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NEWSLETTER

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1. Mumbai ITAT held that Service-tax / R&D cess borne by Indian service recipient are not taxable as Royalty

Background

Mumbai ITAT held that the element of Service Tax and Research & Development Cess, collected, paid and borne by the Indian entities cannot be considered as income in the hands of recipient foreign company. The ITAT rejected revenue's stand that the Foreign company cannot claim deduction from gross royalty towards service tax & other levies as it was taxable on gross basis in terms of Article 12 of the India-USA DTAA. It referred to reverse charge mechanism under the Service Tax Act and also refers to the Research & Development Cess Act provisions, whereby the liability to pay the Service Tax and Research & Development Cess was on the Indian concerns. Thus, considering the statutory framework as well as the contractual framework of the Royalty agreements, ITAT concludes that Royalty was taxable without including the amount of Service Tax and Research & Development Cess.

Brief facts of the case

- The Procter & Gamble Co. USA (the assessee), a company incorporated in the USA, is engaged in the business of manufacturing, selling and distribution of personal care and hygiene related products
- The assessee entered into a technical collaboration and trademark license agreement with two Indian concerns and received a percentage of sales as royalty.
- According to the terms of the agreement, all the taxes and duties were to be borne and paid to the government by the Indian concerns
- In the return of income, the assessee disclosed the amount of royalty inclusive of service tax and research & development Cess (R&D Cess) and claimed the deduction of service tax and R&D Cess therefrom while offering royalty income to tax.
- During the assessment proceedings, the Assessing Officer (AO) denied the deduction and brought the entire amount disclosed as royalty to tax on the premise that the assessee was responsible to pay such tax and Cess
- Aggrieved, the assessee filed an appeal before the Dispute Resolution Panel (DRP) which ruled in favor of the AO and concluded that royalty is taxable on gross basis in terms of the India-USA Double Taxation Avoidance Agreement (DTAA)
- Subsequently, the assessee filed an appeal before the Income Tax Appellant Tribunal, Mumbai (ITAT)

Assessee's contentions

- The onus to pay service tax and R&D Cess was on the Indian concerns according to the terms of the agreement and provisions of the relevant laws governing service tax and R&D Cess.
- Also, service tax collected by the assessee does not have any element of income as the same gets passed on to the Government authorities
- The inclusion of service tax and R&D Cess in the amount of royalty was a symbolic exercise and same cannot partake the character of income and thus, not includible in taxable amount of royalty

Department's contentions

- The burden to pay the service tax and R&D Cess was on the assessee and no deduction could be claimed towards such amount while computing the income chargeable to tax

ITAT'S Order

While holding that only the amount of royalty exclusive of service tax and R&D Cess is taxable, it observed as under:

- In view of the reverse charge mechanism, provisions mentioned in the Research & Development Cess, Act, 1986 and terms of the royalty agreement, ITAT noted that the liability to pay the service tax and R&D Cess falls on the Indian concerns

- From the taxation perspective, the relevant legal position is required to be established. Therefore, the amounts cannot be taxed merely on the basis of manner in which the amounts have been disclosed in the return of income

- The royalty income taxable in the hands of assessee is restricted to the amount computed in accordance with the terms of the royalty agreements

NANGIA'S TAKE

Even though the royalty is taxed on gross basis, items included in the total amount should constitute income in the hands of the taxpayer. Mere receipt of an amount alongwith royalty would not make such amount taxable. Taxability of an income should be driven by the legal position rather than the manner of reporting.

2. Ahmedabad ITAT held that payment for testing services not chargeable to tax as FTS

Background

Anjani Synthetics Ltd. (assessee) a textile exporter availed testing services from Testex AG, a Swizz company. Assessee was required to take certification of adherence to the quality parameters. Income Tax Appellate Tribunal, Ahmedabad (ITAT) noted that the services were mere application of technology by the service provider, not transfer of knowhow and dissatisfied the make available clause. Thus, there was no requirement to deduct tax at source under section 195 of the Income Tax Act, 1961 (Act) on the payment made for availing the testing services.

Brief facts of the case:

- The assessee a textile exporter made payment to Testex AG, a Swizz company for availing testing services.

- Testing services were required to get a certification which is quality parameter certification required by European customer

- During the course of the assessment proceedings, the assessing officer contended that such payment was chargeable to tax under section 9(1) (vii) of the Act and tax was required to be deducted thereon under section 195 of the Act. Consequently, it disallowed the payment made for availing testing services under section 40(a)(i) of the Act.

- The assessee filed an appeal before the Commissioner of Income-tax Appeal, however, the case was decided in favor of the revenue.

- Aggrieved, the assessee filed appeal before the ITAT

ITAT's Judgement

The ITAT held that the assessee did not have any tax withholding obligations from payments made to the Swiss entity in respect of the testing fees. While holding the same, it noted as follows:

- The provisions of the tax treaty would prevail over the provisions of domestic law if the same are more beneficial to the assessee;
- The definition of fee for technical service in India-Switzerland tax treaty incorporates the concept of make available.
- The services rendered by the Swiss entity were such that the assessee was not enabled to apply technology contained therein. The services were simply testing services which did not involve any transfer of technology, thereby dissatisfying the make available condition. Therefore, payment for the testing services would not be liable to tax as FTS.

NANGIA'S TAKE

The ruling is an addition to different judicial precedents holding the view that testing services would not be regarded as technical services. Testing services do not involve the essential character of making available of a technology but mere rendition of service by one entity to other.

3. Delhi ITAT allowed the tax sparing credit in respect of dividend income received by the assessee from its Thailand subsidiary

Background

Delhi ITAT allowed Indian co.'s claim for 'tax sparing credit' under India-Thailand DTAA with respect to taxes payable in Thailand on dividend received from its 100% Thailand based subsidiary. It rejected the contention of the revenue that Foreign tax credit was allowed only in case of the "Thai Tax" payable and not on the notional tax exempted under the domestic law. Further, it noted that benefit of the tax sparing credit shall be provided to the Indian Co., only if dividend received by assessee is taxable in the hands of assessee as per "Thai tax laws" and exemption is available to assessee either as per the 'Revenue Code of Thailand' or as per 'Investment Promotion Act'. Since, the Indian co. was not liable to pay any tax in Thailand by virtue of exemption granted as per Investment Promotion Act, the ITAT allowed Indian Co. the benefit of tax sparing credit of foreign tax payable in Thailand.

Brief facts of the case

- M/s Polyplex Corporation Ltd. (assessee) is an Indian company, engaged in the business of manufacturing of plastic and polyester films
- The assessee received dividend from its 100% Thailand based subsidiary, M/s Polytex Thailand Co. Ltd and claimed foreign tax credit (FTC) @10% in respect of such dividend as per the India-Thailand tax treaty (treaty) while filing its income-tax return in India.
- During the course of assessment proceedings, the assessing officer (AO) contended that the benefit provided by the tax treaty applies only on tax payable in Thailand which does not include any tax exemption provided there.

- It noted that no tax was paid by assessee in Thailand and therefore, disallowed the claim of FTC by the assessee.

- On appeal to the Commissioner of Income Tax (Appeals) [CIT(A)], it further held that the exemption from payment of corporate income tax was granted to the Thailand subsidiary only (via a promotion certificate) and not to the assessee.

- Aggrieved, the assessee filed an appeal to the Delhi Income Tax Appellate Tribunal (ITAT)

Assessee's contentions

- It was entitled to claim tax sparing credit of foreign tax payable in Thailand but not paid due to an exemption available to assessee as per Investment Promotion Act under Article 23(3) of the tax treaty.

- FTC was also available in respect of the tax exempted in Thailand since under the tax treaty "Thai tax payable" deemed to include any amount which would have been payable as Thai tax for any year and also an exemption or reduction of tax granted for that year or any part thereof by virtue of Investment Promotion Act or of Revenue Code

Department's contentions

- Article 23 of the tax treaty allows relief against income which has been subjected to tax both in India and Thailand whereas in assessee's case, dividend income has been exempted from tax under the laws of Thailand

- Since no tax has been paid in Thailand, the issue of double taxation of income does not arise Article 23 of the tax treaty, which explains Thai Tax payable, excludes the incomes which have been exempted from tax Exemption as per the promotion certificate is applicable only for the Thailand company and assessee is not entitled to claim any benefit thereof

ITAT'S order

While allowing the tax sparing credit in respect of dividend income received by the assessee from its Thailand subsidiary, the ITAT noted as follows:

- Commentary to UN Model Convention and Klaus Vogel notes regarding Article 23 of the tax treaty that the assessee shall be granted 'tax sparing credit' to the assessee only if the dividend received by assessee is taxable in his hands as per Thai tax laws and exemption is granted to assessee as per the Investment Promotion Act or Revenue Code. Thus, "Thai tax payable" would also include any tax exempted either under the provisions of Revenue Code or Investment Protection Act

- The Investment Promotion Act, provides exemption on income tax on dividends derived from a promoted activity in Thailand. Thus, the assessee is entitled to claim exemption from payment of tax on dividend received from its Thailand based subsidiary. Accordingly, credit of taxes can be claimed for the tax deemed to have been payable in Thailand.

NANGIA'S TAKE

Tax sparing credit which aimed at not depriving the foreign investors with the benefits provided by the source jurisdiction has always been a subject matter of discussion. Tax officers generally deny FTC on account of non-payment of tax in foreign jurisdiction in light of the exemption available in the foreign jurisdiction. The given judgement has step by step interpreted the law alongside the facts of the case to the establishes exemption was provided to assessee by the Thai domestic law due to which it duly became entitled to FTC in India under the terms of the tax treaty.

4. Addressing the Tax Challenges of the Digitalisation of the Economy – OECD Policy Note

On 29 January 2019, the G20/OECD Inclusive Framework on Base Erosion and Profit Shifting (BEPS) released a short Policy Note to provide an update on their work on Addressing the Tax Challenges of the Digitalisation of the Economy.

Task Force on the Digital Economy (TFDE) is following a two pillars based approach to work towards reaching a new consensus-based long-term solution in 2020. One pillar addresses the broader challenges of the digitalised economy and focuses on the allocation of taxing rights, and a second pillar addresses remaining BEPS issues

Pillar 1: Allocation of taxing rights including both nexus and profit allocation rules

It has been agreed to explore the proposals made on allocation of taxing rights on a without prejudice basis. Following are the areas being considered with possible effects:

- Evaluating the principle, on a without prejudice basis, to allocate more taxing rights to market or user jurisdictions in situations where value is created by a business activity through participation in the user or market jurisdiction that is not recognized in the framework for allocating profits
- Reconsideration of the transfer pricing rules. Solution may go beyond the arm's length principle
- Also, solutions may go beyond the limitation on taxing rights determined by physical presence
- Consideration of changes to the permanent establishment threshold

At a hearing held in Brussels, a tax executive from luxury clothing firm Kering also said the company's decision The objective of the inclusive framework is to bring simplification in administration, collection of revenue and reaching a solution comfortable to both the tax authorities and tax payers. It has been noticed that solutions would not impact only small set of digitalized business but various business models such as limited risk distribution structures.

Pillar 2:

The second pillar seeks to address profit shifting to entities subject to a low effective rate of tax through the development of two inter-related rules:

- An income inclusion rule that would tax profits as income in the hands of a related party investor; and
- A tax on base eroding payments to deny a deduction (or impose withholding tax) in the source country on payments subject to no or only very low taxation.

Different aspects have been considered by the second pillar of inclusive framework which intends to address the continued risk of profit shifting. It provides that countries are free to adopt unilateral measures to tax but recognizes the risk of unilateral and uncoordinated measures resulting into levy of more tax by different countries. Further, it aims that no taxation should take place where there are no economic profits or result in double taxation, thereby ensuring level playing field.

NANGIA'S TAKE

The note gives a broad view of the perspective with which the work is being undertaken by the task force to address the challenges of digital economy. While it is evaluating the proposal known to the community, it highlighted its intention to establish a streamlined system of taxation of digital economy which is not only limited to digital business model by bringing in the simplification in the procedure and fair collection of taxes.

http://www.oecd.org/tax/beps/policy-note-beps-inclusive-framework-addressing-tax-challenges-digitalisation.pdf

5. US Treasury Leadership Gives Direction to the OECD Digital Tax Project in January 29 Note

With the release January 29, 2019 of an important tax policy note (the “Note”), the Organization for Economic Cooperation and Development (the “OECD”) has introduced greater direction for its BEPS mandate to introduce proposals to address the tax challenges of the “digitalization” of the economy.

The international tax community is now anxiously awaiting further detail in the publication of the OECD “consultation paper” on or around February 11, 2019 ahead of a “public consultation” March 13-14 at OECD headquarters in Paris

https://www.natlawreview.com/article/us-treasury-leadership-gives-direction-to-oecd-digital-tax-project-january-29-note

6. S.Korea's tax agency to intensify probe into companies' tax evasion

South Korea's tax agency has planned to intensify a probe into the tax evasion of companies suspected of committing tax dodging and embezzlement.

The plan was unveiled during a meeting of senior tax officials on Monday at the main office of the National Tax Service (NTS). Hong Nam-ki, minister of economy and finance who doubles as deputy prime minister for economic affairs, said at the meeting that the tax justice must be achieved by taking stern measures against tax evasion, urging the officials to secure a stable tax revenue through the stern measures.

http://www.xinhuanet.com/english/2019-01/28/c_137781406.htm

7. Irish corporation tax faces new squeeze as OECD kicks off digital reform probe

Ireland's corporation tax revenues are under threat as an international reform process kicks off in earnest. The Organisation for Economic Co-operation and Development (OECD) is looking to change the way big technology companies are taxed. It has now said it will consider moving to a system where companies will be taxed, at least in part, according to where users are based rather than where the company is based.

https://www.independent.ie/business/irish/irish-corporation-tax-faces-new-squeeze-as-oecd-kicks-off-digital-reform-probe-37766815.html

8. Investors Facing Tax They May Not Owe Must Move Fast With IRS In (1)

U.S. taxpayers at risk of getting a chunk of investment income withheld now have a chance to stop it from happening.

The Internal Revenue Service is fully operating, at least temporarily, meaning it will again issue letters to verify the identities of taxpayers who made errors on a key tax form. That could free up potentially billions of dollars that otherwise would go to a 24 percent tax that banks and asset managers must withhold from distributions if the taxpayer meant to receive it can't get identity confirmation in time.

https://news.bloombergtax.com/daily-tax-report/investors-facing-tax-they-may-not-owe-must-move-fast-with-irs-in?utm_source=twitter&utm_medium=taxdesk&utm_campaign=F8926790-27AB-11E9-AE6B-0A1A50017A06

9. Romania Imposes 10% Tax on Cryptocurrency Earnings

Romania has amended its tax laws, allowing it to start taxing gains from bitcoin investments at a rate of 10 percent. The improved fiscal code legislation categorizes earnings generated from buying and selling cryptocurrencies as "income from other sources" and therefore subject to income tax, local media reports.

https://news.bitcoin.com/romania-imposes-10-tax-on-cryptocurrency-earnings/

10. Money routed through AE for advance payment to third party is not a case of capital financing and accordingly outside ambit of 'international transaction'

Outcome: In favour of the taxpayer
Category: Advance payment to third party through AE

Facts and Contentions

- KSS Limited (formerly known as K Sera Sera Productions Ltd) ("the taxpayer") is engaged in the business of production and distribution of films.

- During Assessment Year 2009-10 ("the year under consideration"), the taxpayer, for the purpose of acquiring distributorship of Hollywood films in India, contracted M/S. Citi Gate Trade FZE ("Citi Gate"/ "third party") through its UAE based AE as the Citi Gate would not have dealt with the taxpayer directly.

- To operationalize the said arrangement, the taxpayer first entered into an agreement with its AE and then AE entered into agreement with the Citi Gate. Subsequently, the taxpayer routed money through its AE in the form of advances and in turn AE paid up such amount to Citi Gate.

- However, the arrangement did not work out and accordingly, Citi Gate, refunded the advance to the AE of the taxpayer and consequently AE returned money to the taxpayer. In the process, however, some time was consumed and the repayment was made over a period of time.

- During the course of Assessment Proceeding, Transfer Pricing ("TP") officer contended that the taxpayer has transferred its profit by making interest free advances to the AE.

- Therefore, by holding that the above transaction covered under Chapter X of the Income Tax Act, 1961 (“the Act”) TP officer made significant TP adjustment. The same was upheld by the Assessing Officer in its draft assessment order and also confirmed by the Dispute Resolution Panel. Aggrieved by the same, the taxpayer filed an appeal before Income Tax Appellant Tribunal (“ITAT”/ “the Tribunal”).

ITAT’s Ruling

ITAT made the following observations:

- The taxpayer had entered into an agreement with its AE which envisaged that Citi gate would grant, sale, assign and transfer to the AE as well as the taxpayer all rights for sale, absolute and exclusive rights for distributorship. The AE was authorised to negotiate the price and other terms of the agreement. Upon acquisition of such rights, the AE would transfer the same to the taxpayer at the price at which it had acquired such rights from Citi Gate;

- The amount in question was never remained with the AE as per the bank statements and was immediately transferred to Citi Gate. Further, whenever the amount was refunded by the Citi Gate (upon cancellation of the agreement), the same was also routed through the AE without any retention time by the AE, accordingly, AE did not retain the amount for any significant period of time for its own use or purpose;

- There must be transaction or arrangement between two or more AEs which give rise to the income or benefit in the hands of at least one of them in order to attract the Transfer Pricing provisions and in the present case, advance was given to third party and not to the AE which was for the purpose of acquisition of rights of distributorship.

- On the basis of such findings and placing reliance upon the case of ***Vodafone Services Pvt. Ltd Vs. Union of India***, ITAT concluded that there was no diversion of income and therefore, no TP provision would be applicable.

- Aggrieved by ITAT decision, Revenue relied on the explanation as per clause (c) of section 92B and challenged the order of tribunal before High Court (“HC”), arguing that the advances were made by the taxpayer out of its borrowed funds on which the taxpayer was paying considerable interest and accordingly, the present case give rise to TP mechanism.

HC’s Ruling

HC made the following observations:

- HC analyzed section 92(1) of the Act which provides that any income arising from an international transaction shall be computed having regard to ALP and clause (c) of Section 92B of the Act which states that the expression "international transaction" shall include capital financing, including any type of long-term or short-term borrowing, lending or guarantee, purchase or sale of marketable securities or any type of advance, payments or deferred payment or receivable or any other debt arising during the course of business;

- HC distinguished the present case with the aforementioned capital financing transaction having regard to the nature of entire arrangement & the different transactions. Further HC also observed that neither at the point of payment nor at the point of refund of money, the AE retained the money for any significant period of time.

- In light of the above, HC held that the present case was simple one where the money was routed through the AE by the taxpayer for the purpose of acquisition of distributorships and not a case of either financing or lending or advancing of any money;

- In light of the aforementioned observations, HC rejected revenue's contention and in furtherance to the ITAT decision upheld the case in favor of the taxpayer by concluding that the said transaction did not result into diversion of income of the taxpayer to its AE and therefore, no TP provision would be applicable as the transaction does not come under the purview of international transaction.

NANGIA'S TAKE

- ***In this ruling, the HC and ITAT has meticulously analyzed the arrangement as a whole and did not bifurcate it into the transactions for isolation consideration and concluded that the instant transaction has not resulted into any diversion of income of the taxpayer as AE only acted as a facilitator and did not provide any services to the taxpayer.***

- ***The aforesaid case was analyzed in the light of Vodafone Services Pvt. Ltd Vs. Union of India which provides that since the transaction of issue of shares is a capital transaction and also does not give rise to the income or benefit in the hands of at least one of the parties, accordingly the same does not fall under the ambit of the meaning of international transaction.***

- ***Thus the aforesaid ruling reiterates the fundamental principle / objective of transfer pricing provision which provides that there should not be any artificial avoidance of tax in the form of shifting of profits by manipulating prices charged or paid in international transactions, thereby eroding the country's tax base.***

Source: KSS Limited (formerly known as K Sera Sera Productions Ltd) [TS-1379-HC-2018(BOM)-TP]

11. ITAT characterize Microsoft India as Contract R&D service provider instead of routine software developer by placing reliance on detailed functional and risk analysis

Outcome – Partially in favour of Both
Category – Functional classification- Contract R&D

Facts and Contentions

- Microsoft India (R&D) Pvt. Ltd. ("the taxpayer"), a subsidiary of Microsoft Ireland Research Ltd with parent company, Microsoft Corporation USA ("Microsoft USA"), is mainly engaged in rendering software development services and information technology enabled services to its Associated Enterprise ("AE") and remunerated on a cost plus 15%.

- During the year under consideration, the taxpayer applied Transactional Net Margin Method ("TNMM") as the Most Appropriate Method to benchmark the international transactions using external comparable companies.

- During the course of assessment proceeding, TPO held that the taxpayer was not a routine software developer but was engaged in rendering high quality software engineering services to its AE viz. Microsoft USA and therefore stated that transaction was not at ALP as service were in the nature of contributions to the products being integrated there, earned margin ranging between 60 to 70% of the cost.

- TPO accordingly rejected almost all the comparable companies of the taxpayer on this ground and introduced some new comparable companies and thereby proposed an adjustment of INR 197 crore. Consequently, DRP also upheld the order of TPO.

❖ Thus, aggrieved by the directions of DRP, the taxpayer filed an appeals before Income Tax Appellate Tribunal ("ITAT") challenging the inclusion and exclusion of comparable companies from the final list of comparables.

Proceedings before ITAT ("the Tribunal")

ITAT noted the following observations:

❖ **Provision of Software Development Services**

- Before ITAT, taxpayer explained that it is engaged in writing and testing codes under the directions of its AE and the services were rendered only for certain functions or modules within the product and not for the whole product as the same was done by the AE in USA.
- ITAT further observed that integration of all the software developed is done in USA, does not mean that the research work done by the taxpayer cease to be research work in itself as the work done by the taxpayer result into the creation of intangibles.
- Thus, ITAT held that the 113 patentable inventions were carried out by the taxpayer which were registered in the USA, leaves no room for doubt that it is undoubtedly engaged in research activities which is significantly different from a routine software developer.
- Further for determining the functional profile of taxpayer ITAT analyzed the below mention submission/documents produced by the taxpayer before ITAT: -
    - ITAT relied on interviews of certain employees conducted by the Advance Pricing Agreement ("APA") Authorities and pointed that the taxpayer was providing routine software development services of coding and testing under the direct supervision of Microsoft USA, and further such services were of little consequence in the overall MS products.
    - ITAT after analysing the amended Parent-Subsidiary Agreement (PSA) between Microsoft USA and the taxpayer which clearly indicate that the work done by the taxpayer is that of Research and Development (R&D).
    - ITAT further examining circular No. 3/2013 which laid down guidelines for identifying if a Development center in India is a contract R&D service provider with insignificant risk, and noted that the taxpayer satisfied all the ingredients except the one given at Sl. no. 5 which is not applicable to the facts of the instant case.
    - At last, examining Taxpayer's letter dated 12 January 2015 which states that taxpayer admitting that it must be characterized as a Contract R&D service provider bearing insignificant risk.

Based on the above findings, the ITAT remitted the matter back to the file of the TPO for fresh determination of the Arm's Length Price ("ALP")

Provision of I.T. Enabled Services

❖ Under this Segment, ITAT after examining the functional profile, noted that taxpayer entered into a Product Support Service Agreement ("PSSA") with Microsoft Corporation to provide ITES in nature of product support services.

❖ Further, ITAT observed that the arguments under this segment is similar to that of the Provision of Software Development Services, thereby ordered to remit the matter back to the TPO for **fresh determination of ALP.**

NANGIA'S TAKE

❖ ***The instant case emphasis the crucial first step in a TP analysis is examination of the economically significant functions performed, risks assumed, and assets used by each party to the transaction. Therefore, FAR analysis should be based on specific demonstrable facts and their relative evaluation of their weight and significance and not on vague generalities.***

- ***This ruling emphasizes the importance of proper documentation of the allocation of risks between AEs and the adherence to the same for the purpose of determining the appropriate characterization of entities for transfer pricing purposes. Further, this ruling also demonstrates that proper documentation of the risk allocation is a key component of a Taxpayer's defense in an audit.***

Source: Microsoft India (R&D) Pvt. Ltd. [TS-1015-ITAT-2018(Del)-TP]

12. ITAT deletes addition on AMP expenditure in absence of any agreement or arrangement with AE

Outcome: In favour of the taxpayer
Category: Marketing intangibles/AMP adjustment

Facts and Contentions

- PepsiCo India Holdings Pvt Ltd. ("the taxpayer"), is engaged in the business of manufacturing of soft drink/juice based concentrates and other agro products.

- During the year under consideration, the taxpayer had obtained a non-transferable, royalty free license from its Associated Enterprise ("AE") i.e. PepsiCo Inc. for the technology to manufacture the concentrate and to use and exploit the brands owned by the said AE in the regions designated to the taxpayer. Furthermore, taxpayer imported certain keys and essences for the production of concentrate from AE's and the same was duly reported in Form 3CEB.

- During the course of Assessment Proceeding, TPO made significant TP adjustment towards advertising, marketing and promotion (AMP) expenditure in different years on the basis of application of 'Bright Line Test ("BLT")' for Assessment Year ("AY") 2006-07 to AY 2009-10 and Profit Spit Method ("PSM") for AY 2010-11 to 2012-13.

- In respect of AY 2006-07, the taxpayer disclosed an international transaction of reimbursement of expenditure of Rs. 33.60 Cr. to its AE for sponsorship rights of cricketing events worldwide. In relation to this, the TPO noticed that the AE was recovering some part of AMP expense incurred by it from the taxpayer. Further, in view of the above recovery by AE and considering the magnitude of AMP expenses i.e. (2/3rd of total expense), the TPO concluded that the taxpayer created marketing intangibles for promotion of brand and products of the AE and opined that such expenditure was in the nature of intra-group services provided to the AE which require compensation on an Arm's Length basis.

- Accordingly, the taxpayer paid its proportionate share of reimbursement on cost to cost basis. Further, it was submitted that the approval and review of the advertisements to be telecasted in India by the AE were only to ensure that the applicable **"Brand guardrails"** are being followed and it is not at all directed to control the marketing function.

- Further, the Tribunal noted that the taxpayer has a marketing team in India and the taxpayer carries all the necessary function of strategizing, advertisement and marketing activities, its implementation for market penetration in India was as per the ethos, culture, and aspiration of the local population. Also, there was no material on record to infer that there was any arrangement or agreement with the AE wherein the taxpayer was required to spend on AMP or it was done at the behest of the AE.

- The ITAT referred to the definition of 'transaction' which has to be read in conjunction with the definition given in section 92B of the Income Tax Act, 1961 (the Act) and explained that for a transaction to be characterized as an international transaction, it is necessary to demonstrate that the transaction arose in pursuant to an arrangement, understanding or action in concert and such arrangement has to be between the two parties and not any unilateral action by one of the parties without any binding obligation on the other or without any mutual understanding or contract. Accordingly, if any party is incurring any expenditure for its own business purpose by its own volition without there being any binding obligation on the other or any kind of arrangement existing, then it cannot be characterized as international transaction within the scope and definition of section 92B (1). Hence, the Tribunal held that the expenditure incurred by the taxpayer was purely a domestic transaction entered with a third party in India for its own business purpose.

❖ Further, the TPO's contention that the taxpayer did not own and develop its own brand and thus AMP expenses incurred by the taxpayer was purely towards building the brand owned by AE. In this regard, the tribunal held that since the AE has not charged royalty for the use of trademark in India to allege that taxpayer should have been compensated for the brand developed and conceptualized by it, is too far-fetched and also considering that the brand developed in India is exclusively for the products to be sold in India. Accordingly, the same will only help in promotion of sales in India as it was manufactured after considering the spices suitable for local consumption and not in the jurisdiction of the other AEs.

❖ ITAT further place reliance on Delhi High Court ruling in case of Maruti Suzuki India Ltd, Honda Siel Power Products, Whirlpool of India Ltd., Bausch & Lomb Eyecare (India) Pvt. Ltd. Where it was held that "***in the absence of an agreement/arrangement with the AE, AMP expenditure could not be treated as an international transaction***".

❖ ITAT further referred to the final report of **Action 8-10 of Base Erosion and Profit Shifting Project (BEPS)** of OECD titled as **"Aligning Transfer Pricing Outcomes with Value Creation"** wherein it was suggested that no adjustment was required on AMP expenditure incurred by full-fledged manufacturers and if the legal owner did not perform any relevant function, used no relevant assets, and assumed no relevant risks but acted solely as a title holding entity, then the legal owner of the intangible would not be entitled to any portion of the return derived by the MNE group from the exploitation of the intangible other than the arm's length compensation, if any, for holding the title. Since PepsiCo Inc was not entitled to any return for holding such title, there was no reason as to why it should compensate its subsidiary in India for the marketing activities while operating in India as a full-fledged manufacturer who alone is reaping the profit from the operation in India.

❖ Based on above, ITAT concluded that "firstly, there is no international transaction in the form of any agreement or arrangement on AMP expenditure incurred by the taxpayer; and secondly, under FAR analysis also, no such benefit from the AMP expenditure having any kind of bearing on the profits, income, losses or assets as accrued to the AE or any kind of benefit has arisen to the AE."

Application of Profit Split Method

❖ ITAT observed that the TPO had neither applied PSM correctly nor had he analyzed the contribution made by both entities on the relative value of FAR of each of the entity and noted that TPO had not provided any reliable external data based on which the relative contribution of the entities involved in the transaction could have been evaluated either.

❖ Thereafter, TPO compared the AMP spent by the AE with that of the taxpayer Company and multiplied that ratio with the global net profit of the US parent AE arising from marketing activities to compute the TP adjustment on account of AMP expenses.

- ITAT opined that *"Such an approach of the learned TPO is wholly erroneous,* as *PSM* is *applicable mainly in international transaction involving transfer of unique intangibles or in multiple international transactions which are interrelated and interconnected that they cannot be evaluated separately for the purpose of determining the Arm's Length Price of any one transaction."*

- In view of this, ITAT held that the ***"profit earned on account of AMP expenses incurred by the taxpayer by way of economic exploitation of the trademark/brand in India already stands captured in the profit and loss account of the taxpayer company and the same has duly offered to tax and hence there was no logic to compute or make any Transfer Pricing Adjustment on this score."***

- ITAT also held that that *"Comparison of the AMP over sales ratio of the taxpayer with the AMP ratio of Pepsi Co Group on a worldwide basis was nothing but a* ***distorted version of the BLT.****"*

- Thus, ITAT concluded that *"in none of the year mentioned above, the AMP adjustment made by the TPO/Assessing Officer can be sustained and accordingly, same is directed to be deleted."*

NANGIA'S TAKE

- ***The issue in relation to 'marketing intangible' is recognized as an extremely challenging and complex issue especially considering that India is one of the largest consumption markets which has the potential to significantly enhance the brand value of consumer goods manufacturers.***

- ***The instant case raises the fundamental question that needs to be answered is that whether in the absence of any arrangement or agreement between the AEs for payment of AMP expenses can it be held as an international transaction, only on the basis that substantial AMP expenditure incurred by the taxpayers would have benefitted the AEs, who owned the brands used by the taxpayer.***

- ***This ruling also places reliance on <u>BEPS Action Plan 8-10</u> wherein it was stated that no adjustment was required on AMP expenditure incurred by full-fledged manufacturers. In the instant case, as the taxpayer's AE was not entitled to any return for holding the title of legal owner, therefore, there was no reason as to why it should compensate its subsidiary in India for the marketing activities carried out in India as a full-fledged manufacturer when the taxpayer alone was reaping the profit from the operations in India.***

- ***Further, As the AMP is a contentious issue and the matter relating to AMP expenses is pending for adjudication before the Supreme Court, the taxpayers are advised to look at their inter-company transactions/arrangements in a manner that the risks on account of such transfer pricing adjustments are minimized.***

<u>Source: PepsiCo India Holdings Pvt. Ltd (erstwhile Pepsi Foods Pvt. Ltd) [TS-1250-ITAT-2018(DEL)-TP]</u>

13. ITAT held that Hedging-loss on derivative contract entered with third parties to cover forex fluctuation for the purpose of loan advanced to its AE is not an international transaction

Outcome – In favour of taxpayer
Category – Interest on loan, applicability of Transfer Pricing and treatment of share application money.

Facts and Contentions

- Aries Agro Limited ("the taxpayer"), is engaged in the business of manufacturing, exporting of multi-micronutrient fertilizers, other nutritional products and major fertilizers.

- During the year under consideration, the taxpayer borrowed the loan from the ICICI Bank Bahrain@ LIBOR plus 250 basis points and advance the same to its subsidiary/Associated Enterprise ("AE") viz. Golden Harvest Middle East FZC and charged same rate of interest. The said loan was sanctioned for setting-up a manufacturing facility at Fujairah with an objective that majority of the production will be sold to taxpayer and will realise the benefit of cost economy in production.

- During the course of assessment proceeding, TPO found that the loan arranged by the taxpayer was a secured loan whereas the money advanced to the AE was an unsecured therefore there was an attendant risk in advancing the said loan. Accordingly, TPO observed that the taxpayer should be compensated for bearing an additional risk. Hence, TPO restricted the interest rate at 5.82% and proposed an upward TP adjustment.

- Further, after analysing the annual report of the taxpayer, AO made TP adjustment on account of hedging losses borne by the taxpayer was in the connection with the loan provided to the AE and considering it as an international transaction.

- Consequently, TPO proposed one more adjustment on the account of share application money remitted during the FY 2010-11 and 2011-12 and the shares were not issued within a reasonable period against the same due to the non-receipt of the approval from the free trade zone rules. Accordingly, TPO treated the share application money in the nature of loan @ 12.06% and proposed an upward TP adjustment.

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

Proceedings before ITAT ("the Tribunal")

ITAT made the following observations:

- ITAT relied upon ruling in the case of Everest Kanto Cylinder Ltd. V. ACIT and others wherein ITAT observes that the rate of interest charged by the taxpayer from its AE is same rate of interest which charged by the ICICI Bank Bahrain from the taxpayer @LIBOR plus 250 basis points which is benchmarked by applying CUP method.

- Further, in relation to hedging of foreign exchange losses ITAT held that the derivative contract entered into between the taxpayer and the independent third party i.e. ICICI Bank, Mumbai. Therefore, any expenses or losses on account of hedging of foreign exchange is not an international transaction as the said losses incurred under a contract between the taxpayer and third party.

- In regard to advancement of share application money by the taxpayer to its AE wherein ITAT held that no income has been accrued from the share application money to the taxpayer and therefore such transactions could not be subjected to transfer pricing provisions.

- In view of the aforesaid observations, ITAT reverse the direction of the DRP and direct the AO to delete the addition.

NANGIA'S TAKE

This ruling emphasised that the charging same rate of interest on loan advanced with that of loan borrowed does not lead to any earning of income as there is no increase in revenue and should not be liable for any upward adjustment. Further, foreign exchange loss on account of derivative contract entered with third party, to cover forex fluctuation in interest payment to foreign bank (on loan borrowed for further advancing to AE) is not an international transaction if there exists a written contract between the parties.

This ruling again highlights the issue of considering share application as international transaction which is a litigated issue in many rulings. The ITAT in the aforesaid ruling reiterates that transactions related to share application money falls outside the purview of Section 92 of the Act as no income is accrued on the same.

Source: Aries Agro Ltd [TS-1326-ITAT-2018(Mum)-TP]

14. 'Advance ruling- No IGST on the warehoused goods supplied to Domestic Tariff Area from Free Trade Warehousing Zone'

An recent advance ruling pronounced by the Tamil Nadu Authority for Advance Ruling ('AAR') in the matter of M/s Sadesa Commercial Offshore De Macau Limited ('Applicant') on the taxability of sale of goods to a Domestic Tariff Area from a Free Trade Warehousing Zone ('FTWZ'). The key substance of the advance ruling is discussed below:

The Applicant is a foreign supplier (manufacturer of leather) engaged in exporting goods to India from outside taxable territory (i.e. Thailand & Argentina). The applicant stores goods in FTWZ managed by Logistics Service Provider. In this regard, the applicant sought an advance ruling on:

Whether sale of goods stored and warehoused in FTWZ and supplied to a Domestic Tariff Area ('DTA') unit, would result in supply and subject to levy under IGST Act or CGST Act or TNGST Act ('GST Acts').
Whether the applicant is required to get registered under the GST Acts.

ORDER ISSUED BY THE AAR

In this matter, the AAR ruled as under:

- The Applicant is not liable to pay Integrated Goods and Services Tax ('IGST') when stored goods in FTWZ removed to DTA under GST legislation;
- Indian customer is required to pay Customs duty (i.e. Basic Custom Duty, IGST etc. as applicable under customs legislation) when the goods are removed from the FTWZ to DTA by filing bill of entry; and
- The Applicant is exclusively exporting goods to FTWZ and which are subsequently sold to Indian customer who clear the same on payment of appropriate custom duty. Thus Applicant is not liable for registration in terms of GST legislation.

It should be noted that an advance ruling pronounced by AAR or Appellate AAR is binding only on the applicant who has sought the advance ruling and on the concerned officer/jurisdictional officer in respect of the applicant. However, principles discussed in the said ruling may be referred in other cases as well. Copy of advance ruling is attached for your reference.

ABOUT US

Nangia Advisors LLP is a premier professional services organization offering a diverse range of Taxation, Transaction Advisory and Business Consulting services. Nangia Advisors LLP has presence currently in Noida, Delhi, Gurugram, Mumbai, Dehradun, Bengaluru and Pune. Nangia Advisors LLP has been in existence for more than 38 years and has been consistently rated as one of the best advisory firms in India for entry strategy, taxation, accounting & compliances over the past many years. Nangia Advisors LLP had announced a strategic collaboration agreement with Andersen Global last year in May. Andersen Global is an international association of legally separate, independent member firms comprised of tax and legal professionals around the world. Established in 2013 by US member firm Andersen Tax LLC, Andersen Global now has over 4,000 professionals worldwide and a presence in over 129 locations through its member and collaborating firms.

Quality of our people is the cornerstone of our ability to serve our clients. For this reason, we invest tremendous resources in identifying exceptional people, developing their skills, and creating an environment that fosters their growth as leaders. From our newest staff members through senior partners, exceptional client service represents a dedication to going above and beyond expectations in every working relationship.

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