NEWS CRUNCH

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CHARTERED ACCOUNTANTS

What's inside . . .

DIRECT TAX

1. Payment made under membership agreement by the member entity not taxable on the principle of mutuality, thus no obligation to withhold tax

Facts and Background

❖ KPMG ('Assessee') was an Indian firm engaged in the business of providing services such as auditing, accounting, taxation and management services. The assessee was Indian member firm of M/s KPMG International ('KPMGI') which is mutual association/organization registered in Switzerland and having its head office in Netherlands.

❖ The assessee made certain payment to KPMGI to enable them in discharging its function within the terms of membership agreement signed between assessee and KPMGI. The assessee had not deducted tax at source u/s 195 of the Act on such payments and the Assessing Officer issued a show-cause notice for proceeding u/s 201(1)/201(1A) of the Act.

❖ The assessee, in response contended that the principle of mutuality applied in the present case and the amount remitted outside India was in the nature of reimbursement of cost to KPMGI.

Therefore, the assessee was not liable to deduct tax at source because reimbursement of expense at cost cannot be treated as income chargeable to tax.

- ❖ After hearing, the AO concluded that the expenses incurred on account of alleged reimbursement of cost in is in the nature of 'royalty' as covered u/s 9(1)(vi) of the Act. Therefore, the assessee was liable to deduct tax at source in respect of such expenses by applying the rate of royalty provided under article 12(2) of India-Switzerland DTAA. Aggrieved revenue filed an appeal before the ITAT.

- ❖ The Revenue argued that the basic motive of the assessee was to avail the goodwill associated with name of 'KPMG' and other consequential benefit, additional and incidental incentive. The payment made to KPMGI was for the use of brand name and therefore, covered by the definition of 'Royalty'.

- ❖ The KPMGI charged the interest and guarantee on finance support required by any member. Further, the feature like inspection of books, levy of penalty, imposing restrictions on professional & financial decision of members treated as watch over the activities of members. These all are against the principle of mutuality.

- ❖ The main object of KPMGI are tainted with commerciality i.e. to create an international chain of professional by using its name and marks, in terms of making payments of percentage from the respective turnover. All these issues made the principle of mutuality inapplicable.

- ❖ KPMGI was a mutual association/organization and the assessee was a member of the organization. KPMGI does not work with any profit motive while carrying business or profession.

- ❖ In order to co-ordinate the activities of the members, double up abilities and raise professional standards certain cost was incurred by KPMGI. As per arrangement between KPMGI and the members, the cost of KPMGI was decided to be pooled by its member's firms without any markup on the basis of respective turnover of the member firm, to enable the members to have access all the benefit arises from such membership.

- ❖ The principle of mutuality applies to the case of assessee and the amount paid by assessee was reimbursement of expenses at cost, and there was no element of income chargeable to tax therein. Hence, the assessee was not liable to deduct tax at source under section 195 of the Act

Tribunal's Ruling

- ❖ As per section 28(iii) of the Act, income derived by a trade, professional or similar association from specific services performed for its members is chargeable to income tax under the head 'Profit and gains of business or profession'. The provision was introduced to stop the exemption to the taxpayer who derives income for making profits as a result of rendering its specific services for its members in a commercial manner.

- ❖ The Hon'ble Apex Court and various High Courts has laid down the following principles on 'Principle of Mutuality':

  - ➢ There are three principle conditions for application of the principle of mutuality;

    - ▪ **Identity:** There must be complete identity between the contributors and the participants. This means identity of the persons who are contributing are identical with the persons entitled to participate.

- **Excess Funds**: The actions of the participants and the contributors must be in furtherance of the mandate of the association.

- **Absence of profiteering**: The basic principle is that 'no one can make profit out of himself. There must be no scope of profiteering by the contributors from the fund made by them, which could only be expended for mutual benefit or returned to themselves.

❖ Simply because some incidental activity of the taxpayer (the member) is revenue generating that does not give any justification to hold that it is tainted with commerciality and reaches the point where a relationship of mutually ends and that of trading begins.

❖ The case of the assessee falls within the four corner of the ambit of the 'Principle of Mutuality'. Therefore, the income would not be taxable in the hands and KPMGI, accordingly, the assessee was not required to withhold taxes on such payments.

NANGIA'S TAKE

If the arrangement is such that it satisfies the conditions of the 'Principle of Mutuality', the reimbursement of cost is not taxable and there will be no obligation to withhold taxes on such payments.

2. Depreciation claim on government approvals and non-compete fees disallowed by Tribunal

Delhi Income Tax Appellate Tribunal (Tribunal) in the case of Pitney Bowes India (P) Ltd. ('Assessee') dealt with the issue of allowance of depreciation claim on certain government approvals and non-compete fees, in terms of the provisions of the Income-tax Act, 1961 ('the Act').

Facts and Background

The Assessee is a subsidiary of a US company. Prior to formation of the Assessee, its holding company had authorized another company, KOAL to distribute and sell its products in India and, in respect thereof, KOAL had obtained approvals from the regulatory authorities (government approvals). After the Assessee was formed, the Assessee acquired KOAL's business by way of a slump sale. Post the acquisition, the Assessee allocated the slump purchase price on the basis of the valuation report and assigned values, inter alia, to the government approvals and non-compete fees, and claimed depreciation thereon by classifying them as "intangible assets".

Tribunal's ruling

The Tribunal agreed with the Taxpayer that items like business know-how, customer and vendor lists etc., are rights of business or commercial nature, similar to other items enumerated in the definition of "intangible assets" and, hence, eligible for depreciation. Hence, the Tribunal directed that the Taxpayer should be allowed depreciation on goodwill to the extent of excess of slump sale consideration over tangible assets, the government approvals, non-compete fees and adjustment of liabilities taken over.

The Tribunal rejected the depreciation claim on both the items and, furthermore, rejected the Assessee's alternative claim of classifying them as "goodwill". The Tribunal held that the government approvals were specific to the holding company products and were not assigned to the Assessee. In fact, the Assessee had to obtain fresh approval post the acquisition. On non-compete fees, the Tribunal followed the jurisdictional Delhi High Court (HC) ruling in the case of Sharp Business System, in which it had taken an adverse view on allowance of depreciation on non-compete fees. On the Assessee's alternative claim of depreciation on goodwill, the Tribunal, on principle, held that depreciation was admissible on excess of slump sale consideration over tangible assets, the government approvals, non-compete fees and adjustment of liabilities taken over.

NANGIA'S TAKE

Though the Tribunal admitted depreciation on residual commercial rights but the same were not specifically identified in the valuation report for allocation of values. Hence it is imperative that Assessees consider the principles arising from the present ruling in the exercise of allocation of slump purchase price to individual assets and liabilities. There are conflicting rulings on allowability of depreciation on non-compete fees, hence, assessees in other jurisdictions may be able to rely on favorable rulings.

3. CBDT notifies the transactions of listed equity shares not eligible for Long Term capital gains exemption

CBDT recently issued a notification[1] under Section 10(38) of the Act, providing a list of transactions of listed equity shares not eligible for Long Term capital gains exemption. Section 10(38) of the Act provides that any capital gains arising from transfer of listed equity shares held for a period of more than 12 months is not taxable if the sale is subject to Securities Transaction Tax (STT). It was observed that benefit of exemption was misused for routing of unaccounted money through the medium of capital gains exemption. In order to deal with the menace of routing unaccounted income, Finance Act 2017 amended Section 10(38) of the Act which seeks to curtail benefit of capital gains exemption.

Pursuant to the amendment, the exemption for the purpose of computation of capital gains will not be available if the shares are acquired on or after 1 October 2004 and such acquisition was not chargeable to STT. In order to protect the capital gains exemption for genuine acquisitions, CBDT Notification provides the negative list of transactions in respect of which the benefit of capital gains exemption will not be available, as under:

[1] F No. 43/2017/F. No. 370142/09/2017/2017-TPL

a. Acquisition of existing listed equity shares which are not frequently traded on a Recognized Stock Exchange ('RSE') by way of preferential issue

However, the benefit of exemption may not be denied in respect of above category in following cases where acquisition of preferential issue is:

- Approved by Supreme Court, High Court, National Company Law Tribunal (NCLT), Securities and Exchange Board of India (SEBI) and Reserve Bank of India (RBI)
- By non-resident in accordance with foreign direct investment (FDI) guidelines issued by the CG
- By SEBI registered Investment Fund
- By specified Venture Capital Fund qualified under the ITL
- By a Qualified Institutional Buyer
- Where preferential issue is not governed by Chapter VII of SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009

b. Acquisition of existing listed equity shares otherwise than through a RSE

However, the exemption will not be denied in the below cases, which is in accordance with Securities Contract (Regulations) Act, 1956, if applicable, where the acquisition of shares is:

- By a company other than the preferential issue covered by para (a) of the notification
- By scheduled banks, reconstruction companies or securitization companies or public financial institutions during the ordinary course of business
- Approved by Supreme Court, High Court, NCLT, SEBI and RBI
- Under employee stock option scheme or employee stock purchase scheme framed under SEBI (Employee Stock Option Scheme and Employee Stock Purchase Scheme) Guidelines, 1999
- By non-resident in accordance with FDI guidelines issued by the CG
- Under SEBI (Substantial acquisitions of shares and Take overs) Regulations, 2011
- From Government
- By SEBI registered Investment Fund
- By Venture Capital Fund qualified under the ITL
- By a Qualified Institutional Buyer
- By a mode of transfer which are not regarded as transfer for capital gains taxation purpose under the ITL, provided that the transferor was eligible for the capital gains exemption under the Section if such shares were sold by the transferor
- By way of slump purchase of business, provided that, the transferor was eligible for exemption under the Section if such shares were sold by transferor

c. **Acquisition of unlisted equity shares during the period between the delisting and the day immediately preceding the re-listing of such shares on the RSE.** There are no carve out provided for clause (c). The delisting could be either voluntary or compulsory.

NANGIA'S TAKE

The Notification is definitely welcome by stakeholder for its pro-active approach, however, unintended hardship may be experienced in certain cases where the acquisition is during the period where the shares of the company are delisted irrespective of the reasons for delisting. Also, there may be concerns when acquisition is outside the stock exchange but on account of events such as liquidation, contribution of shares to the firm, dissolution of the firm etc. Long term capital gains arising from sale of listed shares of an Indian Company is of significant relevance particularly after amendments to Indian treaties with Mauritius, Singapore, and Cyprus.

INTERNATIONAL TAX

4. Mauritian Prime Minister during his Budget 2017-18 speech announces some major reforms to strengthen the tax environment of Mauritius

- A 10 years vision for the financial services sector will be developed in collaboration with the EDB, BoM, FSC and stakeholders of the sector. It will ensure that financial services sector remains competitive in the international market

- Mauritius further strengthens substance rules for Global Business License (GBC1) companies; Budget 2017-18 proposes that GBC1 companies going forward will be required to fulfill at least two of the six criteria instead of one, to demonstrate substance

- Mauritian Prime Minister also states that "We will also reform our tax regime for global business companies so that it evolves and meets the new international requirements"

- Mauritius also proposes introduction of "Innovation Box" regime of 8 years tax holiday from IP and also 8-year income-tax holiday for new companies engaged in the manufacturing of pharmaceutical products, medical devices and high tech products

5. Italy offers 'webtax' to IT companies, ensuring no tax disputes

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.

Source : https://www.reuters.com/article/us-italy-tax-internet-idUSKBN18I216

6. US's Border Adjustment Tax

Under the border-adjustment tax proposal in the House GOP blueprint, imports would be subject to a 20 percent tax and exports would be exempt. Those who have championed the idea, argue that it would raise revenue to pay for lowering tax rates and would encourage companies to move jobs back to the United States. But the proposal also faces long odds because of opposition from retailers and GOP lawmakers, who fear it would lead to higher prices on consumer goods.

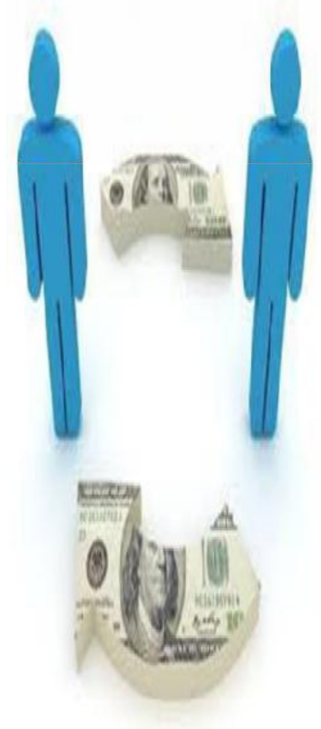
Goal with ax reform "is to find the proverbial 'sweet spot' that will maximize the growth potential of the final package without jeopardizing its prospects for passage." Says Senate Finance Committee Chairman Orrin Hatch

Source : http://thehill.com/policy/finance/336707-hatch-doesnt-rule-out-border-adjustment-tax

TRANSFER PRICING

7. The taxpayers are required to furnish adequate rationalities before the appellate authorities to contradict its own position taken earlier while benchmarking the transactions with its associated enterprises

Background



Evalueserve.com Pvt. Ltd. ("the taxpayer") is engaged in the business of providing IT enabled services to its associated enterprises ("AEs"). During the year under consideration [i.e. assessment year ("AY") 2006-07], the taxpayer selected transactional net margin method for benchmarking its international transactions AEs. During the course of assessment proceedings, the Transfer Pricing Officer ("TPO") excluded two out of six comparables selected by the taxpayer on the grounds of persistent loss making in case of one comparable and on the basis of declining operating profits (i.e. phase of negative growth) in case of the other. Based on the average operating margin of remaining comparables, the TPO made an adjustment of INR 16.24 crores.

The aggrieved taxpayer filed objections before the Dispute Resolution Mechanism ("DRP") who upheld the actions of the TPO. Thereafter, the taxpayer filed an appeal before the Income Tax Appellate Tribunal ["the ITAT"/ "the Tribunal"] who remanded back the taxpayer's case to DRP for passing the non-speaking order. Subsequently, the DRP passed a detailed order wherein it again confirmed the actions of TPO. The aggrieved taxpayer again filed an appeal before the ITAT and raised an additional ground for exclusion of two comparable (earlier considered as comparables in its own TP documentation) on the basis of not being functionally comparable to the business of the taxpayer.

<u>Proceedings before the Tribunal</u>

1. On admission of an additional ground for exclusion of comparables

The taxpayer argued before the ITAT that the two of its own comparables (selected earlier in its TP report) ought to be rejected as one of the comparables is engaged in knowledge process outsourcing and the other is into exploration and production of oil as against the business of the taxpayer who characterizes itself as a low end IT-enabled service provider. In this regard, the taxpayer placed reliance on the case of ***DCIT Vs. Quark Systems Private Limited [TS-23—ITAT-2009(CHANDI)-TP]*** in which the Tribunal allowed the appellant to resile from two companies which were earlier considered by the appellant as comparable. The ITAT, while adjudicating on the captioned issue, observed that the taxpayer neither during the course of proceedings before DRP (in 2 rounds) nor before the ITAT (in 1st round) objected the inclusion of two comparable companies.

The ITAT stated that *"it is disgusting to note that taxpayer has field its return of income in 2006 and continued to contest the TP adjustments up to 2017 and then arguing for exclusion of comparables in 2017"*. Further, the Tribunal clarified that the appellant, in case of ***Quark Systems (supra),*** furnished certain genuine reasons of rejection of its comparables. The ITAT, in the instant case, posited that *"merely making a reference about their functional dissimilarity without pointing out specific functional dissimilarity in the function of the taxpayer vis-à-vis comparables, the taxpayer cannot be allowed to resile from comparables selected by it"*. Having said that, the ITAT noted that AY 2006-07 (involved in the present case) is very near to the assessment year involved in case of ***Quark Systems (supra)*** (i.e. AY 2004-05) and based thereon, the ITAT admitted the additional ground filed by the taxpayer.

2. On functional profile of the taxpayer

Both the taxpayer and Revenue placed reliance in the taxpayer's own cases for AY 2007-08 and AY 2005-06 wherein the ITAT held the taxpayer to be low-end service provider and high-end service provider respectively. The Tribunal, for the year under consideration (i.e. AY 2006-07), observed that the coordinated bench, while deciding the taxpayer's case for AY 2007-08 did not considered the findings of the bench for AY 2005-06 wherein the taxpayer was held as a high-end service provider. In the light of the same, the Tribunal, for the year under consideration, remitted the matter back to the file of AO/TPO to decide the whole issue afresh and adjudicate accordingly.

NANGIA'S TAKE

In the present case, the Tribunal, by admitting the additional ground raised by the taxpayer on account of assessment year under consideration was an initial year of TP assessments in India (i.e. AY 2006–07), although take a liberal stand, but also made a significant observation in the form of obiter-dicta that "anytime and every time, the taxpayer, cannot resile from its own position taken in its TP documentation while benchmarking its international transactions". While contradicting its own stand, the taxpayers are required to furnish adequate reasons to substantiate the same before the appellate authorities.

Source: Evalueserve.com Private Ltd [TS-390-ITAT-2017(DEL)-TP]

8. The ITAT found the AMP intensity adjustment, applied by TPO by considering the AMP expenditure of the taxpayer as a separate 'function', reasonable and in-line with the High Court's view in case of Sony Ericsson

Background

Luxottica India Eyewear Pvt. Ltd. ("the taxpayer") is a part of Luxottica group which is engaged in design, manufacture and distribution of sun glasses and prescription frames in mid and premium price categories. During year under review, the taxpayer procured finished goods from its associated enterprises ("AEs") and benchmarked the same using Resale Price Method ("RPM"). In the course of assessment proceedings, the Transfer Pricing Officer ("TPO") noticed that the taxpayer incurred significant advertisement, marketing and promotion ("AMP") expenses, which eventually is benefitting the taxpayer's AE by enhancing the value of 'brand' owned by the AE.

The TPO treated the same as ***"marketing function"*** performed by the taxpayer and thus, compared the intensity of AMP expenditure of the taxpayer with that of comparable companies. Using this mechanism, the TPO applied the AMP intensity adjustment on the profitability of the comparables and re-computed their operating margins.

For this purpose, the TPO undertook following steps:

- The Taxpayer's AMP expenses were determined as a percentage of sales – Intensity of the taxpayer's AMP expenses;
- Identify comparables and compute intensity of AMP expenses incurred by comparable companies in same manner; and
- Excess intensity of expenses was considered as excessive AMP expenditure incurred by the taxpayer

Based on the above, the TPO carried out the excess AMP intensity adjustment in the operating margins of comparables and computed their average operating margin at 6.03%. By applying such average adjusted margin, the TPO proposed TP adjustment amounting to INR 4.26 crore. Thereafter, the Dispute Resolution Panel also confirmed the actions of the TPO. The aggrieved taxpayer subsequently appealed before the Income Tax Appellate Tribunal ["the ITAT"/ "the Tribunal"].

The Tribunal's Verdict

1. On AMP intensity adjustment made by the TPO

The ITAT found the TPO's action of considering AMP expenditure of the taxpayer as a separate "function" in-line with the High Court's view in case of ***Bausch & Lomb Eyecare India Pvt. Ltd. and Ors. Vs. Addl.CIT and Ors. (2016) 381 ITR 227 (Del)*** wherein it was held that *"a distinction is required to be drawn between a 'function' and a 'transaction', and that every expenditure forming part of the function cannot be construed as a transaction."* The aforesaid view was also supported by HC in the case of ***Sony Ericsson (2015) 374 ITR 118 (Del)***. The Tribunal held that as the taxpayer did not raise any objections in relation to carry out AMP intensity adjustment to the profit rates of the comparables by the TPO, the same is considered to be in accordance with the view of HC as decided in aforesaid rulings.

For the taxpayer's plea of restricting the amount of TP adjustment in proportion to the value of import of goods by considering its "total operating cost" instead of "total cost of material consumed" in denominator, the Tribunal rejected the same by explaining that components of the numerator and denominator have to remain same. The ITAT stated that as the numerator in the instant case is the purchase cost of material from AE (not disputed by the taxpayer), then as a natural corollary, the denominator cannot be any figure other than the purchase cost of material consumed purchased from AEs and non-AEs.

2. On RPM Vs. Transactional Net Margin Method ("TNMM")

The taxpayer was aggrieved with TPO's application of TNMM over RPM for determining the amount of TP adjustment. In this relation, the ITAT observed that use of RPM was approved by Tribunal and jurisdictional HC in the taxpayer's own case for previous assessment year. However, the Tribunal stressed that in the instant year, the AMP function has been embedded by the TPO in the international transaction of 'purchase of finished goods from AE'. In the light thereof, the ITAT held that, *"firstly, the RPM should be applied for determining the arm's length price of purchase of goods from AE, but, by carrying out the AMP intensity adjustment in the profit rate of comparables."* However, if such an adjustment cannot be done due to any reason, the Tribunal further held that, *"then the RPM should be discarded and another suitable method be adopted, which encompasses the effect of AMP intensity adjustment."*

NANGIA'S TAKE

As the traditional Bright Line Test approach has been completely disdained by Indian Courts, it seems that the tax authorities, through mechanism adopted in instant case, are trying to evolve unorthodox means to target the AMP expenditure of the taxpayers and thereby making upwards adjustment through adjusting the margins of comparable companies. Prima facie, it appears that the mechanism adopted by TPO in instant case finds its factum in Indian TP legislation which advocates the comparability adjustments for difference in functional profile of the taxpayers with that of comparable companies. Thus, it becomes crucial on the part of taxpayers to dig out the fundamentals of economics and TP to counter such fresh approaches.

Source: Luxottica India Eyewear Pvt Ltd [TS-406-ITAT-2017(DEL)-TP]

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