Tax - Heads Up

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Contents	Page
Judicial Updates	2 - 3
Regulatory Updates	4
Other Updates	5 - 6

Judicial Updates

Li and Fung India (Delhi High Court)
Appeal No. 306 of 2012

Context: Transactional Net Margin Method ("TNMM") is one of the most commonly adopted method by taxpayers, to demonstrate that the transactions undertaken between Associated Enterprises ("AE's") are at arm's length. The instant case is one of the few ones in which the dispute was not regarding the TP methodology or comparables, but on the cost base that should be adopted while applying TNMM.

In this case, the taxpayer filed an appeal before the Delhi High Court, arguing that since it had earned adequate margins on the cost incurred by it in providing services to its AE, its international transaction was at arm's length. The Revenue argued that since the taxpayer had assisted its AE in providing buying support services to its customers, the arm's length margin should be computed as a percentage of FOB value of goods which have been exported by Indian manufacturers to independent third party customers (pursuant to efforts of the taxpayer). This stand of the Revenue was based on the argument that all the critical functions, being development of supply chain with the help of tangible and unique intangibles, were undertaken by the taxpayer, and since these functions had helped the AE to enhance its business and ensure locational savings for AE's overseas customers, the mark-up on cost paid to the taxpayer was inadequate and not at arm's length.

In its decision, the Court held that its the cost incurred by the taxpayer that has to be taken into account to determine if margins being earned by it are adequate; and adopting cost incurred by any unrelated party, third party vendor or the AE, to undertake such determination will be contrary to TP regulations.

The High Court made the following significant observations:

› Once TNMM was accepted to be the most appropriate method by the Revenue, only the norms and rules prescribed in law with regards to TNMM could have been applied. As these rules do not envisaged application of margins on cost incurred by third parties, approach adopted by the Revenue was wrong.

› While adopting such contrary mechanism to determine if a transaction is at arm's length, the Revenue authorities must clearly specify the reason for rejecting the taxpayer's approach.

› The Revenue should base its conclusions on specific facts, and not on vague generalities, such as "significant risk", "functional risk", "enterprise risk“, etc. – without any material on record to establish such findings. If such findings are warranted, they should be supported by demonstrable reason, based on objective facts and the relative evaluation of their weight and significance.

The Court determined that in view of the functions undertaken and limited risks of the taxpayer, the margins earned by it were adequate, and no interference in its approach was required.

Heads Up's Views:

The approach adopted by the Court is welcome, as it clarifies that in order to reject the TP analysis undertaken by the taxpayer, Revenue authorities are required to demonstrate adequate reasons and put forward cogent arguments. Any rejection of taxpayer's approach based on generic arguments is thus wrong and cannot be sustained.

Judicial Updates

Gem Granites (Madras High Court)
Appeal No. 504 of 2009

Context: Penalty for concealment of income has been a subject matter of persistent litigation. This judgment of the Madras High Court examined the impact of a recent decision of the Supreme Court, and laid down some important requirements for imposition of penalty for concealment.

In facts of the case, a search was conducted on the taxpayer and an addition was made on account of cash which was found. The taxpayer had contended that the said amount represented "on-money" which was to be taken into account as income in later years based on 'completed contract method' of accounting. In the appeals made against such addition, the same was sustained by the Tribunal.

In an appeal before the Tribunal against the imposition of penalty, the taxpayer argued that there was a mistake in entries made with respect to a particular sale and there was no concealment of income. On a detailed examination of this explanation as well as the facts of the transaction, the Tribunal held that penalty for concealment cannot be imposed as the possibility of wrong entry cannot be ruled out and the Revenue had failed in proving concealment beyond doubt.

The High Court, while deciding upon the Revenue's appeal, relied on factual observations of the Tribunal (on possibility of unintentional wrong entry) and upheld its decision. The High Court made the following significant observations:

- The *bona fide* explanation of taxpayer must be looked at, and his conduct should be taken into consideration for determining whether or not such penalty shall be imposed.
- In the recent decision of the Supreme Court in case of **Mak Data**, it was held that explanation to Section 271(1) raises a presumption of concealment, when a difference is noticed by the Tax Officer between the reported and assessed income. The burden is then on the taxpayer to show otherwise, by cogent and reliable evidence. When such initial responsibility is discharged by the taxpayer, the onus shifts to the Revenue to show that the amount in question constituted a concealment.
- Applying the above principal, the High Court held that the taxpayer – by providing a cogent and reliable explanation, that there was a mistake in entries made – has discharged the onus placed upon it. If the Revenue did not agree with taxpayer's explanation, it should have proved the factum of concealment. Since the Revenue failed to discharge such onus in the instant case, the imposition of penalty was not sustainable.

Heads Up's Views:

This is an important judgment which reinforces the importance of conduct of the taxpayer and lays down that *bona fide* arguments of taxpayer can help escape penalty, even if the underlying addition to income stands confirmed.

The decision also emphasizes that once the initial burden of providing cogent explanation has been discharged by the taxpayer, the onus then lies on Revenue to prove concealment.

Regulatory Updates

Another push to infrastructure from the RBI

To improve the flow of finances to the infrastructure sector, the RBI has introduced the following two changes to the Indian exchange control regulations:

1. The RBI has permitted Holding Companies /Core Investment Companies (CICs) to raise External Commercial Borrowings (ECBs) for project use in Special Purpose Vehicles (SPVs). Such permission is subject to several conditions such as:

- Business activity of the SPV should be in the infrastructure sector, as defined under the present ECB regulations. This definition was relaxed earlier this year, taking into account the harmonized master list of infrastructure sub-sectors.
- Such SPV should have been established exclusively for implementing the infrastructural project.
- It can raise such ECB upto 3 years after the date of their commercial operations.
- The ECB should be utilized either for fresh capex or for refinancing of existing rupee loans (for capex) availed from domestic banks.
- No other method of funding should be utilized for such portion of fresh capex that has been financed through the ECB.
- The other existing provisions of the ECB policy will continue to apply.

Wheels of Nation

2. The RBI has permitted Indian companies (that have been authorized by the Government), to borrow in local currency by issuing tax-free, secured, redeemable, non-convertible Rupee-denominated bonds to persons resident outside India – to use their proceeds for lending/re-lending to the infrastructure sector. Pending such permissible utilization, such proceeds can be parked in fixed deposits with Indian banks.

Heads Up's Views:

These developments are definitely positive news, as global investors, including FIIs, have been interested in investing in bonds issued by public sector companies such as NHAI, REC, PFC, IIFCL, etc. The borrowers will also benefit from this development as they get access to international investors, without being exposed to the exchange-fluctuation risk.

Other Updates

Cyprus Tax Saga,
and lessons for Multi-National Groups

If there is a God of taxation, the Island nation of Cyprus surely seems to have upset it. The tax woes of Cyprus began earlier this year when several countries, as a condition for bailing it out of its banking crisis, demanded to improve transparency in Cypriot banking sector. Its banking sector is long seen as having weak controls against money laundering.

Shortly thereafter, the Global Forum on Transparency and Exchange of Information for Tax Purposes (which is overseen by the Organisation for Economic Co-operation and Development) declared that Cyprus does not meet the international standards on tax transparency.

After the Indian enforcement wings also reported difficulty in eliciting information from Cyprus during their probes into money laundering and tax evasion, India too declared its 7th largest FDI contributor, as a 'Notified Jurisdictional Area'. This effectively resulted in withdrawal of treaty-benefits to payments made to Cyprus resident entities, subjected them to TP provisions and a 30% withholding tax, and most importantly, gave extremely wide powers to Revenue, to treat receipts from Cyprus as taxable in India, in the absence of a satisfactory explanation as to their source.

Pursuant to this development, Cyprus authorities are closely working with their Indian counterparts, to work out a solution. The developments so far, are as under:

- Cyprus and India have held consultations to address the issues of an effective exchange of information between them, and the long pending renegotiation of their DTAA.
- ‘Limitation of Benefit’, an anti-abuse provision, is being discussed for inclusion in the DTAA.
- A consensus appears to be emerging that once the notification of Cyprus as a ‘notified jurisdictional area’ is rescinded, it will be with retrospective effect.
- The Indian Ministry of Finance has decided to open an Income Tax Overseas Unit (ITOU) in Cyprus, for effective collection of information.

While the climax of this saga is yet to be seen, it leaves us with an important lesson.

The whole World is getting serious about tax transparency and OECD’s action plan on Base Erosion and Profit Shifting (BEPS), and India is no exception to this.

The MNC groups that have invested in India through any of the tax havens (particularly Luxembourg, British Virgin Islands, Switzerland, Seychelles, and of course, Cyprus), need to seriously re-evaluate their jurisdiction structures. GAAR provisions may be a few years away, but this is not likely to slow down the Indian taxmen from plugging the leakages on account of treaty structuring using non-transparent jurisdictions.

Other Updates

BIG BOSS chahtey hain
ki unhey tax na kaatna padey

The AAR recently ruled in favor of the BIG BOSS, or to be more specific, in favor of Endemol India (P) Ltd. (EIPL), the producer of the relaity show Big Boss and Fear Factor.

EIPL had engaged Endemol Argentina SA (Endemol) for providing line production services. While EIPL contended that these services are administrative and logistical in nature (and therefore, were not subject to withholding tax as 'Fees for Technical Services' or FTS), the Revenue argued that these services were technical in nature, as they were for providing special effects, photography, camera operator and sound system.

The Authority applied the 'Rule of Harmonious Construction' and agreed with the contention of the taxpayer that payments for production of programmes for the purpose of broadcasting and telecasting are covered under the scope of the expression 'work' as defined under section 194C of the Act; accordingly, the same cannot be taxed as FTS.

Big Boss is ruling kay liye Advance Ruling Authority ki sarahna kartey hain.

CBDT letter on Safe Harbour provisions

The term safe harbour refers to situations prescribed in law, wherein the Transfer Price declared by a taxpayer will be accepted by Revenue authorities. The safe harbour rules were introduced in September 2013.

Recently, CBDT has issued an internal letter on procedural applicability of these rules. The significant aspects covered in this letter are:

- Where the taxpayer has adopted safe harbour rules, but has reported margins which are less than those specified in the rules, income will be computed by the tax officer on the basis of margins / rates specified in these rules; and
- Where the taxpayer has not opted for safe harbour rules (or where exercising such option has not been found to be valid), the TP audit has to be conducted without taking into consideration, the margins / rates specified in the rules.

This letter provides guidelines as regards TP assessment.

Standard Abbreviations

The Act	The Income-tax Act, 1961
ST Law	Service Tax Law, i.e. The Finance Act, 1994
FEMA	The Foreign Exchange Management Act, 1999
DTAA	Double Taxation Avoidance Agreement
SC	The Supreme Court
HC	The High Court
ITAT / Bench / Tribunal	The Income Tax Appellate Tribunal
AAR	Authority for Advance Rulings
CBDT	Central Board of Direct Taxes
AO / Tax Officer	Assessing Officer
TPO	Transfer Pricing Officer
TP	Transfer Pricing
TDS / WHT	Tax Deducted at Source or Withholding Tax
RBI	The Reserve Bank of India
INR	Indian Rupees
AY	Assessment Year
Tax Year / PY	Previous Year
Sec.	Section
S.s.	Sub-section

Heads Up – Who are we

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Heads-up : hedzʌp / hedz-uhp / [Business English];

n. a short statement giving information on how a situation is developing; a piece of advice about something so that you are prepared for it.

adj. alert; perceptive; resourceful; quick to grasp a situation.

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