Tax - Heads Up

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Judicial Updates

Virola International – ITAT Agra

Context: Under the Indian tax laws, certain specified business expenditures including all international remittances that are taxable in India, are deductible in computing the payer's taxable profits, only if he has withheld appropriate taxes therefrom. Applicability of WHT provisions to such international remittances is dependent upon the provisions governing their taxability, which have been subjected to several retrospective amendments in last several years.

As a result, the tax position taken by a payer at the time of remittance, may get reversed by a future retrospective amendment to the provisions governing its taxability. In such a case, the tax authorities question the eligibility of the taxpayer for claiming such payment as a deductible expenditure, inspite of non-deduction of tax therefrom.

In the instant case, the Taxpayer incurred a 'design and development expenditure' in FY 2007-08 in respect of certain technical services which were rendered outside India by a non-resident. At the time of its payment, the legal position under the Indian tax laws (as explained by the Supreme Court in a landmark case) was that in order to bring a FTS to taxability in India, not only that such services should be utilized in India but these services should also be rendered in India. Basis such a position, the Taxpayer did not withhold any taxes from the subject remittance.

However, the tax officer took a view that the abovementioned position was altered by the Finance Act, 2010, through a retrospective amendment that brought even such FTS within the scope of taxation in India, where the services were rendered outside India – and accordingly, the payment had become subject to WHT in India by virtue of the amended law.

The ITAT, while upholding the view of the Taxpayer, held as under:

- Liability to withhold tax depends on the law as it existed at the time when payments were made.
- The payer cannot be expected to have the ability of knowing how the law will change in future.
- A retrospective amendment in law does change taxability of an income with retrospective effect, but it cannot change the tax withholding liability, with retrospective effect.

Accordingly, the ITAT held that the Taxpayer cannot be said to have defaulted in his withholding tax responsibility and the subject expenditure was, therefore, deductible in the relevant year.

Heads Up's Views:

Frequent retrospective amendments in the tax provisions applicable to non-residents, have noticeably dented the perception of India as an investor-friendly destination. The constant attempts made by tax authorities to stretch these amendments to the withholding tax liabilities of existing Indian businesses, adds insult to such injury. The decision of the ITAT highlights appropriately the impossible burden of expectations cast upon the Taxpayers by the authorities, and shows the right way of interpreting retrospective amendments.

Judicial Updates

Booz & Company (Australia) (P.) Ltd. – AAR

Context: It is a common feature of Global business enterprises to operate through local subsidiaries - which, for the purpose of their business, avail the services of personnel of their overseas affiliates. Indian authorities commonly take a position that such arrangements result in creation of an Indian 'Permanent Establishment' ("PE") of such affiliates, which triggers an adverse tax incidence for them.

The subject rulings were applied for, by several companies forming part of an MNC group (engaged in the business of rendering management consulting services), for a determination of taxability of their receipts in connection with provision of services of technical /professional personnel to their Indian group company. Their questions pertained to applicability of the provisions relating to Fees for Technical Services / Royalties, to such receipts. However, these questions proceeded on the premise that the affiliates do not have any PE in India – which was challenged by the tax authorities.

Such challenge was based upon the following facts (as stated in the Applications):

- Foreign group companies have the power to recall and replace its personnel.
- Overall control over the personnel is that of the foreign affiliates.
- Foreign affiliates are liable for third party liabilities in respect of claims made on Indian company.
- Business model of the group is such that all the entities in the group are interdependent as they cannot attain optimal efficiency without receiving services from each other.

The AAR held that the subject arrangement resulted in creation of an India PE, as well as a 'Business Connection' (a concept similar to that of PE, under the domestic tax laws) of the affiliates.

In arriving at this conclusion, it heavily relied upon the aforementioned facts and analyzed several relevant judicial precedents. The AAR referred to the following tests for establishing the existence of PE:

- The foreign company should have certain premises 'at its disposal' in the source country.
- The foreign company must have the element of ownership, management and authority over such local establishment.

However, apart from the above, the AAR has not elaborated, how the precedents analyzed by it are applicable to the facts of the case or lead to the conclusion that the affiliates have a PE / Business Connection in India. Further, it has not commented upon whether the affiliates have a Fixed Base PE, an Agency PE or a Service PE in India. Similarly, it has not specifically stated, as to which of the three prerequisite activities stated under the Act for constitution of a Business Connection in India, are being undertaken by the Indian affiliate.

Heads Up's Views:

Indian courts have examined on a number of occasions, the taxability of various arrangements wherein personnel employed by overseas companies are assigned (say, by way of secondment, deputation or stewardship) to their Indian group companies. However, due to varying approaches adopted in these decisions, the issue is far from settled. Given that such arrangements are common in almost all global businesses, there is an urgent need for clarifying the specific tests for determining the existence of an Indian PE of foreign companies.

Judicial Updates

Tilda Riceland Pvt. Ltd. (Delhi Tribunal)
Appeal No. 6279 of 2012

Context: The Indian TP regulations do not accord priority to any one Transfer Pricing methodologies over the remaining ones and there is no hierarchy in these methodologies. However, generally transactional methods for benchmarking international transactions are considered better in comparison to profit methods. This ruling of the Delhi bench of the Tribunal throws light on certain important issues in applying Comparable Uncontrolled Price ("CUP") methodology for benchmarking the international transactions.

In this case, the Taxpayer benchmarked the international transaction being export of different qualities of rice to its Associated Enterprises ("AE") (for which no fixed price contracts were entered into) by using CUP methodology. In benchmarking the transaction, the Taxpayer compared average price of exports made by it to its AE with average price of similar transactions as per database of export data, compiled by a private software company. This database was made on basis of export data collected by the software company from information publicly available with Customs Department, by categorising prices on basis of quality of rice exported and geographical location to which exports were made. While making the comparison, the Taxpayer also made certain adjustments being elimination of transaction with extraordinary profits etc.

The TPO did not agree with the approach adopted by the Taxpayer and held that for adopting CUP method, stringent comparability is required which was not present in the instant case. The TPO also held that the software relied upon by the Taxpayer is not covered within comparable information prescribed under TP provisions, and thus cannot be relied upon.

The TPO further questioned various adjustments made by the Taxpayer while making the comparison and rejected the method adopted while proceeding to determine Arm's Length Price ("ALP") using Transaction Net Margin Method ("TNMM"). The Dispute Resolution Panel agreed with all the observations of the TPO.

The Tribunal while deciding on Taxpayer's appeal against rejection of CUP methodology held as under:

- The TPO was wrong in rejecting the database used by the Taxpayer for applying the CUP methodology as the same only provided compilation of publicly available data. The Tribunal also held that Rule 10D(3) of Income Tax Rules is only illustrative and not exhaustive, and thus information available in public domain can be used as a comparable while applying CUP methodology.

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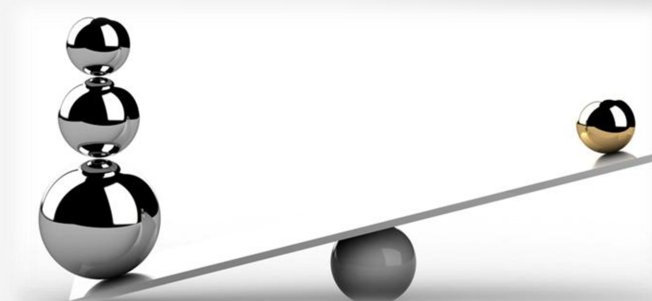

Judicial Updates

- For applying CUP methodology, the comparables need not be exactly the same. In case products are general in nature and have been categorized on reasonable generic description, the same is sufficient for analysing comparability.

- Even though the choice of methodology by the Taxpayer was correct, the Taxpayer erred in the manner in which the same was applied. Each international transaction undertaken by the Taxpayer has to be benchmarked, and thus the Taxpayer had erred in comparing average of its export price for various transactions with average uncontrolled export price. It was held that while average of uncontrolled export price can be used as comparable, every export transaction to AE (and not average of all such transactions) has to be compared with the same.

- It was also held that unless there was a cogent reason to do so, the Taxpayer while applying the CUP method had erred in excluding uncontrolled transactions undertaken at exceptionally high prices. The Tribunal held that the same was not permissible under the CUP methodology.

- In light of the aforesaid, the matter was remanded back to the AO for determination of ALP by applying the CUP methodology.

Heads Up's Views:

This is an important judgment which provides significant guidelines on the manner in which CUP methodology is to be applied for benchmarking an international transaction. It reinforces the usage of publicly available data for undertaking comparability analysis under CUP and clarifies that attributes of comparable transactions need not be 'exactly' the same as the transaction being benchmarked.

Judicial Updates

Maruti Suzuki India Limited (Delhi High Court)
Writ Petition No. 5086 and 5003 of 2013

Context: Powers of the Tribunal to grant stay of demand has been the subject matter of several judicial controversies in recent past. The Courts have had divergent views on whether the Tribunal has the powers to grant stay of demand beyond a period of 365 days. This ruling of the Delhi High Court tries to elucidate on the issue.

In this case, the Revenue moved the Court against the order of the Tribunal extending the stay of demand beyond a period of 365 days. It argued that post the insertion and further amendment of third proviso to section 254(2A) of the Act, the issue is settled and the Tribunal does not have the powers to extend the stay beyond 365 days. The said proviso was amended by Finance Act 2008 and provided that the period of stay granted by the Tribunal shall not exceed 365 days in any case, and the order of stay shall be vacated after expiry of this period, even if the delay in disposal is not attributable to taxpayer.

The Taxpayer argued that such interpretation will be against the principle of natural justice, as the Taxpayer will be adversely impacted even in cases when the delay is administrative and the Taxpayer has no fault in the same. The Taxpayer argued that the Tribunal has inherent powers to grant stay and the intent of insertion of the proviso was to ensure speedy disposal, and not to take away the right to grant stay in deserving cases.

The Court while deciding on the issue held:

› There may be instances when delay in disposal is not attributable to the Taxpayer, but since Courts are there to interpret the law and not legislate; they cannot go beyond the written statute. Therefore, post amendment to third proviso, the Tribunal cannot grant stay beyond 365 days.

› The Court, however, held that in such cases the Taxpayer can approach the High Court by way of a writ petition for extension of stay beyond 365 days. In such cases the High Court will examine the factual matrix and shall grant extension of stay in appropriate cases. The High Court also observed that to avoid High Courts being burdened by such petitions, the Tribunal must ensure disposal of appeal within the period of 365 days, and in cases where delay is attributable to Revenue authorities, the authorities must give an assurance that no coercive steps will be taken to recover the demand.

› In light of the aforesaid observations, the High Court in the instant case directed the Tribunal to dispose the appeal at the earliest (preferably in two months) and granted the stay for this period.

Heads Up's Views:

There have been divergent judgments on this issue from different courts. While Bombay High Court has taken a favorable position, the Karnataka High Court in a recent case decided to take an adverse view. The issue is also pending before the Supreme Court. Pending disposal of the issue in the Apex Court, this judgment provides a clear alternative to the Taxpayer for getting stay of demand beyond 365 days, in case when the delay in deciding the appeal is not attributable to the Taxpayer.

Other Updates

Circular – Disallowance under sec. 14A where no exempt income earned during the year

Context: Sec. 14A of the Act was introduced in 2001 in order to disallow such expenses that are incurred by taxpayers to earn tax-exempt incomes, and it has constantly been in tax-news since then. Its applicability has been challenged by the taxpayers on various grounds, several of which have been often upheld by the courts. One of such grounds is the validity of such a disallowance in a tax year wherein the taxpayer has not earned any exempt income.

In several cases, Taxpayers challenged the disallowances made by tax officers under section 14A of the Act, on the ground that during the said year, no exempt incomes had been earned by them and therefore, section 14A cannot apply to such years. While a Special Bench tried to clear the confusion resulting from contradictory decisions pronounced in past by several benches of the Tribunal and held that disallowance under such circumstances is possible; the Gujarat High Court in its subsequent decision (which relied upon tribunal decisions passed prior to that of the Special Bench decisions), held the opposite and restored the position back in favor of the taxpayers.

In order to make its stand clear, the CBDT has recently released a circular, clarifying that the intent of introducing sec. 14A of the Act, was to allow only such expenses which are relatable to earning of income and therefore, expenses which are relatable to earning of exempt income have to be considered for disallowance, irrespective of whether or not any such income has been earned during the year.

It is pertinent to note that this circular is not binding on the taxpayers or the judiciary, and represents, at best, the position of the CBDT.

In other words, while the taxpayers are free to take a position contrary to this circular, they should be mindful that the same will, in all likelihood, result in a challenge from the tax authorities.

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
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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