NEWS CRUNCH

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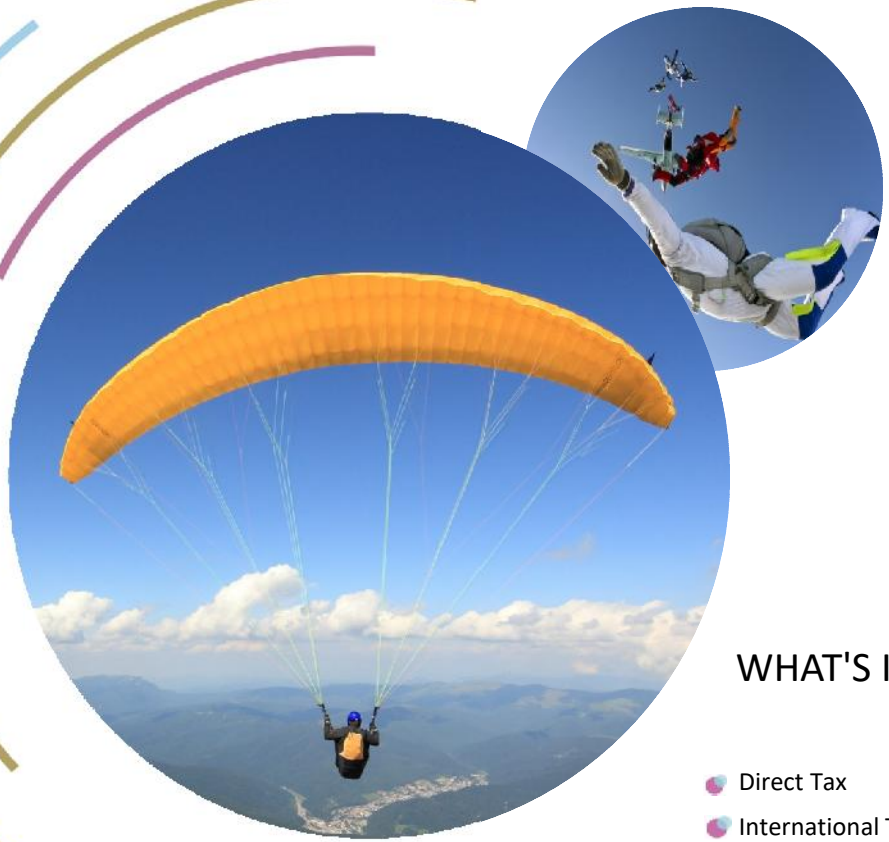

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What's inside . . .

DIRECT TAX

1. Marketing support services availed by BPO to expand its market outside India is not chargeable to tax in India – Kolkata ITAT

Brief Facts of the Case:

- On Process ('assessee'), an Indian BPO, operating a call center, availed the services of various foreign entities to expand its market base in foreign jurisdictions. One of such foreign entity was its wholly owned subsidiary in USA.
- During the course of the assessment proceedings, the assessing officer ('AO') treated the payment by the assessee to the foreign entities as business income under section 9(1)(i) of the Income Tax Act, 1961 ('the Act'), since the orders were executed in India and contended that tax should have been deducted at source ('TDS') on such payment.
- Upon appeal to Commissioner of Income-tax (Appeals) ['CIT(A)'], it upheld the disallowance, but held that payment made for availing market support services were in the nature of FTS under the Act as well as under the Article 12 of India-USA tax treaty ('Tax Treaty').
- Subsequently, the matter travelled to the Kolkata ITAT ('ITAT'), which delivered a favorable ruling, holding that the assessee was not required to deduct TDS as the services were not chargeable to tax in India.

Assessee's Contention

- The assessee engaged in providing the BPO services availed the service of different foreign entities including its subsidiary to expand its market in foreign jurisdiction. Relying on the market support agreements in place between the assessee and its US subsidiary, it contended that the US subsidiary was only acting as a service provider and all the rights pertaining to intellectual property belonged to the assessee. It also contended that the said services were not technical in nature and also were not rendered in India.

Department's Contention

- Department contended that the marketing services were covered under the definition of technical consultancy basis the principles of ejusdem generis under section 9 of the Act. Basis Article 24 of the Tax Treaty, it also contended that treaty benefit could not be availed as the assessee failed to prove that such benefits were available to the payees.

ITAT's Judgement

- ITAT observed that the main question for consideration was to ascertain whether market support services were technical in nature and have a nexus with India.

On this aspect the ITAT made many important observations which are as follows:

- Upon perusal of the market support service agreement between the assessee and its subsidiary in USA, it clarified the role of the subsidiary only as the service provider. It further noted that the scope of work in the agreement to include only rendering of market support service and recruitment of staff.

- The sample copies of the invoices further provide evidenced that the services performed were only the market support services.

- The agreement with the other service provider in the foreign jurisdiction were similar to the agreement between the assessee and its US subsidiary and were confined to marketing assessee's BPO service amongst US customers.

- ITAT held that the services performed were not technical in nature. Thus, it clarified that for the purpose of canvassing customers in the foreign territories, foreign entities did not render any service in India nor the services performed were technical to attract the provisions of section 9(1)(vii) or Article 12 of the Tax Treaty

- It examined the taxability under Article 12 of Tax Treaty. In order to analyze the fee for included service, the "make available" condition should be satisfied i.e. rendering the technical services in a way wherein technical knowledge, experience, skill, know-how etc., are made available to the recipient of service. It held that the market support services were in the nature of consultancy and it did not make available any technical knowledge/experience.

NANGIA'S TAKE

The ruling has aided the understanding of the tax challenges faced while availing the market support services from outside India. It has laid a clear logic for not treating the payment made for pure market support service as fee for technical services. This ruling is an addition to the other rulings laid on the similar grounds by the different ITATs, thereby strengthening the position.

Source: JCIT Vs Onprocess Technology India Pvt. Ltd [TS-265-ITAT-2018(Kol)]

2. Bengaluru ITAT reaffirms payment for Adwords program as royalty in case of Google India

Facts of the case

- Google India Private Limited ('GIPL' or 'Assessee') is a wholly owned subsidiary of Google International LLC and engaged in the business of providing Information Technology ('IT') and Information Technology enabled services ('ITeS') to its group companies. GIPL also acts as a distributor for AdWords Program in India.

- Google AdWords is an online facility which is used display the advertisements to the web users.

- GIPL entered into two contracts with Google Ireland Ltd. ('GIL'), a Service Agreement for provision of IT and ITeS and a distribution agreement for adword program.

- Under the distribution agreement, GIPL purchased Ad Space from GIL and marketed & distributed the space purchased to the Indian advertisers. During the Assessment proceedings, the Assessing Officer ('AO') noted that GIPL had made the payment for purchasing the space without deduction of tax at source treating the same as payment for royalty.

- The assessee contended that the said payment should be treated as business profit by GIPL which was not taxable in the absence of PE in India.

Contentions of the Revenue:

- The assessee used confidential data to market and distribute the space acquired and the payment made to GIL for the use of patent invention, model, design, secret formula, process, etc., which constituted royalty, under the Act and the DTAA.
- The distribution agreement was entered into for the purpose of acquiring GIL's Intellectual Property as marketing and distribution involved sale of certain rights in the AdWords Program.
- The presence of a non-disclosure agreement ('NDA') and a confidentiality clause in the distribution agreement made it clear that the payments to GIL were for acquisition intellectual property qualifying as royalty.

Contentions of the Assessee:

- The assessee is merely distributor having no access to the intellectual properties except which is incidental to the distribution function. Also, it did not have any access or control over the infrastructure or the process that are involved in running the AdWords program
- Further, the assessee contended that it had no control over displaying the advertisement.
- The limited license, GIPL received, regarding Google Ireland's intellectual property under the Services Agreement was only for enabling the provision of quality control and IT/ITeS services for which it receives a separate consideration.
- The confidentiality clauses and NDAs are generic to most contracts and were meant to protect confidentiality of the information acquired by either party to the contract during the course of business.
- Mere use of brand name for procuring ad contracts would not amount to use of trademark.

ITAT'S Ruling

- ITAT observed that GIL is allowing the assessee an access to all intellectual property and confidential information which is used for activities related to distribution agreement. This implies that the assessee had right, title and interest over the intellectual property of Google.
- Through use of Google's intellectual property, the AdWords tools for performing various activities are made available to Google India and the advertisers. Therefore, payments made to Google Ireland for use of its intellectual property would therefore clearly fall within the ambit of "Royalty".
- ITAT observed that necessary safe-guards are provided by the Act in the form of Sec. 195(2) which clearly provides that in case the assessee has any doubt about the chargeability to tax of the payment, then the assessee may make an application to the AO for the purpose of determining whether the sum is chargeable to tax or not. In the present case, no such application was made by the assessee. GIPL on its own, without having knowledge, information and privy to the accounting standard and accounting practice of GIL, has treated the said payment as a business profit of GIL in its books of account.
- The services rendered under Services Agreement cannot be divorced with the activities undertaken by Google India under the Distribution Agreement. The bifurcation of agreements was only a design / structure prepared by Google India to avoid the payment of taxes.

NANGIA'S TAKE

The ITAT has gone beyond the realms of verbatim interpretation and has undertaken an intensive fact-finding operation. It has taken a clear departure from earlier judgements on the characterization of advertisement revenue, and payments made under distribution arrangements.

The ITAT has meticulously analysed the arrangement to bring out that using underlying technology and Intellectual property for purposes of marketing and distribution is in fact royalty and not business income (which is not taxable in the absence of PE in India).

Further, sensing the application of GAAR, we opine that going forward the tax department will subject the taxpayers to a fair scrutiny by examining the conduct of both the parties, especially those trying to avoid taxes by misusing the provisions the Income Tax Act or the DTAAs.

Source: M/S Google India Private Limited [TS-235-ITAT-2018(Bang)]

3. ITAT: Franchise agreement doesn't create Indian PE for dominos

Facts of the case

- Dominos Pizza International Franchising Inc. (Assessee) is a US based company. It entered into a Master Franchise Agreement (MFA) with M/s Jubilant Food Works Limited in India (Jubilant)

- The assessee earned three incomes in the form of franchise fee, consultancy services and 3% on the sale made by Jubilant and the sub-franchises.

The consultancy income was earned for providing certain store opening services to Jubilant whereas franchise fee was paid for using the Domino's Trademark and right to use technology, new product development and system improvement.

- In its return of income, the assessee offered the income to tax as royalty amounting to Rs. 1.65 crores in accordance with the Double Taxation Avoidance Agreement (DTAA)

- The Assessing Officer (AO) held the Jubilant as the dependent agency/ Permanent Establishment (PE) of the assessee in the Draft Assessment Order and taxed 95% of its income.

- Aggrieved, the assessee filed an objection before the Dispute Resolution Panel (DRP) contending that it had not constituted a PE in India as per the DTAA. This view was accepted by DRP, which led the revenue to file an appeal against the order before the Income Tax Appellate Tribunal (ITAT).

Contentions of the Assessee:

- Relying on MFA, Jubilant contended that it did not act on behalf of the assessee and that Jubilant is legally and economically independent entity.

- It argued that the MFA provided it various rights which indicated there was complete independence with regard to business dealing and transaction. Such rights included right to determine prices, appoint sub-franchises, discharge statutory obligations, irrevocable right to appoint commissionaire in India for the supply of food ingredients and other supply.

Contentions of the Revenue:

- Jubilant is dependent on the assessee as it had to take approvals with regards to the pricing, quality of material and equipment, expansion etc. It contended that income of the assessee is taxable as the business income under the Act and DTAA.

- That Jubilant does not have economic independence and its modus operandi is not on principal to principal basis.

ITAT's Ruling:

The ITAT made the following observations to conclude that the assessee did not have permanent establishment in India:

- None of the conditions of the DTAA are attracted establishing the assessee's PE in India

- Profit and loss from business belongs to Jubilant or the sub-franchise.

- MFA entitles the assessee to examine accounts, approve suppliers and control advertisements. However, Jubilant or sub-franchises are not storing goods on behalf of the assessee.

- Considering the contents of the MFA, Master Franchise is an independent business entity and the restrictions provided in MFA only to safeguard brand value and to ensure correct receipt of the royalty income

NANGIA'S TAKE

The ITAT laid a clear phenomenon to analyse the fact driven judgments. The ruling is a welcome relief for the entities carrying out their operations through the other entities. Judgements like these not only encourage foreign entities to carry on business smoothly within the country, but also encourage new entities to set-up business in India.

Reasonable Tax rates along with ease of doing business is what entities desire the most. The ruling has furthered that the object that genuine benefits as per the law and the treaties should not be denied.

Source: M/s Dominos Pizza International Franchising Inc [TS-260-ITAT-2018(Mum)]

4. CBDT issues notification for start-up companies seeking exemption from provisions of section 56(2)(Viib)

Brief Facts of the Case:

- The Income-tax law provides different methods to ascertain the fair market value of the unquoted shares u/s 56(2)(viib) of the Act. One of such methods is the computation of share price using discounted cash flow method either by a chartered accountant or merchant banker
- This became contradictory with the notification issued by DIPP on 11 April 2018 (G.S.R. 364E) which requires the valuation of shares to be done only through the merchant banker
- Therefore, CBDT has issued a new notification in order to avoid anomaly and streamline the provisions of the Act with the notification. It clarifies that for the purpose of the section 56(2)(viib) of the Act, valuation of unquoted shares shall be done by the merchant banker only.

NANGIA'S TAKE

The notification is a procedural change which would streamline the implementation of different provisions of applicable laws.

Source: [Notification No. 23/2018/F. No.370142/5/2018-TPL]

5. CBDT issues instructions to smoothly implement the income tax provisions concerning start-up companies

Brief Facts of the Case:

- The share capital raised by the start-up companies in excess of the fair market value was being charged to tax under section 56(2)(viib) of the Income-tax Act, 1961 ('the Act') which caused grievance to the budding entrepreneurs.
- Department of Industrial Policy and Promotion ('DIPP') had issued a notification (G.S.R. 364(E) dated 11 April 2018 to protect the start-up companies from the hardship of undesirable tax burden.
- The said notification laid certain conditions to be satisfied by the start-up companies in order to take itself out of the tax net.
- However, in order to effectively apply the DIPP's notification, it was necessary to bring the said notification in consonance with the tax laws.
- A new notification has therefore been issued by the CBDT dated 24 May 2018 in suppression of its earlier notification (45/2016) which provided to exempt the share capital in excess of fair market value received only from the residents by the start-up companies.

- The new CBDT notification provides that the share capital received in excess of the fair market value shall not be chargeable to tax u/s 56(2)(viib) of the Act if it has been received in accordance with the approval specified for the purpose in the aforementioned DIPP's notification.

NANGIA'S TAKE

This notification is important from two stand points. It has provided a clear structure in the interpretation and implementation of the laws. Further, it has removed the bar from the residential status of the investor putting in money in a start-up company. The excess consideration received from any kind of investor shall be exempt if it has been approved in the specified manner.

Source: [Notification No. 24/2018/F. No.370142/5/2018-TPL (Pt)]

INTERNATIONAL TAX UPDATES

6. US-China trade war is back on: White House repeats threat to tax Middle Kingdom import

US President Donald Trump has put a missile, in the form of trade sanctions, back on the launchpad, started fueling it, and programmed its computer to strike Beijing. The countdown clock for liftoff is set for mid-June.

In March, America's commander in chief threatened to increase the tax on Chinese imports, which would affect certain aerospace parts to specific computer components, demanding potentially up to 25 per cent extra in charges on incoming equipment. Then, in April, the US government got a little more explicit, singling out nuclear reactor hardware, magnetic hard drives, vaccines, turbine parts, optical network connectors, and so on.

What had sparked this backlash? The White House had accused China of placing outrageous levies and requirements on stuff exported from the States to the Middle Kingdom, for allowing Chinese organizations to rip off American technology or steal blueprints through corporate espionage, and basically for making life difficult for US enterprises. It used the threat of increased import levies to force negotiations with China on easing the pain for American companies.

Source:
https://www.theregister.co.uk/2018/05/29/us_govt_china_tariffs/

7. Silicon Valley tsunami? Tax plans aimed at Apple, Google could start a new wave, city leaders say

Cupertino, Mountain View and East Palo Alto have begun to ponder new taxes based on employer headcounts — levies that could jolt Apple and Google — and if voters endorse the plans, a fresh wave of such measures may roll toward other corporate coffers.

Alarmed by traffic and other issues brought on by massive expansion projects, the three Silicon Valley cities are pushing forward with separate plans to impose new taxes that could be used to make transit and other improvements.

If those measures become reality in the cities being touted, some of the Bay Area's highest profile companies could be affected.

Apple is based in Cupertino; Google and its owner, Alphabet, are in Mountain View; Intel calls Santa Clara home; Facebook is headquartered in Menlo Park; and Twitter is in San Francisco. The proposed Mountain View tax could cost Google $5.4 million a year. It's not yet clear how much Cupertino's proposal would cost Apple or other large employers.

Source: *https://www.mercurynews.com/2018/05/29/apple-google-headcount-taxes-three-silicon-valley-cities-just-the-start/*

8. Canadian economic policies in hot seat after U.S. tax changes

The brass at Martinrea International Inc. ran the numbers, and they added up to a no-brainer. The new technical centre would be built across the border in Michigan, not in its home province of Ontario.

For a company with manufacturing and engineering facilities in eight countries, it wasn't necessarily surprising that Canada's third-largest auto-parts supplier would make such a decision. But the reasoning was harsh.

"Canada's advantage is in the process of going out the window," chairperson Rob Wildeboer said in an interview before the ribbon-cutting on the research and development complex in Ann Arbor that employs about 160 people.

Wildeboer reeled off his evidence, including rocketing electricity costs and changes to Ontario's labor rules, which include a 30-per-cent hike to the minimum wage. While national economic growth is projected to slow this year, the U.S. economy is accelerating, getting a boost from tax cuts that he said put his country in the shade.

Sure, Michigan offered some tax abatements, but Wildeboer said that wasn't the biggest draw. The U.S. is just more business-friendly, he said. "Be competitive, or you're going to kill the goose that laid the golden egg."

Source: *https://www.thestar.com/business/2018/05/29/canadian-economic-policies-in-hot-seat-after-us-tax-changes.html*

9. Amazon, EBay Put Spotlight on Rivals in U.K.'s Tax Fraud Fight

Amazon.com Inc. and eBay Inc., two of the world's largest online marketplaces, have put pressure on their rivals by publicly signing up to the U.K.'s latest efforts to crack down on value-added tax fraud.

The U.K. government May 29 published a list of companies that have signed up to the measure so far: Amazon, eBay, and U.K.-based e-marketplace Fruugo.com Ltd. This comes after its call April 25 for e-marketplaces to publicly commit to tackling VAT fraud among traders using their online platforms.

Targeting VAT fraud among online marketplaces has become a priority for the U.K.'s tax authority, largely due to foreign traders skirting the levy on their sales to consumers based in the country. This evasion undercuts U.K. traders and online sellers as they must charge VAT on their sold goods.

Source: *https://www.bna.com/amazon-ebay-put-n57982093006/*

10. Merkel proposes new data tax

German chancellor Angela Merkel (CDU) has proposed introducing a new tax on data in the digital economy on Monday night.

Speaking at the Global Solutions Summit in Berlin, Merkel highlighted that intermediary physical goods were already assigned a financial value and taxed accordingly. She argued that digital data used by companies for commercial purposes needed to be "considered in our taxation system" as well.

The chancellor urged scientists to make concrete suggestions for a reform, including how to price data.

She warned that failure to address existing loopholes would create a deeply unfair world where some people delivered their data for free and others earned a profit from this resource.

The idea to offer online users some form of financial compensation for their data, which constitutes the key value-added for social media companies like Facebook, is not new. However, Merkel's comments marked the first time that a global leader has publicly taken up the cause

Source: *http://www.xinhuanet.com/english/2018-05/29/c_137215391.htm*

TRANSFER PRICING

11. HC upheld ITAT's invocation of Rule 10B for allowing capacity utilization adjustment to manufacturer taxpayer

Facts of the case

Petro Araldite Pvt. Ltd. ("the taxpayer") was engaged in the business of manufacturing and dealing in basic liquid and solid resins as well as formulations. During the Assessment Year ("AY") 2005-06, the taxpayer entered into international transaction on account of export of finished goods to Associated Enterprises ("AEs"), import of raw materials from AEs & payment of management charges to AE. The transactions were aggregated for benchmarking purposes and Transactional Net Margin Method ("TNMM) was adopted as the most appropriate method (MAM). During Transfer Pricing ("TP") assessment proceedings, Transfer Pricing Officer carried out a fresh search and selected 4 comparables and computed the average margin of the comparables considering the Profit Level Indicator ("PLI") as Operating Profit ("OP")/Total Cost at 13.50% as against taxpayer's margin of 9.48% and accordingly, proposed a TP adjustment.

Aggrieved by the same, the taxpayer filed an appeal before the Commissioner of Income Tax Appeals ["CIT(A)"] wherein taxpayer contended that its claim for capacity utilization adjustment was ignored by TPO and adjustment was computed on total sales instead of considering the value of its international transactions. Further, CIT (A) accepted taxpayer's all contentions and deleted the TP adjustment.

Aggrieved by the order of CIT (A), Revenue filed an appeal before the Income Tax Appellate Tribunal ("ITAT").

ITAT Ruling

ITAT noted that the difference in capacity utilization would affect the profit margin of a manufacturing concern stating that the fixed overheads of any manufacturing concern would be constant, irrespective of the capacity utilization. Further, ITAT submitted that the higher capacity utilization would lead to higher profitability as fixed costs would be spread over a larger number of units manufactured and vice versa in case of under-utilization of capacity. Thus, ITAT held that difference in capacity utilization would materially affect the profit margin and if there was a difference in the level of capacity utilization of the taxpayer and the level of capacity utilization of the comparable, then adjustment would be required to be made to the profit margin of the comparable on account of difference in capacity utilization in terms of Rule 10B(1)(e)(iii) of the Income Tax Rules, 1962 ("the Rules").

Further, for the purpose of arriving at the profit margin of comparable uncontrolled transactions to enable the ALP determination of the taxpayer's transactions with its AEs, ITAT invoked Rule 10B(1)(e)(iii) of the Rules.

Being aggrieved by the ITAT order, Revenue filed an appeal before Bombay High Court ("HC").

The HC's Ruling

Capacity utilization adjustment by invoking Rule 10B(1)(e)(iii)

HC noted that Revenue had not disputed that *"capacity utilization of a comparables manufacturing unit would impact the net profit margin of the comparable"*.

HC opined that "*the invocation of Rule 10B (1) (e)(iii) of the Rules, cannot be found fault with*". HC stated that this was a self-evident position that all aspects/differences between the international transactions and the comparable uncontrolled transactions materially affecting the net profit margin had to be taken into account so as to have the fair comparison while determining the ALP of the tested party's transaction.

Accordingly, dismissing Revenue's appeal, HC held that *"this question does not give rise to any substantial question of law as Rule 10B (1)(e)(iii) of the Rule is self-evident"*.

Entity level vs. transaction level

Before HC, Revenue contested whether Tribunal was correct in holding that profit margin of the comparable should be applied only to the value of the international transactions entered with its AEs to determine the Arm's Length Price and not at entity level.

However, HC noted that Revenue accepted the issue in taxpayer's own case for AY 2008-09 ***[TS-586-HC-2015(BOM)-TP]*** and in other judicial precedents.

Hence, following the same HC held that **"*question as proposed does not give rise to any substantial question of law*"**.

NANGIA'S TAKE

The verdict in the instant case reiterated that adjustments under Rule 10B are ought to be undertaken in order to eliminate differences between the tested party and comparables. Further, the judgment also held that undertaking capacity adjustments is in line with the provisions of Rule 10B and the same should be undertaken in order to bring about comparability between the tested party and comparables while determining the ALP.

Source: Petro Araldite Pvt Ltd [TS-317-HC-2018(BOM)-TP]

12. ITAT discards WDV based benchmarking of purchase transaction and agrees to take customs/DCF/chartered engineer's valuation.

Facts of the case

Sarens Heavy Lift (I) P Ltd. ("the taxpayer"), wholly owned subsidiary of Sarens NV Belgium, is engaged in the business of hiring and leasing heavy cranes. During the Assessment Year 2010-11 ("year under consideration"), the taxpayer purchased used cranes from its Associated Enterprises ("AEs") and benchmarked this international transaction using external Transactional Net Margin Method ("TNMM"). The custom authorities assessed the value of cranes for custom purpose and the taxpayer correspondingly got them valued by an independent chartered engineer.

The Transfer Pricing Officer ("TPO") rejected the benchmarking approach adopted by the taxpayer, and has taken written down value ("WDV") of the cranes as Arm's Length Price ("ALP") applying Comparable Uncontrolled Price ("CUP") method, and therefore, proposed an upward adjustment. Further, TPO also made an adjustment towards proportionate disallowance of interest paid in relation to purchase of cranes from its AEs.

Aggrieved, the taxpayer filed an appeal before Dispute Resolution Panel ("DRP").

The DRP relied on the verdicts given in case of ***Tecumseh Products India Private Limited [TS-154-ITAT-2014(HYD)-TP]*** and set aside the order of the TPO by noting the following observations:

- The WDV of cranes in the books of the AE cannot be considered as the ALP as it is not derived from the transaction between the enterprises other than the AEs;
- An old asset cannot be sold at a price exceeding net book value;
- The valuation done by the Chartered engineer, or the value adopted by the custom authorities, or the value derived by the Discounted Cash Flow ("DCF") method can be considered as ALP for the instant transaction.
- Aggrieved by the order of DRP, Revenue filed an appeal before Delhi Income Tax Appellate Tribunal ("ITAT/the tribunal"). At the same time, the taxpayer also filed cross objections in support of the DRP's directions and also contended that the appeal of the Revenue should be quashed since the section 253(2A) has been omitted by Income Tax Act, 1961 vide Finance Act 2016 without any saving clause.

ITAT Ruling

ITAT noted that the TPO ignored the valuation done by independent chartered engineer, custom authorities and fair market value by following the DCF method and proceeded to determine the ALP on WDV of the cranes. Moreover, ITAT also observed that the DRP extracted the relevant portions of the decision Tecumesh (supra) in support of its conclusion and reasoning.

Accordingly, the ITAT opined that the "*impugned directions given by Ld. DRP do not suffer an illegal infirmity so as to invite the interference of the tribunal in this appeal"* and upheld the appeal of the taxpayer.

Further, in relation to the taxpayer's submission that Revenue's appeal should be quashed on the basis that Section 253(2A) stood omitted by the Income Tax Act, ITAT referred to the General Finance Company ruling and opined that "*saving right to initiate proceedings for liabilities incurred during currency of Act would not apply to omission of a provision in an Act but only to repeal, omission being different from repeal."*

NANGIA'S TAKE

The verdict in the instant case emphasizes that the valuation done by the independent chartered engineers / custom authorities or as determined under the DCF method ought to be relied upon while determination of arm's length price. This brings to light the need of undertaking an independent valuation by taxpayers to demonstrate that the written down value of fixed assets corresponds to the ALP.

Source: Sarens Heavy Lift (I) P Ltd [TS-294-ITAT-2018(DEL)-TP]

13. ITAT directed TP Provisions not applicable once transaction proved as sham

Facts of the case

Mitchell Drilling India Pvt. Ltd. ("the taxpayer") incorporated in India, is engaged in the development of burgeoning CBM industry, directional drilling and innovative turnkey management projects within the Oil & gas industry. During the Transfer Pricing ("TP") assessment proceedings for the Assessment Year ("AY") 2006-07, the Transfer Pricing Officer ("TPO") observed that the taxpayer has entered into four international transactions namely,

- Purchase of components and accessories,
- Payment of interest,
- Payment of installation of principal under hire purchase agreement and
- 'Repossession of Rig' for taxpayer purchasing a drilling rig from its AE on hire purchase and return of the rig to its AE**,**

The TPO disregarded the benchmarking analysis performed by the taxpayer and determined the arm's length price ("ALP") as NIL and consequently, made an adjustment of INR 3.58 crores.

Furthermore, the Assessing Officer ("AO") opined that the hire purchase transaction was a sham transaction which was purposefully designed to

avoid not withholding any tax on payment of rental of rig and also to claim depreciation on the rig, which was actually not owned by it.

Based on above, the AO recomputed the total income of the taxpayer and upheld the additions proposed by the TPO. Consequently, the DRP also upheld the order of AO.

Thereon, the aggrieved taxpayer filed an appeal before Delhi Income Tax Appellate Tribunal ("ITAT").

Proceedings before ITAT

ITAT after hearing both the parties and pursuing the material documents noted that the TPO determined ALP of the international transaction holding the hire purchase transaction as genuine.

Further, the AO treated the subject transactions as bogus in his final assessment order. Also, ITAT found that the taxpayer has not challenged the treatment of transaction as sham and hence, the ITAT proceeded to treat the transaction as not genuine.

The ITAT's verdict on the disallowance and additions made by the AO is as follows:

Disallowance of depreciation by the AO:

The ITAT observed that AO had disallowed the depreciation on the complete block of fixed assets whereas disallowance was only required to be made on the rig which is the subject matter of international transaction with the AE.

The matter is restored to the file of the Assessing Officer for allowing depreciation on other assets of block 'A' under the head 'Plant and machinery', except the rig in question.

Transfer Pricing additions:

Before espousing the TP additions, ITAT noted that *"the term transaction has been defined in clause (v) of section 92F to include an arrangement, understanding or action in concert. It shows that the ALP is always determined of an international transaction, which is genuine. If a transaction itself is not genuine, there can be no question of applying the transfer pricing provisions to it."*

Payment of interest under hire purchase agreement

ITAT stated that once hire purchase agreement is treated as not genuine, the payment of interest made under hire purchase agreement cannot be allowed as deduction and the same is upheld by the ITAT.

Payment of installation of principal under hire purchase agreement

ITAT considers taxpayer claim that since no deduction was claimed by the taxpayer in the tax computation accordingly, no addition could have been made by taking Nil-ALP of this transaction.

Repossession of Rig

In this regard, the ITAT observed that if ALP is taken NIL as per AO, the addition would be added back to the value of fixed assets and correspondingly, the amount of depreciation allowance, will also go up resulting in to reduction in the total income.

As the determination of the ALP of the international transaction of 'Repossession of Rig' at Nil has the effect of increasing the claim of depreciation and accordingly reducing the income, rather than increasing the same, the transfer pricing provisions need not be given effect to as per the mandate of sub-section (3) of section 92.

Accordingly, the appeal of the taxpayer is partly allowed

NANGIA'S TAKE

In this ruling, the Hon'ble ITAT has emphasized the principle of substance of transaction over form, which is in line with OECD BEPS Action Plan 8-10 underlying the importance of accurately delineating the actual transactions between associated enterprises through analyzing not only the contractual relations but also the evidence of the actual conduct of the parties.

Further the above ruling, reiterates the provisions under section 92(3), which provides that the provisions of this section shall not apply if it has the effect of reducing the income chargeable to tax or increasing the loss, by applying the Indian TP regulations. Accordingly, in the instant case, determination of the ALP of the international transaction of 'Repossession of Rig' at Nil has the effect of reducing the income. Consequently, the TP provisions were not applied to determine the ALP of the aforesaid transaction.

Source: Mitchell Drilling India Private Limited [TS- 252-ITAT-2018(Del)-TP]

14. ITAT holds that Revenue can determine taxpayer's ALP, despite of AE's Income acceptance, considering likely base erosion

Facts of the case

Filtrex Technologies Pvt. Ltd. ("the taxpayer") engaged in the manufacturing of carbon block cartridges used for removal of harmful contaminants from drinking water. During the assessment year ("AY") 2012-13, the taxpayer paid royalty of Rs. 9.86 crores to its Associated Enterprises ("AE") namely Filtrex Holdings Pte. Ltd. ("FHPL") for right to use technology and further, paid a sum of Rs. 2.4 crores to its other AE i.e. Filtrex International Pte. Ltd. ("FIPL") for receiving administrative, financial and marketing services.

Subsequently, the Assessing Officer ("AO") made reference to the Transfer Pricing Officer ("TPO") for determining the arm's length price ("ALP") of the international transactions under section 92CA of the Income Tax Act, 1961. Accordingly, TPO determined the ALP of the international transaction at NIL by stating that no benefit or service were received by the taxpayer from its AE and these payments were made only to evade taxes by shifting profits to AEs in Singapore which is subjected to lower tax rate. Furthermore, TPO relied on the information received from the Singapore Inland Revenue authority that Mr. Bhoomi Govind who had controlling interest in FTPL was a key person who provided services and not FIPL and FHPL.

As against this, the taxpayer contended that in the assessment proceedings of AEs i.e. FIPL & FHPL, the returned income has been accepted presupposing that the amount received by the AE from the taxpayer was at arm's length and therefore amount paid by the taxpayer should also be considered as at ALP. In contestation of this, Revenue submitted that the acceptance of the return of income of AEs by the AO cannot be presume that the consideration paid by the taxpayer to AEs was at ALP.

Thereon, the aggrieved taxpayer filed the objection before DRP against the AO order. The DRP upheld the TPO's findings in the instant case.
Being aggrieved by the DRP directions and final AO order, the taxpayer filed an appeal before Bangalore Income Tax Appellate Tribunal ("ITAT").

Proceedings before ITAT
ITAT'S Ruling

ITAT after hearing both the parties and pursuing the material documents noted that the TPO has accepted that the income shown by FHPL and FIPL was for service rendered to the taxpayer and the remuneration received was at ALP. ITAT also stated that the AO of AEs has accepted the returned income and service were in fact rendered by FHPL and FIPL. Therefore, TPO cannot say that no benefit or services were received by the taxpayer from AEs. ITAT further place reliance on the Delhi High Court in case of EKL Appliances Ltd. wherein held that "*TPO should evaluate the ALP of an international transaction and without doing so, he cannot give a finding that the taxpayer received no services and therefore determine the ALP as NIL".*

ITAT further referred the proviso to Section 92CA(4) which states that where the total income of AE is computed under section 92CA(4) on determination of the ALP paid to another AE from which tax has been deducted or was deductible under the provisions of Chapter XVIIB, the income of the other AE shall not be recomputed by reason of such determination of ALP in the case of the first mentioned AE.

ITAT referred circular dated November 9, 2001 which stated that second proviso to Section 94CA(4) was meant to apply only when ALP was determined in the case of FIPL and FHPL.

Another aspect which the Circular clarified that the commercial reality of a transaction would be looked into viz., wherever the determination of income or expense in the hands of one enterprise resulted in tax base erosion of the country, the AO was free to apply the provisions of Sec.92(1) read with Sec.92CA(4). Thereafter, ITAT stated that *"corresponding adjustment in the assessment of the other enterprise to the transaction need not be made where there is no tax base erosion of the country".*

However, ITAT stated that the question as to whether the payment for such services was at ALP or commensurate with the benefit received by the taxpayer were all matters to be examined by the TPO. Accordingly, ITAT set aside the order of the AO on this issue and remanded the question of determination of ALP to the TPO for fresh consideration. ITAT clarified that TPO shall not dispute that services were rendered by the AE. ITAT also directed the TPO that if taxpayer's approach in adopting TNMM at entity level was disputed by the TPO, then the taxpayer should be permitted to file TP study for each of the international transaction separately.

At last, ITAT stated that, "TPO misdirected himself by not examining the evidence produced by the taxpayer on the premise that the payment to the AE's was only with a view to reduce tax liability in India and to shift profits earned in India out of India. Since the exercise was not carried out, ITAT remanded the issue to the TPO for fresh consideration.

Accordingly, the appeal of the taxpayer is allowed for statistical purpose.

NANGIA'S TAKE

The verdict in the instant case echoes the fact that the acceptance of return of income of AE's by the AO cannot give rise to the presumption that the consideration paid by the taxpayer to its AE's was at Arm's Length.

Further, the objective of transfer pricing provisions under section 92C is to ensure that the price of international transactions should be at arm's length and the department without any coherent basis cannot held that payment for intra group services made to its AE were to evade taxes by transferring profits to its AE.

Source: Filtrex Technologies Private Limited [TS- 265-ITAT-2018(Bang)-TP]

15. ITAT deletes TP-adjustment on corporate guarantee and remits ALP computation of interest on convertible debentures

Facts of the case

Siva Industries and Holdings Ltd. ("the taxpayer") is engaged in the business of commodities trading (minerals), agro exports, shipping and logistics, realty and hospitality import. During the Assessment Year 2013-14 ("year under consideration"), the taxpayer provided corporate guarantee to its Associated Enterprise ("AE") for which the taxpayer was charging commission from its AE. Additionally, the taxpayer made an investment through optionally and Fully Convertible Debentures ("OFCD") in its AE and charged interest on the same at the rate of 2%.

However, the Transfer Pricing Officer ("TPO") made an upward adjustment on commission received by the taxpayer in respect of corporate guarantees provided to its AE. Further, the TPO considered the investments made through OFCD by taxpayer in its AE which carried interest at rate of 2% as not at Arm's length and computed the Arm's Length Rate at 2.95% post considering the LIBOR rate of 0.95%. and proposed Transfer Pricing ("TP") adjustment for interest charged on OFCD.

Thereon, the aggrieved taxpayer filed the objection before DRP against the draft AO order. The DRP upheld the TPO's findings in the instant case. Being aggrieved by the DRP directions and final AO order, the taxpayer filed an appeal before Chennai Income Tax Appellate Tribunal ("ITAT").

Proceedings before ITAT

ITAT's Ruling

Corporate Guarantee

ITAT noted the taxpayer's contention and opined that "*it may be true that there is a cleavage of opinion, as to the issue whether corporate guarantee to an AE could be considered as international transaction. However, since in Taxpayer's own case in AY 2009-10,* similar adjustment was deleted holding that providing corporate guarantee to AE could not be considered as an international transaction. Therefore, ITAT deleted the TP-adjustment made towards providing corporate guarantee and placed reliance on the verdicts given on ***Bharti Airtel Ltd (supra)*** and ***Redington (India) Ltd (supra)*** and rejected revenue's reliance on contrary ***Mahindra and Mahindra and Prolifics Corpn rulings***, wherein it was held that corporate guarantee constitutes an international transaction.

Interest charged on OFCD

After perusal of various orders of authorities and considering the taxpayer and revenue's contention, ITAT held that though the adoption of LIBOR rate of 0.95% by the TPO could not be faulted, but the TPO erred in adopting 2%+LIBOR rate (i.e. 2+0.95%). ITAT placed reliance on taxpayer's own case for AY 2006-07, wherein similar adjustment was deleted *as interest charged by taxpayer (6%) was higher than LIBOR (4.42%).* ITAT further apprehended that "Once the taxpayer had charged rate of interest more than the LIBOR rate, there could be no question of any TP adjustment.

Thus, the issue was remitted back to the AO/TPO to fix the correct LIBOR before deciding if TP-adjustment was required.

NANGIA'S TAKE

The verdict in the instant case echoes the fact that the transaction related to corporate guarantee is considered outside the ambit of international transaction on account of not having any bearing on profits, income, losses or assets of the enterprise and also following the principles of Res Judicata. Additionally, the department cannot derive the ALP of the transactions on its own whims and fancies and there should be a proper mechanism to be followed for arriving at the ALP.

Source: Siva Industries and Holdings Ltd [TS-208-ITAT-2018(CHNY)-TP]

16. ITAT rejects Nil-ALP determination in respect of royalty payment and discards adoption of foreign comparable for benchmarking brand royalty

Facts of the case

Vodafone Essar Digilink Ltd. ("the taxpayer") is engaged in the business of providing cellular mobile telephony services in the telecom circles of Rajasthan, Haryana and Uttar Pradesh (East). The taxpayer is providing telecommunication services through two models viz., pre-paid model and post-paid model and accordingly, entered into international transaction with its Associated Enterprises ("AE") during the Assessment Year ("AY") 2009-10 ("year under consideration"). During the year under consideration, the taxpayer paid royalty to Vodafone Ireland Marketing Ltd. ("AE") and Rising Group Ltd. ("AE") for use of their respective brand name i.e. 'Vodafone' and 'Essar' respectively; for which taxpayer had entered into an agreement with both the AE's. As per the agreements, the taxpayer was required to pay royalty to Vodafone Ireland Marketing Ltd. and Rising Group Ltd. at the rate of 0.30% and 0.15% of net service revenue respectively. The taxpayer followed Comparable Uncontrolled Price ("CUP") Method for benchmarking the aforesaid transaction and adopted comparable instance under which Forward Industries Inc., USA pays royalty to Motorola Inc., USA for trade mark license for use of Motorola signature and logo at the rate of 7% of net sale.

However, the Transfer Pricing Officer ("TPO") accepted the use of CUP method but did not accept payment of royalty at 7% to Motorola Inc., USA by Forward Industries Inc., USA, as comparable and rejected the same on the basis of functional dissimilarity and determined Arm's Length Price ("ALP") of the aforesaid international transaction as NIL and stated that the taxpayer did not justify royalty rate as there was no cost benefit analysis or economic benefit derived by the taxpayer and no royalty was paid in the past.

Further, the taxpayer also incurred expenses on Advertising, Marketing and Promotion ("AMP") during the year under consideration which was for the promotion of brand owned by the AEs. The TPO applied bright line test and proposed an adjustment.

Consequently, Dispute Resolution Panel ("DRP") upheld TPO order. Aggrieved by the order passed by DRP, the taxpayer filed an appeal before Delhi Income Tax Appellate Tribunal ("ITAT").

ITAT Ruling

Royalty for use of brand

ITAT noted that the TPO computed NIL ALP of international transaction on the basis that no benefit has accrued to the taxpayer and the taxpayer did not paid any royalty in the past and held that *"simply because no royalty was paid in the past cannot be the reason to treat the ALP of royalty at NIL in later years"* and stated that TPO contention and Assessing Officer ("AO") addition on the basis of TPO recommendation was not in accordance with the judgement of High Court ("HC") ***Cushman & Wakefield [TS-218-HC-2015(DEL)-TP]*** in which it was apprehended that the authority of TPO was limited to conducting Transfer Pricing ("TP") analysis for determining the ALP of an international transaction and not to decide if such services existed or

benefits accrued to the taxpayer which were under the exclusive domain of the AO.

Regarding the use of benefit test for determining the ALP, ITAT relied on HC ruling in ***Knorr-Bremse [TS-558-HC-2015(P&H)-TP]*** wherein it was held that a transaction was at an ALP or not was not dependent on whether the transaction resulted in an increase in the taxpayer's profit. HC also held that the only question was relevant that whether the transaction was entered into bona fide or not or whether it was sham and only for the purpose of diverting the profits. ITAT applying the HC ruling in taxpayer's case, considered the international transaction entered in to by the taxpayer with its AEs as 'genuine and bona fide' since it was established beyond doubt that brand names of Essar and Vodafone had actually been used by the taxpayer. Thus, ITAT remitted the matter to the file of AO/TPO for fresh determination.

Comparable Selection

ITAT stressed that pre-requisite for application of CUP method was there must be a complete identity between the international transaction and uncontrolled transaction, with which the comparison was sought to be made. ITAT noted that there was no comparison between taxpayer international transaction and the transaction between Forward Industries Inc., USA to Motorola Inc., USA and apart from that ITAT observed that it was a transaction between two foreign parties and cannot be considered for comparison and hence disapproved the comparable transaction used by the taxpayer for benchmarking the international transaction related to payment of royalty for use of brand name.

AMP Expenses

ITAT, following the view taken in several tribunal orders of co-ordinate bench, set aside the order and restored the matter back to the file of TPO/AO for a fresh determination of the question as to whether the international transaction of AMP expenses existed or not.

However, ITAT clarified that if ALP of AMP expenses came up for determination, then selling expenses would not be a part of AMP expenses. In this regard, ITAT relied upon jurisdictional High-Court rulings which had constantly held that selling expenses cannot be included in the scope of AMP expenses.

NANGIA'S TAKE

The verdict in the instant case reiterates the fact that the authority of TPO is only limited to determine ALP of an international transaction and not to decide if any benefits arise to the taxpayer or whether the services actually rendered or not. Further, the TPO cannot determine the ALP of that international transaction as NIL on the ground that similar international transaction was not undertaken by the taxpayer in the earlier years, and accordingly, the tax authorities cannot make any adjustments without any logical basis.

Source: Vodafone Essar Digilink Ltd. [TS-166-ITAT-2018(DEL)-TP]