregating its Global Sale & Marketing Activity fee amongst its business segment. The ITAT also failed to highlight the precise reason of allocating the aforesaid cost in the ratio of turnover of the international transactions for applying TNMM.

Source: Yokogawa India Limited [TS-453-ITAT-2017(Bang)-TP]

8. The OECD TP Guidelines, inter-alia distinguishes the 'stewardship activities' from 'shareholders' activities' as the former, in few cases, tantamount to provision of services and thus, requires to be remunerated at ALP

Background

Schneider Electric India Private Limited ("the taxpayer") is engaged in the business of manufacturing and sale of switches, outlets and other electrical products. During the year under consideration, the taxpayer selected transactional net margin method ("TNMM") as the most appropriate method for benchmarking its international transactions including payment towards cost allocated in relation to the management services rendered by its associated enterprise ("AE"). During the course of assessment proceedings, the Transfer Pricing Officer ("TPO") viewed that the payment made by taxpayer in relation to procurement of management fee lacks benefit of economic and commercial value.

To corroborate this fact, the TPO stated that the taxpayer failed to provide reasonable documents/ evidences that support the rendition of services by the AE and the compensation so made by the taxpayer in this connection does not commensurate with the benefit derived therefrom.

He also disregarded the central cost allocation agreement produced by the taxpayer for justification of the said transaction. The TPO further held the services received by the taxpayer from its AE in the nature of stewardship activities or shareholders activities for which the taxpayer is not required to compensate its AE.

In the backdrop of the above, the TPO determined the arm's length price ("ALP") of the aforesaid transaction at NIL value. The aggrieved taxpayer filed objections before the Commissioner of Income tax appeals ["CIT (A)"] who upheld the actions of the TPO. Subsequently, the taxpayer challenged the addition made by the TPO/ CIT(A) before the Income Tax Appellate Tribunal ["the ITAT"/ "the Tribunal"].

The Tribunal's Verdict

At the outset, ITAT noted that the facts of the case were materially identical to the case of ***Merck Limited [TS-143-ITAT-2016(Mum)-TP]*** wherein the co-ordinate bench had deleted the TP-adjustment by stating that," *"when determining the ALP of services, it is wholly irrelevant as to whether the assessee benefits from intra group services or not. What is more relevant is whether the price of this service is what an independent enterprise would have paid"*. The ITAT further noted in the instant case that just because the lower level authorities had viewed the intra-group services worthless, their ALP cannot be determined at NIL.

The Tribunal further observed that Revenue's contentions with respect to 'no services were rendered' at one side and 'the taxpayer could have performed these services' on the other side in itself were contradictory to each other.

The Tribunal also held that while benchmarking the intra-group services, the TPO questioned the TP methodology adopted by the taxpayer. However, he failed to apply any other TP method as alternative while determining the ALP of aforesaid transaction.

In addition to the above, the Tribunal duly considered the cost allocation agreement and detailed documentation support placed on record by the taxpayer and accepted the actual rendition of services. The contention of TPO on the services being stewardship or shareholder's activities, the Tribunal quoted the OECD TP Guidelines and stated that Stewardship activities cover a range of activities by a shareholder that may include provision for services to other group members. As per the aforementioned Guidelines, the consideration is not required to be charged for shareholder activities while other stewardship activities can and must be compensated.

In the light of the above, the ITAT deleted the TP adjustment.

NANGIA'S TAKE

The Tribunal, in the instant case, made a clear distinction between the 'stewardship activities' and shareholders' activities'. Taking reference from OECD TP Guidelines, the ITAT fairly clarified 'stewardship activities' inter-alia covers a range of activities by the shareholders which can be construed as provision of services and thus, are required to be remunerated appropriately. Such activities can be distinguished from shareholders activities which are performed solely on account of ownership interest and thus, do not require to be compensated. As far as the benefit test, in relation to the procurement of services are concerned, the tax authorities should concentrate on determining the ALP of the services rather than oppugning the commercial expediency of the taxpayer.

Schneider Electric India Private Ltd [TS-390-ITAT-2017(DEL)-TP]

9. Marketing expenditure incurred by taxpayer for obtaining prospective customers (i.e. unrelated parties) cannot be considered as operating in nature while determining the arm's length price charged by such taxpayer from existing customer (i.e. unrelated entity) for benchmarking its transactions with group entities

Background

Msource (India) Private Limited ("the taxpayer") is engaged in the business of operating and managing offshore call centres in India. The taxpayer provides call center services to its Associated Enterprises ("AEs") as well as unrelated third parties ("Non-AEs"). During year under review, the taxpayer rendered call center services to its AE and benchmarked the same using Cost Plus Method ("CPM"). During the course of assessment proceedings, the Transfer Pricing Officer ("TPO") rejected the comparables selected by the taxpayer and based on internal segmental data (AE and Non-AE based),

as provided by the taxpayer, applied the internal CPM and made an upwards adjustment of INR 5.13 crore on account of difference in the gross profit ("GP") earned by the Company in aforesaid segments. The TPO, while computing the GP margin, disallowed the taxpayer's advertisement, marketing and Promotion ("AMP") expenses under the Non-AE segment. The TPO further set aside the taxpayer's contentions with regard to difference in functions performed, geographical locations, period and volume of transactions and capacity utilization etc while applying internal CPM.

Aggrieved, the taxpayer filed an appeal before Commissioner of Income Tax who confirmed the TPO's stand. Subsequently, the taxpayer approach Income Tax Appellate Tribunal ("ITAT" or "the Tribunal").

The Tribunal's Verdict

Following were the main observations of the ITAT:

- The function performed by the taxpayer *qua* with its AE and Non-AE during the year under consideration were similar and comparable;

- The ITAT did not find any adversity in the approach followed by the TPO for application of internal comparability analysis using CPM;

- The Tribunal rejected the taxpayer's arguments of difference in business volumes of the AE and Non-AE owing to the price differences.

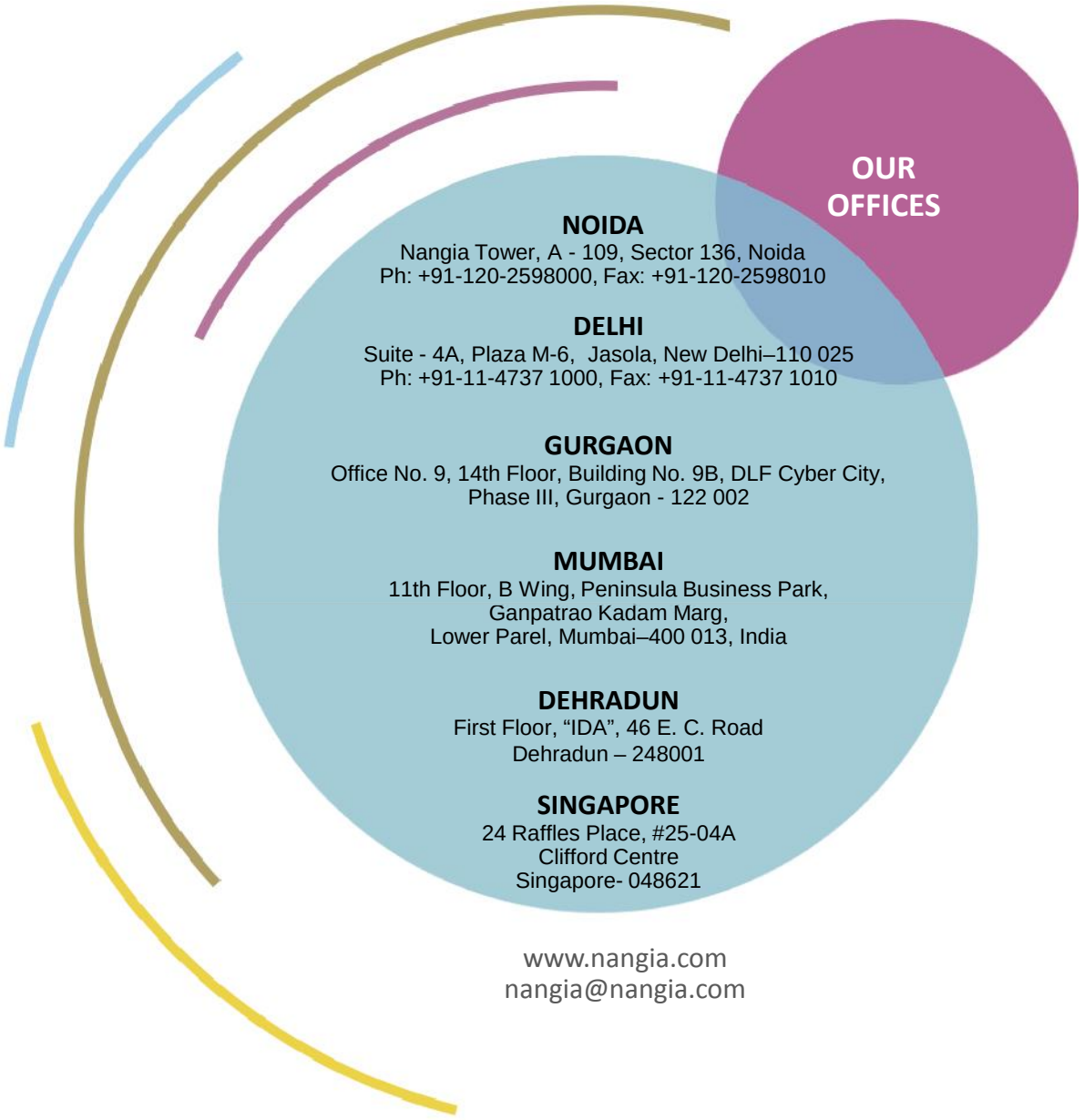
- While doing so, the Tribunal noted various ITAT rulings which consistently held that if the turnover of the comparable is within the range of 1/10th or 10 times of the turnover of the tested party then such comparable can be considered for benchmarking purposes. In the instant case, since the turnover of the taxpayer from Non-AE is 13% of the total revenue of the taxpayer, the taxpayer's argument do not hold good;

- The taxpayer's agreement with Non-AE (which has been considered for application of internal CPM) was entered in the year prior to the previous year relevant to the assessment year under review. Accordingly, the incurrence of AMP expenses for obtaining new customers in future cannot be considered as operating cost of the turnover for the present year and thus, the same are not required to be considered. The ITAT further held that the taxpayer's AMP expenditures (which were incurred for bolstering the sales of the taxpayer) has no correlation with the prices to be charged from unrelated parties. Accordingly, such expenses cannot form part of the operating expenses while computing the gross profit margin. In the light of the above, the Tribunal dismissed the taxpayer's appeal.

NANGIA'S TAKE

The ITAT, in instant case, has re-emphasized the use of internal comparable data over external data. The Tribunal, while doing so, also clarified that the marketing expenditure incurred by taxpayer to obtain business from its prospective customers cannot be considered for determining the arm's length price charged from the existing unrelated entities for examining the intra-group transactions.

Source: Msource (India) Private Limited Vs. DCIT [TS-447-ITAT-2017(Bang)-TP]



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