Tax - Heads Up

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Steria India Limited (AAR)
AAR No. 1055 of 2011

Context: Applicability of protocols signed along-with the Treaty is an issue which has been time tested. The applicability thereof seemed to be a settled position. This ruling, however, has raised doubts over this settled position of applicability of protocols and once again highlights the need for uniformity in interpretation of tax laws to restore investor confidence and boost economy.

In this case, the Taxpayer availed management services from Steria France. Though the services qualify as FTS under the domestic tax laws as well as India-France DTAA, however, pursuant to the Most Favored Nation ('MFN') clause in the protocol to India-France DTAA, the Taxpayer contended that the restrictive definition of FTS in India-UK DTAA (i.e. 'make available' clause) need to be read into India-France DTAA. Accordingly, since the make available clause is not satisfied in the present case, the management services would not qualify as FTS.

The AAR rejected the argument of the Taxpayer and held the following:

- AAR relied on its own ruling in the case of Perfetti Van Melle Holdings B.V. and held that a protocol cannot be treated as the same with the provisions contained in the DTAA itself, though it may be an integral part thereof.
- Protocol could be used for interpreting provisions of DTAA, but cannot be used to import any clause like 'make available' therein, so as to change the tax complexion of its provisions;
- Notification giving effect to the protocol did not include anything about the 'make available' provision. Had the intention been to include 'make available' clause in India-France DTAA, the same would have been done in the Notification itself.

Thus, AAR held that the services would qualify as FTS and the Taxpayer is liable to withhold tax on the same.

Heads Up's views:

The AAR ruling ignored various judicial precedents in favor of the Taxpayer on protocols being an integral part of the DTAAs and unsettled an existing position on applicability of protocols. Furthermore, this ruling failed to distinguish between protocols which are automatic and the ones which require further action (like India-Switzerland and India-Philippines DTAA). Also, this ruling has suggested a very restrictive application to MFN clause by applying the same, only to the rates contained in the DTAA and not to scope thereof, without giving any basis for the same.

Judicial Updates

Nortel Networks India Intl. Inc. (Delhi Tribunal)
ITA No. 1119-21 and 1153-55 of 2010

Context: Taxation of foreign companies from offshore supply of equipments to India (which forms part of a turnkey contract), has constantly drawn attention of Indian authorities. While there have been several landmark decisions on this issue, it remains one of the foremost areas of tax litigation, due to ever evolving contract structures, unique facts of each case and high stakes involved.

This case relates to 3 group entities – Nortel India, Nortel US and Nortel Canada. Nortel India entered into a contract with Reliance Communications for supply of hardware equipment, and for installation thereof. The equipment supply contract was assigned to Nortel US which, in turn, purchased the equipments from Nortel Canada and supplied them under an arrangment purported by the Taxpayer, to be an 'Offshore supply', not taxable in India.

However, the Revenue did not agree to the Taxpayer's position and emphasized that:

- Nortel India undertook all pre-supply activities, including negotiation of all terms, finalization of documents and signing of the contract.
- Immediately after signing of the contract, it was assigned to Nortel US (that was incorporated just the day before) without any consideration.
- Employees of Nortel US carried out its business through the premises of Nortel India and the LO of Nortel Canada. Hence. both Nortel US and Nortel Canada had a PE in India.
- Title in the equipments had passed in India and therefore, profits therefrom were taxable in India.
- Estimation of profits attributable to the Indian PE was not possible on the basis of the P&L account furnished by Nortel US – as it was unaudited, and showed an unexplainable gross loss of 65% and 48% (in 2 years) on sale of equipment purchased from its group company.

The first appellate authority upheld the assessment order, and held that 50% of the profits (as determined by the AO) from supply of hardware to Indian customers, were attributable to the alleged PE in India.

Upon a cross-appeal, the ITAT upheld the order of the first appellate authority in favor of the Revenue. In doing so, it held that:

- Nortel US was only a paper company, formed for the sole purpose of evading taxes in India.
- Nortel India and the LO of Nortel Canada constituted an Indian PE of Nortel US as well as Nortel Canada. Nortel India not only acted as a service provider, but acted as a sale outlet.
- The supply was not completed overseas, and the equipment remained in 'virtual possession' of Nortel Group (till the time it was set up and acceptance test was done).
- Had Nortel US entered into an arm's length transaction with Nortel Canada, there would have been no reason for it to have made such huge operating losses.
- Accounts of Nortel Group (and not that of Nortel US alone) would give a true and correct picture of profit of the Taxpayer.

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Nortel Networks India Intl. Inc. (Con'd)

- Various attribution rates cited by the Taxpayer could not be considered without taking into account the facts of the cases in which the said rates were upheld.

In light of the above, the ITAT attributed to the Indian PE, 50% of the profits (from various activities including supply of equipment) after reducing selling and R&D expenses from gross profit computed by reference to the GP margin applicable to global accounts.

Heads Up's views:

This decision stands out from various judicial pronouncements on taxability of turnkey contracts and offshore supplies.

In this case, the Taxpayer offered remarkably detailed legal submissions on how Nortel US and Nortel Canada did not have a PE in India, and even if for argument's sake, they had a PE in India, how no part of their income (particularly income from equipment supply contract) could be taxed in India. However, the ITAT did not undertake a very detailed analysis of each of these legal arguments.

On the other hand, the Revenue aggressively attacked the Taxpayer on facts – creating severe doubts on the *bona fide* of the structure. The Revenue even disputed the genuineness of documents furnished by the Taxpayer, particularly where they were confidential documents of its competitors, and challenged how they came into Taxpayer's possession.

The ITAT, it seems, was significantly convinced with the Revenue's arguments.

The immediate take-aways from this decision, are:

- The quality of representation by the Revenue in the course of litigations, has gone up tremendously.
- In case the facts of the case suggest tax avoidance through use of conduit companies, and group company transactions that do not meet the tests of commercial expediency and arm's length approach – No amount of aggressive structuring and complex legal submissions can be of much help.

Judicial Updates

Cushman & Wakefield (India) P. Ltd. (Delhi HC)
Income Tax Appeal No. 475 of 2012

Context: Reimbursement of expenses to AE has always been a contentious issue. It is a settled position that reimbursement of expenses solely incurred by the AE for the specific need of the Indian taxpayer shall be treated as reimbursement. However, if services are being provided by any employee of the AE and the expenses are recharged to the Indian taxpayer, adopting an argument that the same amounts to reimbursements of cost and thus does not require benchmarking, may not stand judicial scrutiny. This case examines the need for benchmarking in instances when cost of services are claimed to be reimbursements. The case also lays down the domain of the AO and the TPO with respect to examination of international transactions.

In this case, the Taxpayer paid certain amount to its Overseas AEs for coordination and liaison services in respect of its clients. The Taxpayer claimed that as it paid only for the cost incurred by overseas AE and nothing more, no benchmarking is required to be undertaken for the said payment.

The Taxpayer further contended that in contrast, an uncontrolled transaction would involve an additional element of profit for the service provider, which means that the Arm's Length Price ("ALP") for such a transaction would at least be above or equal to what was paid by the Taxpayer. Undoubtedly, this would place the transaction within the realm of Section 92(3) of the Act, which states that the provisions of Section 92 of the Act will not apply if the result of the ALP determination is a reduction of the overall tax incidence in India.

The AO referred the payments to TPO, who disallowed deduction of such reimbursement of

costs on the basis that no evidence for provision of services was produced by the Taxpayer. The DRP in its order also concurred with the view of the TPO.

On appeal, the ITAT decided the issue in favor of the Taxpayer on the basis that the Taxpayer had provided evidence to demonstrate that the service was indeed provided. Aggrieved by the impugned order, the Revenue appealed before the High Court. The Delhi High Court while deciding on the issue held that:

› Certain amounts were charged by the AEs as reimbursement for actual costs incurred. Nevertheless, whether a third party, in an uncontrolled transaction with the Taxpayer would have charged amounts lower, equal to or greater than the amounts claimed by the AEs, has to be tested under the various methods prescribed in Section 92C of the Act;

› The question which thus required to be addressed and determined is that for the same services as were provided by the AEs, what amount would have been charged by an independent entity;

› An independent entity would quite possibly include a mark-up, and thus exceed the value charged by the AEs in this case. The cost incurred by other entities may be more (in which case Section 92(3) would clearly apply), or lower. This however, cannot be a matter of speculation or a logical inference from the fact that the AEs have only asked for reimbursement of cost;

- This being a transaction between related parties, the only matter to be tested under a comprehensive transfer pricing analysis is whether or not the cost itself is inflated; and
- Only after ALP is determined, one can consider provisions of Sec. 92(3) and thus the stand of the Taxpayer that no benchmarking is required in the instant case is incorrect.

The Court set aside order of the ITAT deleting the adjustment and directed the TPO to verify actual activity carried out and determine correct value for the same.

While deciding on the issue, the HC, relying on couple of ITAT judgments clearly laid out the domain of the AO and TPO in examining an international transaction. The Court held that the role of the TPO is restricted to determination of ALP for a transaction and the TPO is not authorised to examine the need or benefit of a service rendered.

The HC held that examination of a payment from the perspective of it being incurred for purpose of business is in realm of the AO and if this condition is satisfied, expenditure is to be allowed irrespective of its need or whether the same generated any monetary benefit.

In the instant case, the payment of referral fee by the Taxpayer to its AE (held to be at arm's length by the TPO) was also examined. In this regard, it was held that irrespective of the fact that referral fee has been held to be at arm's length by the TPO, the AO can still examine the payment to determine if the same was for the purpose of business and whether services for which payment is being made, were indeed rendered.

On this issue the Court clearly disagreed with the view of the ITAT which had held that once the transaction has been held to be at arm's length by the TPO, the same cannot be examined by the AO for issues other than pricing of the same.

Heads Up's views:

This ruling is important as the same clearly lays down the respective domain areas of an AO and TPO in examining an international transaction. It also provides clear guidance on the fact that irrespective of the claim of the Taxpayer that payment made by it to its AE for a service is only cost reimbursement, the same is to be benchmarked using TP methodology. On the other hand, it also clearly states that the role of the TPO is to determine value of service and venturing into issues of need and benefit of a payment, would be beyond his authority.

Judicial Updates

Bharat Bijlee Ltd. (Bombay HC)
Income Tax Appeal No. 2153 of 2011

Context: Slump sale is transfer of a business as a going concern, lock, stock and barrel. While the simplicity of this medium finds favor in the commercial world, the complexity of disputes around its taxation compelled the legislature to bring an amendment in the Act through the Finance Act, 1999. This amendment, *inter alia,* defined a 'Slump Sale' as a transfer of a business undertaking as a result of the sale for a lump sum consideration.

In this case, the Taxpayer transferred its 'Lift Division' under a Court sanctioned Scheme of Arrangement under the Companies Act, 1956. No monetary consideration was received by the Taxpayer for such transfer. Instead, it was issued preference shares and bonds by the buyer company.

The AO taxed this transaction (under the specific provision inserted by the Finance Act, 1999 for taxing slump sales), by treating the fair value of such shares and bonds, as the sale consideration.

In an appeal before the Bombay HC, the Revenue argued that the subject transaction was for consideration in rupees, and merely because the transfer was based on a Court sanctioned Scheme of Arrangement, it did not mean that it was not a slump sale.

On the other hand, the Taxpayer contended that since the undertaking had been transferred for issue of shares and bonds, no monetary consideration was received by it. Consequently, the transfer was an 'exchange' and not a 'sale' – and did not qualify as a slump sale, as defined under the Act.

After a detailed analysis, the High Court held in favor of the Taxpayer, that the subject transaction did not qualify as a slump sale. In doing so, it specifically observed that:

- This was not a case where the consideration was determined and decided by parties in terms of money, but its disbursement was to be in terms of allotment / issue of shares or bonds.
- A combined reading of the entire Scheme of Arrangement, envisaged that the transfer of the Lift Division, was not for any monetary consideration.
- In light of the above, the subject transfer was a case of exchange and not a sale.

Accordingly, the Court held that as the expression 'slump sale' is defined under the Act, to mean transfer 'as a result of the sale', the subject transfer was not a slump sale.

Heads Up's View:

The HC has interpreted the definition of 'slump sale' in a strictly literal manner. We believe such distinction – while interesting in an academic sense from the perspective of principles of interpretation and jurisprudence – could be abused by unscrupulous taxpayers by masking a 'slump sale' as a 'slump exchange' to avoid paying capital gain tax on business transfers.

Judicial Updates

Paramount Communication Ltd. (Jaipur CESTAT) 2014 - TIOL - 630

Context: This case examines whether the provisions of the Factory Act, 1948 will affect the ability of a taxpayer, to avail the credit of service tax paid by it on outdoor catering services for providing food to its employees.

Under sec. 46 of the Factory Act, 1948, it is mandatory for every factory to provide canteen services to its employees, when their number exceeds 250.

Availability of credit of service tax paid on outdoor catering services, in case of applicability of sec. 46 of the Factory Act, has been examined and upheld in past by the CESTAT, in the case of GTC Industries Ltd.

In case of the Taxpayer, the Commissioner (Appeals) chose not to follow the said decision, by observing that in aforementioned decision, outdoor catering service were held to be an input service, because the taxpayer in that case was under a statutory obligation to provide such services (having more than 250 workers). He distinguished that in the present case, the Taxpayer was under no such obligation, as it had less than 250 employees.

Upon appeal, the CESTAT observed that in the abovementioned case, the factual position as regards the number of workers was only one of the criteria upon which the Larger Bench had relied to hold the services as input services; but the same could not be inferred to mean that the said aspect alone, was the ratio of the law declared by the Larger Bench, without taking into account its reasoning.

Further, the CESTAT observed that the Larger Bench had placed more emphasis on the fact that outdoor catering was an input service, irrespective

of whether the expenditure was borne by the factory, recovered from workers or provided by way of subsidized food.

It also placed reliance on two decisions of the Karnataka HC on similar issue - in the case of Stanzen Toyotetsu India (P) Ltd., and in the case of ACE Designers Ltd. Following these decisions, the impugned order was set aside and the appeal was allowed in favour of Taxpayer.

Heads Up's Views:

The CESTAT has pronounced a very rational decision while setting aside the artificial distinction made by the first appellate authority, for not following the decision of the Larger Bench in the case of GTC Industries Ltd.

This decision has put to rest the issue of admissibility of CENVAT credit for service tax paid on outdoor catering, irrespective of whether or not a taxpayer is under a statutory obligation to provide food under the Factories Act, 1948.

Judicial Updates

RL Fine Chem. (Bangalore CESTAT) 2014-TIOL-737

Context: The present case examines whether a refund claim filed be a taxpayer within due-date can be denied on the grounds of limitation – where it was returned by the authorities due to certain deficiencies and the taxpayer re-submitted the completed documents after the due date.

In this case, the Taxpayer filed on the applicable due date, a claim for refund of service tax paid on commission on export sales, under Notification 41/2007-ST dated 06 October 2007 (as amended by Notification 17/2008-ST dated 01 April 2008). The refund was sanctioned by the authorities after the Taxpayer complied with a deficiency memo issued by them, by re-filling complete set of documents along with the application for claim of refund.

Upon challenge, the first appellate authority denied the refund on the ground that the Taxpayer has filed the claim, beyond the period specified in the Notification.

The Taxpayer appealed to the CESTAT and contented that:

- benefit of the Notification should not have been denied, as the claim was filed within the due date.
- After filing of the claim, the Superintendent of Central Excise, issued a letter intimating certain deficiencies therein – that the Taxpayer had not furnished bank realization certificates and proof of having paid the service tax.
- The refund claim was returned to the Taxpayer, to get the deficincies removed
- The claim was re-filed alongwith the certificate and proof of payment.
- Reliance was placed by the Taxpayer, on the decision in the case of Sudhir Papers Ltd. (Kar.).
- It was also highlighted that as such, the claim could not have been returned by the Superintendent, as he had no such authority.

The Revenue contented that as per the conditions specified in the Notification, the Taxpayer was required to submit the claim alongwith all relevant documents. In the absence of such documents, the claim filed was not valid, and refilling thereof falls beyond the prescribed limitation period.

The CESTAT observed that the eligibility of the claim *per se* was not in dispute, and the question before it was whether its re-submission was hit by the limitation prescribed in the Notification. In this regard, it held that;

- A substantive benefit should not be denied to a taxpayer, if underlying conditions stand fulfilled.
- Instead of returning the claim, the Superintendent could have just asked the Taxpayer to file the missing documents; in such a case, the refund claim (once rectified) would have been well within the prescribed limitation period.
- The Notification does not envisage rejection of the refund claim when it is due, if the exports are made and substantiated.

Heads Up's Views:

This decision will play an important role in avoiding unnecessary litigation. It reiterates the logical view, that a right of the taxpayer can not be denied on the ground of limitation, merely due to a procedural deficiency.

Heads Up – Who are we

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Business Advisory

Heads-up : hedzΛp / 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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AAR	Authority for Advance Rulings
Act	Income Tax Act, 1961
AE	Associated Enterprise
AO / Tax Officer	Assessing Officer
CCE	Commissionerate of Central Excise
CESTAT	Customs Excise Service Tax Appellate Tribunal
DRP	Dispute Resolution Panel
DTAA	Double Taxation Avoidance Agreement
FTS	Fees for Technical services
HC	High Court
ITAT	The Income Tax Appellate Tribunal
Sec.	Section
TP	Transfer Pricing
TPO	Transfer Pricing Officer