EY Tax and Regulatory Alert

July 2018

Prepared for ACMA

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Indirect Tax

This Section of Tax alert summarizes the Indirect tax updates for the month of July 2018

Judicial Precedents

1. M/S Hyundai Motors India Limited Vs Commissioner of Central Excise & Service Tax, LTU, Chennai

[2018-VIL-455-CESTAT-CHE-ST]

Background and facts of the case

- In the present case Hyundai Motor India Ltd. (HMIL), the appellants herein have company owned show rooms and workshops at Chennai and Delhi. They are registered with the department under the category of "Authorized Service Station Service" and "Business Auxiliary Service" (BAS).

- Pursuant to investigations conducted by the DGCEI, it appeared that the Chennai show room (Appellant 1) of the appellants advised their customers to approach the HDFC bank for taking insurance policies for the vehicles. So also, it appeared that the Delhi show room (Appellant 2) of the appellants advised their customers to approach the HDFC Chubbs or UIIC for taking insurance policies for their vehicles.

- It further appeared that there was a Business Referral Arrangement between both these appellants and HDFC Chubb, as per which for consideration for the payment of Referral Fee, appellants would provide HDFC Chubb with access to their updated customer data basis. The Referral Fee would be paid by HDFC Chubb on the basis of Gross Written Premium (GWP) generated and realized by them on fresh policies issued by them for the first time to customers using the said customer data base, on the condition that such fee payable would not exceed 10% of the GWP.

Department's Contention

- Department took the view that this activity of both the appellants are in the nature of promoting and marketing of insurance products and services provided by HDFC Chubb and would therefore fall under the category of 'Business Auxiliary Service' (BAS) as in Section 65 (19) of the Finance Act, 1994.

- A show cause notice dated 21 Oct 2008 was issued to Appellant-I proposing recovery of service tax amounting to Rs.7,31,883/- with interest and imposition of penalties under various provisions of law.

- Another show cause notice dated 28 Jan 2009 was issued to Appellant-II proposing recovery of service tax amounting to Rs.4,30,562/- with interest and penalties. On adjudication of these notices, original authority confirmed demands of service tax of Rs.6,12,558/- and Rs.4,02,886/- respectively with interest and also imposed penalties under Section 76, 77 & 78 of the Act.

Appellant's Contention

- No relationship in nature of principal and client exist between HMIL and HDFC – hence order deeming that commission received in capacity of 'commission agent' is erroneous.

- Reading definition of BAS – intention of legislature is to tax only third party who acts as an agent for/ on behalf of principal who undertake to sell or distribute goods or alternatively undertakes provision or receipt of services on their behalf for any consideration.

- Commission is for service rendered for selling/ distribution of good sunder an agreement between principal and agent, principal has right over goods/ services, empowers agent to undertake promotional and marketing activities.

- Contractual arrangement is only to extent of sharing database with HDFC

- Service not rendered as commission agent

- Point No.6 of agreement clearly indicates that appellants were not promoting the services of HDFC Chubb:

  > *"You shall not in any manner solicit or procure insurance business for or on behalf of HDFC Chubb. Further you shall not at any time hold yourself out to be a licensed insurance agent of HDFC Chubb during the terms of the agreement".*

Held by Commissioner

- Perusal of the agreement reveals that it is not the case that appellants had provided their updated customer data base for a onetime fee
- On the other hand, HDFC Chubb became entitled to access to the customer data base of the appellants and the Referral Fee was paid only as and when the former could generate and realize fresh car insurance policies
- Based on that information, the appellants may not have actively promoted the insurance policies of HDFC Chubb
- But in restricting their data base access only to HDFC Chubb, that too on real time basis and they enabled the latter to have access to a pool of new vehicle buyers who would obviously also need first time car insurance. The appellants have, in commissioner's view, therefore promoted the business of HDFC Chubb and for which services they were given agreed upon payment for every car insured by HDFC Chubb
- In the present appeal, Commissioner find that the transactional documents and other evidences on record indicate a substantial activity falling within the contours of the definition of 'Business Auxiliary Service' in Section 65 (19) of the Finance Act, 1994
- Hence Commissioner did not find merit in the plea made by the appellant that the impugned activity would not fall within the fold of BAS. Commissioner therefore did not find any infirmity with that portion of the impugned order confirming/ upholding the tax liabilities of Rs.6,12,558/-and Rs.4,02,886 with interest
- However on the matter of penalty, Commissioner find that the issue per se was entangled in confusion and litigation. As earlier noted, the Larger Bench of the Tribunal was constituted only in the wake of conflicting decisions of the coordinate Benches. In such a scenario, it has to be held that appellants had a reasonable cause for their failure to discharge tax liability and given the benefit of doubt
- In light of the above situation, penalties confirmed/ upheld against the appellants is set aside

2. M/S Nissan Motor India Limited Vs Commissioner of Central Excise, Chennai-IV

[2018-VIL-437-CESTAT-CHE-CE]

Background and facts of the case

- Brief facts are that the appellants are engaged in manufacturing motor cars and their parts and are availing the facility of CENVAT credit of duty paid on inputs, capital goods and service tax paid on input services. The appellant informed the department that to facilitate the process of simplifying the manufacturing activities in India, they decided to sell all the machinery and inventory owned by them to M/s. Renault Nissan Automotive India Pvt. Ltd. (herein after referred to as M/s. RNAIPL)
- The business change scheme accorded only to transfer of assets to M/s. RNAIPL and the liabilities would rest with the appellant. Thereafter, the appellant surrendered their registration certificate on 10 April 2012 and became non-functional. They then filed a refund claim on 28 January 2013 for Rs.3,62,58,851/- for the CENVAT credit balance and since they had utilized the balance on various occasions to the tune of Rs.3,37,40,140/-, under intimation to the department filed revised refund claim to the tune of Rs.25,18,712/- only
- Show cause notice dated 15 September 2015 was issued as to why the refund claim should not be denied. After due process of law, the original authority rejected the claim of Rs. 25,18,712/-. In appeals, the Commissioner (Appeals) upheld the rejection

Appellant's Contention/Submission

- It was submitted by the Appellant that they have surrendered the registration certificate and have become totally non-functional
- The whole of the assets were transferred to M/s. RNAIPL and the appellant has retained only the liabilities
- As per the terms and conditions of the business change scheme agreement, the parties had agreed to transfer only the assets and the CENVAT credit was not included in the list of assets

- To support that the CENVAT credit which is lying in balance in the account due to closure of factory, has to be refunded to the assessee, the appellant relied upon the decision in the case of Union of India Vs. Slovak India Trading Co. Pvt. Ltd. – 2007 (1) TMI 556 – SC - 2007-VIL-43-SC-CE

Revenue's Contention

- The appellant ought to have transferred the balance CENVAT credit to M/s RNAIPL who has purchased the machinery and inventory from them. The said unit would thus be able to utilize the CENVAT credit
- There is no provision in the law to refund the CENVAT credit in cases of closure of factory. Therefore, the authorities below have rightly rejected the claim

Held by Commissioner

- Commissioner observed that in present case, as per the business scheme change agreement entered into between the parties, there is no terms and conditions in respect of transfer of CENVAT credit to M/s. RNAIPL
- The appellant has submitted that the liabilities are retained by the appellant. They have surrendered the registration and undisputedly they have become non-functional with effect from 10 April 2012
- Thus they have ceased to be manufacturer of cars with effect from 10 April 2012 due to closure of unit/ surrender of Central Excise registration
- Decisions held by Learned Consultant in case of Rama Industries Ltd. Vs. Commissioner of Central Excise, Chandigarh – 2009 (2) TMI 136 P&H, Apex Drugs and Intermediates Ltd and in case of Slovak India Trading Co. Pvt. Ltd (supra) as well as the decisions of the Tribunal have held that the appellant is eligible for refund of the balance CENVAT credit when the appellant ceases to be a manufacturer due to closure of factory
- The impugned order rejecting the refund claim is set aside and the appeal is allowed with consequential relief, if any

3. M/S Mahindra Two Wheelers Limited Vs C.G.S.T, C.E & C.C.-C.C.E. & S.T.-INDORE

[2018-VIL-471-CESTAT-DEL-CE]

Background and facts of the case

- The facts of the matter in brief are that the Appellant are engaged in the manufacture of two wheelers e.g. motor cycles and scooters falling under Tariff Heading No.8711 20 20 & 8711 20 19 of the First Schedule to the Central Excise Tariff Act, 1985. They are availing the facility of CENVAT credit as provided under Rule 9 of Cenvat Credit Rules, 2004
- During the course of audit it was observed that the appellant have availed suo-motu credit without the cover of documents specified in Rule 9 of CENVAT Credit Rules. The CENVAT Credit of the rejected inputs in respect of which the invoice is prepared, is availed but not dispatched. This resulted in excess availment of CENVAT Credit because full credit is availed on full quantity of goods received on receipt of invoice and thereafter suo-motu credit is again availed on rejected inputs in respect of which the invoice is prepared but goods are not dispatched
- Accordingly a show cause notice dated 3 February 2014 was issued to the Appellant as to why:-
  - An amount Rs. 42,64,135/- wrongly availed and utilized should not be recovered from the Noticee in terms of the provisions of Rule 41 of CENVAT Credit Rules, 2004 read with Section 11A of Central Excise Act, 1944
  - A penalty should not be imposed upon the Noticee under Rule 15(2) of Cenvat Credit Rules, 2004 read with Section 11AC of Central Excise Act, 1944
  - Amount of interest at applicable rates should be recovered from the Noticee in terms of the provisions of Rule 14 of Cenvat Credit Rules, 2004 read with Section 11AA of the Central Excise Act, 1944
- The Appellant submitted that the entire exercise is revenue neutral in nature and there is no loss to the department, therefore impugned order is not sustainable
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the department, therefore impugned order is not sustainable

- The Appellant also raised objection on the extended period of limitation. According to him the demand in the instant matter pertains to the period from January 2009 to January 2013 and the show cause notice was issued only on 3 February 2014 which is beyond the period of one year

- Appellant further submitted that there is no suppression of facts as all material facts were disclosed in the monthly ER-1 Returns. He also submitted that the interest and penalty are not imposable on the facts of the case

- The issues to be decided in the instant Appeal is whether the appellant can avail CENVAT credit on their own invoices issued in the name of their vendor rejecting the inputs, which were actually not cleared from the plant but remained inside the plant and whether the appellant has availed double CENVAT Credit on some goods and also whether the extended period of limitation has been rightly invoked by the department

- There is no doubt that the appellant have adopted a completely wrong practice. If the inputs were urgently required for production of two wheelers, the appellant need not prepare Invoice for sending the rejected materials back to the vendors and instead ought to have rectified the same in-house

- The Appellant availed wrong credit on the basis of unspecified document but also availed double credit in respect of the same inputs. The wrong credit availed in respect of the rejected Inputs on the basis of their own Invoices issued in the name of their vendors is liable to be recovered from the Appellant under the provisions of Rule 14 of Cenvat Credit Rules, 2004

- The fact about the availment of credit in respect of the rejected inputs on the basis of Appellant's own invoices issued in the name of their vendors was never brought to the knowledge of the department

- Appellant never disclosed the fact about in-house rectification of the Inputs by the Appellant and second time credit in respect of such Inputs. The said fact came into the knowledge of audit team at the time of audit only, otherwise the Appellant would have continued with this practice

- This shows the mala fide intention of the Appellant. As per the ld. Advocate for the Appellant, the entire record of the Appellant was audited for the period 2008-09 and 2009-10, but at that time the audit did not raise any objection to such transactions and therefore there is no suppression on the part of the Appellant and as a result thereof the extended period cannot be invoked

- EA-2000 audit conducted by the department is not an audit of 100% records of tax payers. Rather it is a selective audit and it cannot be said that all issues were seen by Audit and ratified by it. If audit has specifically inquired into classification of services and not objected to said classification, then only it can be said that Audit has ratified it

- Mere visit of department's audit party to the factory is not enough to infer Revenue's knowledge about wrongful availment. The burden is on the appellant to prove Revenue's knowledge which has not been proved in this matter by the Appellant. Since the extended period has rightly been invoked by the department, therefore the appellant is also liable to pay interest and penalty

- In conclusion, the impugned order is upheld and this matter is remanded to the ld. Commissioner (Appeals) for the limited purpose of verification about the aforesaid submission of ld. Counsel for the appellant and for passing appropriate order on this issue only

Key Indirect Tax updates

This section summarizes the regulatory updates for the month of July 2018

1) Advance Ruling on transfer of a going concern to be treated as supply of services:

Background and Facts of the case:

- The applicant has three manufacturing units situated at Ramanagara, Hiriyur and Bengaluru (Seshadripurarn).

- It intends to sell the unit situated at Hiriyur along with all its fixed assets namely land, building, plant & machinery etc., current assets namely stock & trade receivables etc., and liabilities namely Bank term loans, bank working capital loans, creditors for supplies etc., for a lump sum consideration.

Observation of the AAR:

- The unit sought to be sold is a fully functional unit and the transaction contemplates the transfer of the entire business to a new person, who would not only enjoy a right over the assets but shall also take over the liabilities.

- As the unit is said to be functional and is desired to be transferred as a whole to a new owner it amounts to transfer of a going concern as a whole.

- The transfer of a going concern, either as a whole or an independent part thereof, for a lump sum consideration does not constitute an activity taking place in the course of business or for furtherance of business.

- According to part 4(c) of Schedule II, when the business is transferred as a going concern then it does not amount to supply of goods.

- According to Notification No. 12/2017-Central Tax (Rate) dated 28th June 2017, serial number 2 provides for 'Services by way of transfer of a going concern, as a whole or an independent part thereof', thereby meaning transfer of a going concern constitutes a supply of service. Further it provides 'Nil' rate of tax on such a supply.

- The Applicant has not furnished any documentary evidence to establish that the Applicant is a going concern except their admission that its an ongoing business and the transaction proposes to transfer all the assets and liabilities to the new owner. It implies that the business will continue in the new hands with regularity and a nature of permanency.

Ruling:

- The transaction of transfer of business as a whole of one of the units of the Applicant in the nature of a going concern amounts to supply of service.

- The transaction of transfer of one of the units of the Applicant as a going concern is covered under Sl.No.2 of the Notification No.12/2017-Central Tax (Rate) dated 28.06.2017 subject to the condition that the unit is a going concern.

2) Advance Ruling regarding taxability of reimbursement of expenses and salary paid by foreign head office to the liaison office in India

Background and Facts of the case:

- Habufa Meubelen B.V. (HO) has a liaison office in India with the prior permission of RBI.

- Liasion office, except the proposed liaison work, shall not undertake any activity of a trading, commercial or industrial nature nor shall it enter into any business contracts in its own name without RBIs prior permission.

- The office in India will not have significant/ commitment powers, except than those which are required for normal functioning of the office, on behalf the Head Office. Further, the entire expenses of the office in India will be met exclusively out of funds received from abroad through normal banking channels.

- The liaison office does not have any independent revenue or clients. The office has been established for the purpose of liaisoning with the suppliers with regard to quality control of goods.

- No amount is charged by the liaison office from HO for any services. It seeks only reimbursement of salary and expenses incurred by it from HO.

- The applicants wants to seek advance ruling on :

  - Whether the reimbursement of expenses and salary paid by M/s Habufa Meubelen B.V.(HO) to the liaison office established in India is liable to GST as supply of service, especially when no consideration for any services is charged/ paid.

  - Whether the applicant i.e. the Liaison Office is required to get registered under GST.

  - If it is assumed that the reimbursement of expenses and salary claimed by liaison office is a consideration towards a service, then what will be the place of supply of such service.

Observation of the AAR:

- The HO in Netherlands reimburses the expenses incurred by the applicant for their operations in India which are in the nature of salary, rent, security, electricity, travelling etc. The applicant does not have any other source of income and it is solely dependent on the HO for all the expenses incurred by the applicant, which are subsequently reimbursed by the HO.

- Since, HO and Liaison Office cannot be treated as separate persons, there cannot be any flow of services between them.

- The amount received from HO are the funds for payment of salary, reimbursement of expenses like rent, security, electricity, travelling, etc. No consideration is being charged by the applicant from the HO for such services.

- Further the liaison office is strictly prohibited to undertake any activity of trading, commercial or industrial nature or entering into any business contracts in its own name. Also the reimbursement claimed by them from their HO is also falling out of the purview of supply of service. As there are no taxable supplies made by the Liaison office, they are not required to get registered.

Ruling:

- If the liaison office in India does not render any consultancy or other services directly / indirectly, with or without any consideration and the liaison office does not have significant commitment powers, except those which are required for normal functioning of the office, on behalf of Head Office, then the reimbursement of expenses and salary paid by M/s Habufa Meubelen B.V. (HO) to the Liaison Office, established in India, is not liable to GST and the applicant i.e. M/s Habufa Meubelen B.V. Jaipur, is not required to get itself registered under GST.

3. Outcome of GST Council's 28th meeting held on 21st July 2018

Changes related to supply of services:

- Supply of food or drink in restaurant, mess, canteen, eating joints, and supplies to institutions (namely office, factories, educational institutions) on a contractual basis shall be taxed at 5% while only the outdoor catering i.e. event based and on occasional basis shall be taxed at 18%;

- GST rates on hotels would be charged on actual tariff / transaction value as opposed to declared tariff. (i.e. if actual tariff is below INR 7500, GST would be charged at 18% and actual tariff above INR 7500 would be taxed at 28%);

- Services provided in sectors like banking, IT have been provided relief by exempting services supplied by an establishment of a person in India to any establishment of that person outside India [i.e. related party] provided the place of supply is outside India;

- GST on supply of e-books has been proposed to be reduced from 18% to 5% for which print version exists;

- For multimodal transportation service providers, GST rate of 12% with full ITC has been proposed;

- Extend the exemption granted on outward transportation of all goods by air and sea by another one year i.e. up to 30th September, 2019 as relief to the exporter of goods;

- GST on supply of services provided by individual Direct selling agents (DSA) to banks/NBFCs has been proposed to be paid under reverse charge by banks/NBFCs. While supply of service by non-individual DSA to banks/NBFCs shall be on forward charge.

Reduction in GST rates of certain goods which inter-alia includes:

- Footwear having retail sale price under INR 1,000 per pair to be taxed at 5%;

- GST rates on the following items have been proposed to be reduced to 18%

- Consumer electronics or appliances i.e. Food grinders and mixers, food or vegetable juice extractors, Water heater, mixer grinder, hair dryers, Washing machine etc.;

  - Televisions up to the size of 68 cm;
  - Paints, varnishes and wall putty;
  - Special purpose vehicles, work truck and trailer and lithium-ion batteries.

- The Council also provided clarifications regarding applicable GST rate on certain goods including milk enriched with vitamins or minerals salt (fortified milk), water supplied for public purposes, beet and cane sugar, including refined beet and cane sugar etc.

Simplification of returns under GST:

- Council has approved the mechanism and design of the simplified GST returns and directions have been issued to law committee to finalize the formats and make suitable changes in the rules and the law;

- It has been proposed that for all tax payers (excluding small taxpayers and ISD) a single monthly return mechanism will be introduced;

- The single return shall have two main tables i.e. one for reporting outward supplies and another for availing ITC based on the invoices uploaded by the vendor;

- The vendor invoices shall be updated on the buyer's platform on a real time basis and the returns shall be designed on a process of "Upload-Lock-Pay" mechanism;

- It has been proposed that the taxpayer would have facility to create his profile based on nature of supplies made and received. The fields of information which a taxpayer would be shown and would be required to fill in the return would depend on his profile.

Simplification for small taxpayers:

- It has been proposed that NIL return filers shall be given facility to file the returns by sending SMS;

- It has been proposed to increase the turnover limit for taxpayer filing quarterly returns to INR 5 crores;

- Quarterly return shall be similar to the main return with monthly payment facility and for small taxpayers (i.e. a) with only b2c supplies and b) for b2b+b2c supply). Simplified returns named Sahaj and Sugam shall be introduced;

- Further, the new return mechanism shall provide facility for amendment of invoice by introducing a new amendment return which will have tax payment facility to save the interest liability of the tax payers.

Migration window to open till 31st August 2018:

- For taxpayers, who were unable to fill the PART – B of the registration form and had only provisional IDs till date, it has been proposed to fill the part B of the form and to approach the jurisdictional officer to migrate their GSTN. Any late fee paid for delayed filing of returns for such cases shall be refunded to the cash ledger.

4) CBIC exempts payment of tax under section 9(4) of the CGST Act, 2017 till 30 September 2018

- We would like to update that CBIC vide Notification No.12/2018 - Central Tax (Rate) dated 29 June 2018 has further extended the timeline for applicability of Section 9(4) of the Central Goods and Services Tax Act, 2017 ('the CGST Act') till 30 September 2018. As per Section 9(4) of the CGST Act, the liability for payment of GST has been placed on registered person on inward supply of goods or services or both received from an unregistered person under reverse charge mechanism.

- The said notification has come into place amending the original Notification No. 8/2017 dated 28 June 2017 and Notification No. 10/2018 dated 23 March 2018 vide which the liability to pay tax under reverse charge mechanism by registered person on supply from unregistered supplier was deferred till 31 March 2018 and 30 June 2018 respectively.

5) Advance Ruling on taxability of High Seas Sales and Admissibility of Input Tax Credit

Background and facts of the case:

- Applicant will be purchasing the goods from its overseas related party situated abroad based on purchase order received from its customers. While the goods are in transit, the goods will be sold by the Applicant to its customers before the goods are entered for customs clearance in India.

Observation and Ruling of the AAR:

- The Authority of Advance Ruling observed that as per Section 12 of the Customs Act, 1962 and Section 3 of the Customs Tariff Act, 1975 the goods which are sold on high seas sale basis are non-taxable supply under the CGST Act as no tax is leviable on them till the time of customs clearance.

- Further, the goods sold on High Seas sale basis

being non-taxable supply as per Section 2(78) of the CGST Act and being exempt supply as per Section 2(47) of the CGST Act, the input tax credit to the extent of inputs, input services and common input services would be required to be reversed by the applicant as per Section 17 of the CGST Act.

5) Amendment in GST laws and provisions

- The name of Central Board of Excise and Customs (CBEC) is changed to Central Board of Indirect Taxes and Customs (CBIC)
- Facilitating or arranging transactions in securities is to be covered under the expression "services"
- Import of services by entities which are not registered under GST (say, they are only making exempted supplies) but are otherwise engaged in business activities shall be taxed when received from a related person or from any of their establishments outside India
- Transactions which involve movement of goods, caused by a registered person, from one non-taxable territory to another non-taxable territory shall not be considered as a supply
- High seas sales and sale of warehoused goods shall not be considered as a supply
- The sub-section which mandates that all registered persons shall pay the tax on reverse charge basis on purchases made from unregistered persons, shall be replaced with a sub-section that gives the Government, the power to notify a class of registered persons who would be liable to pay tax on reverse charge basis in case of receipt of goods from an unregistered supplier
- In the case of "bill-to-ship-to" situations, for the purposes of availing of ITC on goods by the registered person, a deeming provision is present vide which the registered person is deemed to have received the goods where the goods are delivered by the supplier to a recipient or any other person on the direction of the said registered person. It is now proposed to provide this deeming fiction in case of services as well
- The liability to pay interest is removed in case where the recipient has been made liable to pay an amount equal to the ITC availed in case he fails to pay to the supplier of goods or services or both the amount towards the value of supply along with tax payable thereon within a period of 180 days from the date of issue of invoice by the supplier
- Availment of ITC is allowed on activities or transactions specified in Schedule III (other than sale of land and, subject to clause (b) of paragraph 5 of Schedule II, sale of building) by excluding it from the ambit of 'exempt supply' on which ITC is blocked
- The scope of ITC availability is expanded in case of motor vehicles having approved capacity of not more than 13 persons (including the driver) in case it is used for specified purposes. Further, ITC will not be denied in respect of motor vehicles if they are used for transportation of money for or by a banking company or a financial institution
- Presently, ITC is not available in respect of food and beverages, health services, travel benefits to employees etc. This sub-section is amended to allow ITC in respect of such goods or services or both where the provision of such goods or services or both is obligatory for an employer to provide to its employees under any law for the time being in force
- In Assam, the threshold for exemption for registration is raised from Rs. 10 lakhs to Rs. 20 lakhs
- Only those e-commerce operators who are required to collect tax at source under section 52 would be required to take compulsory registration. Other e-commerce operators are not be required to take registration if their aggregate turnover in a financial year did not exceed Rs. 20 lakhs
- Persons having multiple places of business in a State or Union territory are allowed to obtain separate registrations for each such place of business
- The provisions of separate registration for a person having a unit(s) in a SEZ or being a SEZ developer as a business vertical distinct from his other units located outside the SEZ, have been inserted. Further, a person having multiple units in an SEZ is also allowed to take separate registration for each such unit
- Issuance of consolidated credit/debit against multiple invoices is allowed
- Taxpayers are allowed to amend the returns
- A new section is being introduced in order to enable the new return filing procedure as proposed by the Returns Committee and approved by GST Council

- The credit of State tax/ Union territory tax can be utilized for payment of integrated tax only when the balance of the input tax credit on account of central tax is not available for payment of integrated tax

- Further, a taxpayer would be able to utilize credit on account of CGST, SGST/UTGST, only after exhausting all the credit on account of IGST available to him

- Presently, only the supplier making supplies of goods or services to an SEZ unit/SEZ developer can claim refund. It is proposed to allow ITC to the SEZ developer or SEZ unit and the supplier in DTA may recover the tax amount from such SEZ unit, etc

- It is proposed to allow receipt of payment in Indian rupees in case of export of services where permitted by the Reserve Bank of India since particularly in the case of exports to Nepal and Bhutan, the payment is received in Indian rupees as per RBI regulations

- It is proposed to not tax job work of any treatment or process done on goods temporarily imported into India (e.g., gold, diamonds) which are then exported

Direct Tax

This Section of Tax alert summarizes the Direct tax updates for the month of July 2018

Judicial Precedents

1. Mumbai Tribunal rules capital gains of Singapore Company on sale of Indian securities not taxable in India under the Double Taxation Avoidance Agreement (DTAA); Limitation of Relief (LOR) article not applicable

Background and facts of the case

- As per the capital gains provisions of the DTAA, income from sale of any property [other than immovable property, movable property forming part of business, ships or aircrafts] is taxable only in the country of residence of transferor (i.e. resident state).
- The DTAA contains an anti-abuse provision in the form of LOR article. This provision restricts any relief from taxation in Source country (say, India) in the form of exemption or reduction of tax by virtue of the DTAA, where such income is not received in or remitted to Singapore and, hence, exempt from Singapore tax under its domestic law. The LOR operates to avoid such "double non-taxation" or less than "single taxation" by virtue of the DTAA. Thus, in effect, exemption or reduction of tax in India is allowed only to the extent of income as is remitted to or received in Singapore and, hence, taxable therein.
- The Taxpayer is a tax resident of Singapore carrying on its business operation including trading in securities from Singapore. It does not have permanent establishment in India. The Taxpayer has earned capital gain on sale of shares, debt instruments and derivatives (collectively referred to as "securities") in India and claimed non-taxability in India under the DTAA which provides exclusive taxation rights to Singapore on such gains.
- The Tax Authority denied the capital gain benefit under the DTAA on the premise that capital gains income was not remitted/ repatriated in Singapore. This resulted in non-satisfaction of LOR article under the DTAA.
- As against this, the Taxpayer contended that the gains were not taxable in India based on following:
  - Under capital gains article, gains from sale of securities in India are taxable in Singapore
  - LOR provides for restriction of exemption in source country (India) to the extent of repatriation of such income to resident country (Singapore). The Taxpayer is liable to tax in Singapore on its worldwide income, as substantiated by a letter of the Singapore tax authorities. Accordingly, remittance-basis taxation in Singapore under LOR provision is of no relevance for the purpose of claiming benefit under the DTAA. To support this contention the Taxpayer relied on Mumbai Tribunal ruling in the case of Citicorp Investment Bank Singapore Ltd. [2017-EII-59-ITAT-MUM-INTL]
- The Dispute Resolution Panel (DRP), ruled in the favour of the Taxpayer. Aggrieved by this the Tax Authority appealed before the Tribunal.

Tribunal's ruling

The Tribunal ruled in the favour of the Taxpayer and held that LOR provisions are not applicable to the facts, on the following basis:

- The LOR provision applies if income derived from a source state is either exempt from tax or taxed at a reduced rate in that source State. This condition is not fulfilled in the present case.
- Capital gains derived by the Taxpayer from sale of Indian securities is taxable only in the resident state i.e. Singapore. The provision is clear and unambiguous and expresses itself as not an exemption provision but it speaks of taxability of particular income in a particular State by virtue of residence of the Taxpayer.
- The expression "exempt" with reference to the capital gain derived by the Taxpayer has been loosely used. Therefore, capital gain which was not taxable in India cannot be termed as an exemption.
- The Tribunal referred to the decision cited by the Taxpayer, Citicorp Investment Bank Singapore Ltd. (supra).

Source: D.B. International (Asia) Ltd. [ITA no. 992/Mum./2015]

2. Ahmedabad Tribunal rules non-furnishing of Tax Residency Certificate (TRC) cannot deny tax treaty benefit

Background and facts of the case

- Under the Income Tax Laws (ITL), any taxpayer eligible to claim tax treaty benefits can choose to be governed by the provisions of the ITL to the extent that is beneficial. Furthermore, any non-resident taxpayer claiming tax treaty benefits is required to furnish a TRC containing the particulars prescribed as an evidence of it being a resident of the tax treaty country, and also such other documents and information as may be prescribed.

- The Taxpayer, an Indian company, made payments to a US entity for services in relation to installation and commissioning of certain equipment purchased by the Taxpayer. The Taxpayer did not withhold any taxes as it was not falling within the ambit of Fees for Included Services (FIS) under the DTAA.

- The Tax Authority was of the view that such payments were in the nature of FIS under the DTAA and, thus, the Taxpayer was liable to appropriately withhold taxes.

- The First Appellate Authority ruled in favour of the Tax Authority and also observed that, in the absence of a TRC, the US entity was not entitled to protection under the DTAA.

- Aggrieved, the Taxpayer filed an appeal before the Tribunal.

Tribunal's ruling

On eligibility of tax treaty benefit

- The Tribunal ruled that the tax treaty protection cannot be denied merely on the ground that the Taxpayer had not been able to furnish a TRC in the prescribed form, as:

  - The provisions of the ITL that provide an option to the Taxpayer to be governed by the beneficial provisions between the DTAA and the ITL, provide an unqualified tax treaty override. Furthermore, tax treaty override is permissible only in cases where the general anti-avoidance provisions (GAAR) are invoked.

  - The restriction on the application of tax treaty benefits on failure to provide a TRC does not have an overriding effect (as opposed to GAAR) over the provisions of the ITL which provides for application of beneficial tax treaty provisions.

  - The requirement to furnish a TRC was introduced so that the TRC is regarded as sufficient evidence for granting tax treaty benefit and the Tax Authority is denuded of the powers to demand further details in support of the tax treaty benefits claimed. (Reliance was placed on an Authority for Advance Rulings (AAR) order in the case of Serco BPO Pvt. Ltd. [(2015) 379 ITR 256 (P&H)]). The TRC provision cannot be construed as a limitation to the superiority of the tax treaty over the domestic law.

  - Mere non-furnishing of a TRC cannot be a reason to deny tax treaty benefit and the Taxpayer should substantiate its eligibility to claim tax treaty benefits by means other than a TRC.

Proof of residence by any other mode

- As per the DTAA, a taxpayer should be able to prove its residential status in the other jurisdiction by reason of domicile, residence, citizenship, place of management, place of incorporation or any other criterion of similar nature. Any other criterion in this context would mean (Reference was drawn to DCIT v. General Electric Co. plc & Ors [(2001) 71 TTJ 973 (Cal)]) any locality-related attachment that attracts residence-type taxation.

- Unless the taxpayer is able to satisfy the preliminary requirement of it being treated as a resident of the US, it cannot be regarded as entitled to tax treaty protection.

- The requirement of satisfying residential status by any other mode is far more onerous, as the TRC can be obtained from the US authorities for a modest user fee after filing a statutory form.

- Furthermore, the documents submitted by the US entity did not prove its residential status, as the document was merely a declaration by the US entity and cannot be treated as a certification by any authority. A

declaration by the US entity, without any material to substantiate the basic facts set out in the declaration, cannot be accepted as legally sustainable foundation for a finding of fact.

- As the Taxpayer was earlier not asked to submit evidence other than a TRC to prove residential status of the US entity, the matter was remanded to the Tax Authority for fresh adjudication, with direction to give the Taxpayer a fresh opportunity to furnish evidence not limited to, but including, the TRC in support of the US entity's entitlement to the tax treaty benefits of the DTAA.

Source: Skaps Industries India [TS-330-ITAT-2018 (Ahd)]

3. AAR rules on Permanent Establishment (PE) and royalty income

Background and facts of the case

- Under the India – Singapore DTAA, a foreign enterprise (FE) is regarded to constitute a PE in India in the below circumstances:
  - Fixed place PE: If the FE has a fixed place of business at its disposal in India through which the business of the FE is wholly or partly carried on.
  - Service PE: If the FE furnishes services in India through its employees or other personnel engaged by it for a period aggregating more than 90 days (Reduced to 30 days in case services are rendered to a related party) in the given year
  - Agency PE: If the FE has an agent who habitually exercises, an authority to conclude contracts on behalf of the principal or habitually maintains stock of goods or merchandise from which it regularly delivers goods or merchandise on behalf of the principal or habitually secures orders almost wholly or wholly for the principal or its group entities under common control.
- As per the DTAA, royalty and Fees for Technical Services (FTS) arising in India is taxable in India. Further, royalty is defined to include payment for use or right to use any copyright of a literary, artistic or scientific work, any patent, trade mark, design or model, plan, secret formula or process, any industrial, commercial or scientific equipment or for information concerning industrial, commercial or scientific experience etc.
- Further the DTAA defines FTS to cover fees for managerial, technical or consultancy services if the same makes available technical knowledge, experience, skill, knowhow or processes.
- If a PE is said to exist in India, the profits attributable to the PE are taxable in India. Further, income in the nature of Royalty/ FTS from India, if effectively connected to a PE, would also be taxable in the hands of such PE on net basis.
- The applicant, a company incorporated in Singapore, is part of Mastercard group, a leading global payment solution providers facilitating electronic payments.
- The Applicant carries out transaction processing and payment related services in the Asia Pacific, Middle East and Africa (APMEA) region including India.
- The Applicant has a subsidiary in India, namely Mastercard India Services Private Limited (I Co), which provides support functions exclusively to the Applicant in respect of its India operations.
- During the relevant year, some of the employees of Applicant visited India to understand the future requirement, to provide information about new products and to monitor the efficiency of the operations etc. The presence of employees in India was for a period of more than 90 days.

Transaction processing activity

- The transaction processing activity consists of electronic processing of payments between Merchant's bank and Cardholder's bank through the use of Mastercard Worldwide Network (Network).
- The transaction data are transmitted over the Network with the help of an automated equipment called Mastercard Interface Processor (MIPs) which are placed at the Customer banks' premises in India. While the MIPs are owned by I Co, the software embedded in MIP is owned by the Applicant and upgraded through processing centres situated outside India.
- The transaction processing services provided by the Applicant involves below steps:

(i) Facilitating authorization of transaction including fraud check:

- A Cardholder makes a purchase with a Merchant and uses the card for payment either online or through card swipe machine
- The Merchant forwards the transaction to its banker i.e. Merchant's bank for authorization.
- The MIP located at Merchant bank's premises undertakes preliminary validation of information (such as PIN processing, validation of card codes, name and address verification, etc.) and alerts the Merchant's bank for correction of details in case of errors.
- Upon successful validation, Merchant bank's MIP transfers the data to the Cardholder bank's MIP via the Network, which in turn directs the data to the Cardholder bank for further processing and verification.

  Simultaneously, Mastercard processing centre (situated outside India) processes the data for securing transaction flow, exercising fraud checks, validation check, etc.
- Upon verification, the Cardholder's bank sends an approval message to the Merchant's bank and accordingly payment is made to the Merchant.

(ii) Clearance between Customer banks

- Each transaction would make one bank liable to pay to another bank. A sum total of all the transactions between two Customer banks, on a given day, establish settlement position between those two banks.
- This data is transmitted to an overseas group entity with the help of an Application software owned by the Applicant and installed in the computers of the Customer banks.
- The overseas group entity performs data validation and integrity check and determines the final settlement position between Customer banks after incorporating adjustments such as charge back, fees of applicant, etc.

(iii) Settlement after netting off interbank transactions amount

- Final settlement information is forwarded by the overseas group entities to Bank of India (BOI), which passes the necessary debit and credit entry in the accounts of Customer banks. For these activities, BOI is compensated with a nominal service fee from the Applicant.

- For various activities undertaken, the Applicant charges following fees from its Customer banks
  - Transaction processing fees - for authorization, clearing and settlement of transactions.
  - Assessment fees - for building and maintaining its Network, for setting up and maintaining a set of rules and also for guaranteeing settlement between the Customer banks.
  - Miscellaneous revenue - for the provision of ancillary services e.g. warning bulletin fees for listing invalid or fraudulent accounts, cardholder service fees, etc.
- With respect to the above income received from Indian Customer banks, the Applicant made an application to the AAR to determine tax liability in India and withholding requirement thereupon.

Earlier Structure [prior to Dec 2014]

- Prior to the structure/process flow explained above, the transaction processing activity was carried out by Applicant's indirect holding company Mastercard International Inc. (MCI), a Delaware company, through its liaison office (LO) in India.
- Current employees of I Co were employees of the LO performing the same support functions.
- MIPs were owned by Applicant's overseas group entities and were licensed to the Applicant. Pursuant to the restructuring, MIPs were transferred to ICo. However, no sales tax in respect of the said transfer was paid.
- The maintenance of MIPs was provided by the overseas group entities and they provide these services even post restructuring.

AAR Ruling

On PE

(i) **Fixed Place PE**

MIP as fixed place PE

- MIPs are automatic equipment and satisfy the fixed place test as they are housed at a particular site i.e. at the Customer banks' premises. Further, being fixed to the ground is not a pre-requisite (Reliance placed on SC ruling in case of Formula One World Championship Limited [394 ITR 80], OECD Commentary, Swiss Server decision quoted in case of Formula One ruling).

- As MIPs are placed at the site of the Customer banks throughout the year, the test of permanence is also met.

- Following facts further establish that the MIPs are under the disposal of the Applicant since all risk mitigation functions are performed by the Applicant and all decisions with respect to MIPs are taken by it and not I Co.

  - Ownership of MIP is not a determinant factor of disposal test.

  - I Co is rendering only a support function role as per its Functions, Assets and Risk (FAR) profile. This supports that MIPs are carrying on authorization activities for the Applicant and not I Co.

  - Applicant charges "Mastercard-one time license fee" from its Customer banks to cover the cost of installation of MIP.

  - Applicant is controlling MIPs through licensing agreement and Mastercard rules, which it enters into with Customer banks in India.

  - Post restructuring in December 2014, while ownership of MIPs was transferred to I Co, no new agreements were entered into between Customer banks and ICo.

  - All the decisions related to MIPs, viz. when to repair or buy a new MIP, whom to engage for repairs and at what cost, agreeing to the terms of repairs etc. are taken by the Applicant and not by the I Co even after December 2014.

  - I Co is a cost plus entity and has neither financial nor the technical ability to undertake maintenance and upgradation activities.

Preparatory or Auxiliary activities:

- In addition to acting as communication device as contended by the Applicant, MIPs undertake:

  - Preliminary validation of transaction such as PIN processing, validation of card codes, names and address verification etc.

  - Data encryption for transmission over the Network.

- Without the initial verification/validation by MIPs, the authorization of the transaction would not take place and hence same is a significant activity.

- Activities of MIPs cannot be said to be preparatory or auxiliary in nature, notwithstanding the fact that:

  - The servers outside India also undertake significant activities (such as securing the transaction, validation, fraud check)

  - MIPs are involved only at authorization stage and not during clearance and settlement stage.

  - Cost of MIPs is fractional compared to the cost of overall infrastructure of Mastercard outside India

Accordingly, MIPs create a fixed place PE of the Applicant in India.

Network as fixed place PE

- Network in India consists of:

  - MIPs owned by I Co

  - Transmission tower, leased lines, fiber optic cable, nodes and internet- owned by third party service provider

  - Application software owned by the Applicant, which is installed in the Customer banks' computers

- On similar lines as MIP, the Network also passes the test of permanency and fixed place.

- Further, the following factors indicate that the Network was at the disposal of the Applicant:

- As already concluded, MIPs are at the disposal of Applicant. Also, Application software are owned and also controlled by the Applicant.

- The Network in India is also secured by Mastercard and is responsible to prevent fraud and to enhance security which suggest that the same is also at the disposal of the Applicant.

- An automatic equipment like server can also create a PE and there is no requirement of human intervention.

Preparatory or Auxiliary:

Following facts suggest that activities of Network are not preparatory or auxiliary:

- The Network is indispensable in all three phases i.e. authorization (as discussed above in case of MIPs) as well as clearance and settlement.

- The following task performed by different components of Network are significant and is not restricted only to transmission of data:

  - MIP - preliminary verification/validation part of authorization and encryption of data,

  - Network in India - transmission of data,

  - Application software - sending and receiving data for clearance and settlement

- The functions performed by the Network are for Customer banks and not the Applicant which also supports that the activities are not preparatory or auxiliary activities Reliance placed on commentary by Klaus Vogel book on Double Taxation Conventions, Third Edition, page no 321 and 322).

Accordingly, the Network also creates a PE for the Applicant in India.

BOI as fixed place PE

- The settlement activity (constituting more than 90% of India transactions), essentially being movement of funds between the Customer banks and also passing necessary book entries is carried out by BOI in India.

- Employees of BOI, a dedicated team, carry out these settlement activities in India on behalf of and under the instructions and responsibility of the Applicant. Accordingly, the space occupied by the employees of BOI is at the disposal of the Applicant, even though the Applicant itself does not have free access to the BOI premises.

- Thus, premises of BOI constitutes fixed place PE for Applicant in India irrespective of the fact that:

  - The space is not exclusively used by Applicant (OECD commentary on Article 5).

  - Quantum of remuneration to BOI is very nominal.

- AAR noted that BOI is not a dependent agent as it carried out similar work for others as well.

I Co as fixed place PE

- Movement of Indian operations from MCI's LO to I Co is backed by business efficiency and commercial expediency and thus cannot be regarded as colourable device. Unless a reorganization serves no other purpose except bypassing tax laws, no adverse inference can be drawn by the tax authority. Even otherwise, tax authority cannot sit in chair of businessman to make its decision.

- On I Co as a PE, the AAR ruled that I Co creates a fixed PE for Applicant in India due to following reasons:

  - I Co's functions are same as were of MCI's LO prior to restructuring which were voluntarily accepted to constitute a PE by MCI in the past.

  - Further, I Co is carrying on work of the Applicant and to that extent facility, service, personnel and premise of I Co are at the disposal of the Applicant, through which Applicant is carrying on transaction processing activity.

  - The provisions of the DTAA which provides that subsidiary cannot be regarded as a PE, does not create an absolute bar on trigger of PE. It merely means that subsidiary will not automatically become a PE of its holding company merely due to the ownership.

(ii) Service PE on account of Applicant's employees visiting India

- Activities of employees of Applicant during their visit to India (which exceeded 90 days), such as understanding the future requirement, informing

about new products and monitoring the efficiency of the operations etc., are integral part of transaction processing services rendered by the Applicant to its Customer banks and hence constitutes a service PE.

- In case of automated process, like that of the Applicant, employees are required to check if the process is working fine by interacting with clients and taking feedback etc. Further the employees also meet new clients. All these functions are part of services rendered to a client and cannot be regarded as stewardship functions.

- AAR also clarified that for the purpose of service PE, no account is to be taken of the employees of BOI, who are working in their capacity as employees of BOI and not rendering any services to the Customer banks on behalf of Applicant.

(iii) I Co as a Dependent Agent PE (DAPE)

- I Co is legally and economically dependent on the Applicant basis the facts that it is a 100% subsidiary, gets its instructions and remuneration solely from the Applicant and works wholly on behalf of the Applicant.

  - I Co is habitually securing orders wholly for the Applicant as I Co is the only point of contact for Applicant's Customer banks in India.

  - Though the finalization of proposal/ counter proposal / contracts is done by the Applicant in Singapore, all the orders, agreements and proposals are routed only through I Co and final acceptance of Customer banks is also received by I Co (Reliance placed on Delhi ITAT ruling in the case of Rolls Royce Plc v DIT [(2008) 19 SOT 42] and affirmed by Delhi High Court (HC) [(2011) 339 ITR 147 (Del)].).

  - Further, condition of 'habitually' is also satisfied even though only 2-3 orders are secured by I Co in a year, especially considering the nature of Applicant's business wherein only 7 new Customer banks were secured in the span of 3 years (OECD commentary Para 33.1).

- I Co, thus, constitutes a DAPE of the Applicant in India.

Characterization of service fees as Royalty and FTS

(i) On Royalty

Use of Intangible Property (IP):

- The below factors noted by the AAR, suggest that the Customer banks were using the IPs and hence part of the consideration was in the nature of royalty. Reference was made to the principles laid down in the HC ruling of Formula One.

  - Under a license agreement with MCI (brand owner), the Applicant obtained non-exclusive license (with a right to sub-license) to use Mastercard brand name and trademark (IP) in APMEA region including India against payment of royalty.

  - Further, pursuant to Mastercard Electronic License Agreement (MLA) entered into between Cardholders banks and Applicant (earlier entered by MCI with Cardholders banks and was assigned to the Applicant post restructuring in 2014), the cardholders banks are granted right to use the IP solely in connection with 'payment card programs' wherein cardholders banks issue cards with Mastercard logo to its accountholders. A separate fee is charged by the Applicant such as 'Mastercard one time licensing fee' and minimum revenue fee.

  - There was a direct nexus between the royalty paid by Applicant to MCI and fees received by it from its Indian Customer banks which suggests that the fees charged by the Applicant from the Customer banks in India is consideration for use of these IPs in India.

  - Actual nature of transaction involved licensing of IPs irrespective of the classification as 'service' by parties to the transaction.

  - Following facts imply that licensing of IPs to Customer banks is main purpose and not incidental to transaction processing as:

    - Licensing of IP was not essential for processing of transactions

    - In a case of incidental licensing of IPs, same are granted to service provider in facilitating provision of services by them, whereas in this case IP is licensed to the service recipients (Customer banks).

Equipment royalty

- Part of the receipt from Customer banks also comprised of equipment royalty towards use of MIPs by them.

- Further, the OECD Commentary also provides that it is only physical possession which is required with the customer to constitute equipment royalty and control is not a criterion. Thus, requirement of control is not a Treaty requirement and it can always be clarified through clarificatory amendment in ITL and post retrospective amendment in the ITL, consideration for use of an equipment will be treated as 'royalty', irrespective of possession, control with the payer. Reliance was also placed on ruling of Madras HC in the case of Verizon Communication (361 ITR 525).

- MIPs were under effective control of the Applicant as:

  - The transfer of ownership of MIPs from group entity to I Co in 2014 is incomplete in the absence of sales tax compliance. The MIPs thus continue to be owned by the overseas entities which have further given the MIPs to the Applicant under a license (AAR accepted the fact that seller of MIP had paid capital gains tax and depreciation on MIPs was also claimed by I Co. The AAR however stated that the main purpose of Income-tax Act is only to determine taxable income. For a transfer of ownership, a sale must be effected and sales tax/VAT paid. Only then it is complete).

  - Further, 'Mastercard-one time license fee' charged from the Customer banks towards cost of MIP installation also suggests de facto ownership of MIPs with the Applicant. Thus pre-requisite of ownership of equipment with Applicant is satisfied.

  - Thus, MIPs (de facto) owned by Applicant and used by the Customer banks are equipment whose use constitutes royalty and they are effectively connected with PE created on account of MIPs as well as other PEs.

<u>Process Royalty</u>

- To constitute process royalty under India-Singapore DTAA, the process need not be secret.

- Nonetheless, Applicant's transaction processing involves secret process since:

  - It is not a published technology as was in the case of Panamsat International Systems Inc. (Delhi ITAT-9 SOT 100) referred by the Applicant.

  - Number of processes used in the transaction processing are listed as 'patent' in the IP agreement between MCI and the Applicant implying it to be a secret process not known to general public.

  - Though only few of such patents are granted (or registered) in India so far, the technology still remains patented and secret.

- Thus, there is use of a secret process and hence, a part of the fee paid to the Applicant is also for use of such secret process to be characterized as royalty. The fact that secret technology is not licensed to Customer banks is immaterial.

- This is also supported by the decision of Bangalore ITAT in the case of Google India (ITA no 1511 to 1518/Bang/2013) having broadly similar facts.

<u>Software royalty</u>

- The use of software inside MIP, Cards (debit/credit) and the Applications (Master Connect and Master Card File express) are essential part of the transaction without which no transaction can be completed.

- The facts are similar to Skillsoft case (AAR no 985 of 2010) and Synopsis case (2016-LL-0405-63) to the extent that though there is no license to copy and sell the software, taxpayer in those cases was allowed to copy the software on the computer enabling the user to use the software. Similarly, in the present case, Customer banks have to mandatorily copy the application software on their computer to use it.

- Thus the payment received from Customer banks also covers royalty towards use of software.

Royalty income under each aspect discussed is effectively connected with various types of PEs examined above and hence would be taxable on net basis as business income.

(ii) FTS

- Whether a particular payment is royalty or service or facility needs to be seen from the perspective of the ultimate beneficiary, being the Cardholder.

- The relation between cardholder and the Applicant is in the nature of use of a standard facility and hence, transaction processing service rendered by the Applicant is not in the nature of FTS. Reliance was placed on SC decision in the case of Kotak Securities (383 ITR 1).

- Further, certain services rendered by the Applicant, which are not standard services, does not make available technical knowledge, experience, skill, know-how to the service recipient to fall within the ambit of FTS under the DTAA.

- Thus, the part of fee paid to the Applicant, which is not royalty, will be taxable as business income arising through the PE.

Attribution of profits to PE in case of Arm's Length Price (ALP) remuneration to the DAPE

- Arm's length remuneration to I Co would not absolve from further attribution of profits to PEs in India as the FAR profile of I Co does not take into account all the functions performed and risk undertaken.

- SC ruling in the case of Morgan Stanley (292 ITR 416), relied upon by the Applicant is distinguished as:

  - SC dealt with agency PE, whereas in the present case, there is also a fixed PE on account of I Co.

  - Principle of no further attribution for PE would hold good only when the Associated Enterprise (AE) has been remunerated on an arm's length basis taking into account all risk taking functions of the non-resident enterprise.

Obligation of customer banks to withhold tax on payments made to the Applicant.

- The tax is required to be withheld at full tax rate applicable to non-residents on the income attributable to the PE including royalty income.

Source: MasterCard Asia Pacific Pte. Ltd. [TS-304-AAR-2018]

4. Indian HC rules on principles for admissibility of transfer pricing appeals by HCs

Background and facts of the case

The Taxpayer is an Indian affiliate of a multinational group which is engaged in the provision of software development services to its AEs. The Taxpayer was subject to a TP adjustment based on a TP audit conducted by the Tax Authority. The TP adjustment was made largely by adopting a different set of comparable data as well as by adopting different criteria for selection of comparable data by the Tax Authority as compared to what was used by the Taxpayer in its TP documentation. The Taxpayer obtained partial relief at the first-appellate level before the Commissioner of Income-tax (Appeals), an administrative appellate authority under the hierarchy of appellate authorities. An appeal against the order of the first appellate authority was filed before the Tribunal, the second level appellate authority, by the Taxpayer as well as by the Tax Authority. The Tribunal ruled in favour of the Taxpayer by upholding the Taxpayer's selection of comparable data and rejecting the approach adopted by the Tax Authority. The Tax Authority thereafter filed an appeal before the jurisdictional HC against the order of the Tribunal. The key questions raised before the HC was:

(a) whether the Tribunal was right in law in rejecting a few comparables; and

(b) whether the Tribunal was right in determining the threshold for comparability filters for selection of such comparables.

However, before addressing the questions, the HC sought to address the threshold issue of whether the questions in appeal come up to the level of definition/meaning of "substantial questions of law" for the HC to accept the appeal.

Ruling of the HC

Grounds for admissibility of appeal before the HC

Under section 260A of the ITL, as well as under the Code of Civil Procedures, 1908, an appeal can be made to the HC from every order passed by a subordinate court, if the HC is satisfied that the case involves a "substantial question of law." Therefore, the HC held that unless the findings of the Tribunal are unreasonable and unsustainable and exhibit a total lack of reasoning by the Tribunal to the relevant facts of the case and evidence before the Tribunal, there can be no substantial question of law. The HC has power to not only formulate the substantial questions of law but also to frame additional substantial questions of law at a later stage, if such a substantial question of law is involved in the appeal before it.

What is a substantial question of law?

The HC, while referring to leading case laws on the topic, quoted with approval certain observations which

indicate factors for determining whether an appeal involves a substantial question of law. A question of law having a material bearing on the decision of the case will be a substantial question of law, if it is not covered by any specific provisions of law or settled legal principles emerging from binding precedent and involves a debatable legal issue. A substantial question of law will also arise in a contrary
situation where the legal position is clear, either on account of express provisions of law or binding precedent, but the court below has decided the matter, either ignoring or acting contrary to such legal principle.

Could TP matters be considered as those giving rise to a substantial question of law?

The HC observed that the entire exercise of making TP adjustments on the basis of the comparability analysis is a matter of estimation by the taxpayer as well as the Tax Authority. Further, the Tribunal, being the final fact finding authority, adjudicates on the TP issues based on relevant material/facts produced. The HC also noted that the Tribunal is expected to act fairly, reasonably and rationally to avoid unsupportable decisions.

In the instant case, the HC noted that the dispute was with respect to pairing and matching of comparable companies as identified by the Taxpayer vis-à-vis the Tax Authority for determination of the ALP. Also, the arguments before the HC pertained to appropriate application of filters to be used for comparability analysis. The HC observed that the order of the Tribunal was not unreasonable either in analysing the application of filters or in adoption of the most appropriate method for determining the ALP. Accordingly, based on the principles emanating from the judicial precedents referred to, the HC held that the same does not qualify to be a "substantial question of law."

Further, considering that the Tribunal is the final fact finding body, the HC considered it appropriate not to entertain an appeal in the absence of involvement of a "substantial question of law." Accordingly, the HC opined that it cannot be expected to undertake the "fact finding exercise" which would drag the whirlpool of domestic litigations; thereby defeating the very purpose and purport of section 260A (relating to HC appeal) of the ITL.

Moreover, the HC held that the "substantial question of law" could generally be with respect to interpretation of provisions of tax treaties, interpretation of provisions of the ITL or the overriding effect of the tax treaties over the ITL or the questions pertaining to treaty shopping, interpretation of BEPS guidance/recommendations, etc. Accordingly, in such cases the HC could embark upon the exercise of framing and answering such substantial questions of law. On the other hand, the appeals as in the given case, which are primarily to decide as to whether the comparables have been correctly chosen or not and whether quantitative filters have been appropriately applied or not, do not give rise to any "substantial question of law." The HC also observed that a Court cannot be expected to undertake an exercise of comparability which is essentially a fact finding exercise because the Court has neither sufficient information nor technical expertise to undertake any such fact finding.

Source: Softbrands India Private Limited [TS 475-HC-2018(KAR)-TP]

5. Mumbai Tribunal rules on taxability of receipt of shares at less than Fair Market Value (FMV) under Gift Tax provisions pursuant to buy-back

Background and facts of the case

- The Gift Tax provisions under the ITL levies tax on any taxpayer who is in "receipt" of property, being shares of any company, without consideration or for an inadequate consideration. Inadequate consideration is the difference between FMV (Determined based on normative rules prescribed under the ITL) and the consideration paid, exceeding INR 50,000. The ITL taxes the difference in the hands of the recipient of such property.
- In the given case, the recipient Taxpayer company made an offer to existing shareholders for buy back of shares at value less than FMV of the shares. The price offered to shareholders was INR 26 per share whereas FMV determined by the Tax Authority was INR 32.
- Since the price offered for buyback of shares was less than its FMV, the Tax Authority invoked Gift Tax provisions in the hands of Taxpayer company for taxing the difference between FMV and the consideration paid for buy-back of shares, treating the same as an "inadequate consideration" for receipt of own shares pursuant to buy-back. The First Appellate Authority upheld the Tax Authority's adjustment.
- Aggrieved, the Taxpayer appealed before the Second Appellate Authority, i.e., the Tribunal.

Taxpayer's contentions

- The Gift tax provision and Explanatory Memorandum explaining the objective of

introducing gift tax provision in the hands of recipient provided that Gift Tax provision would apply if the property received is in the nature of capital asset in the hands of recipient. In the given case, the Taxpayer company had acquired shares under buyback scheme which were extinguished subsequent to the buy-back. The acquired shares never became capital asset of the Taxpayer company to invoke Gift Tax provision.

- Reliance was placed on the decision of co-ordinate bench in the case of Sudhir Menon HUF v. ACIT [(2014) (148 ITD 260)] which held that issue of shares on pro-rata basis does not lead to receipt of any property (shares) in the hands of shareholders. Similar analogy could be applied in the hands of recipient Taxpayer company for shares received pursuant to pro-rata buy back of shares.

Tribunal's ruling

- A conjoint reading of Gift Tax provisions and its Explanatory Memorandum explaining the Gift Tax provisions suggests that the shares should become the "property" of the recipient taxpayer for levy of gift taxation in the hands of recipient.

- In the given case of buy-back of shares, the recipient Taxpayer company received back its own shares. The receipt of own shares cannot be considered as receipt of "property" for the purpose of Gift Tax provisions. The shares would become "property" in the hands of recipient only if such shares are of any other company and not own shares.

- Further, the shares acquired under buy back were extinguished subsequently by the recipient Taxpayer company thereby failing to become property in the hands of recipient to levy Gift Tax provisions.

- Thus, receipt of own shares and subsequent extinguishment of such shares failed to meet the test of "becoming property" in the hands of recipient as well as fulfilling the criteria of being "property" for the purpose of Gift Taxation since the term property would require shares of any other company.

Source: Vora Financial Services Pvt. Ltd. [ITA No. 532/Mum/2018 dated 29 June 2018]

6. Andhra Pradesh HC held that transaction which can be statutorily considered 'void' under section 281 additionally does not require judicial declaration

Background and facts of the case

- Section 281 of the ITL regulates the validity of transfer or alienation of assets (including immovable property) by a taxpayer with an intention to avoid payment of tax. According to section 281 of the ITL, if any assessment or other proceedings under the ITL are pending against the taxpayer, or such proceedings under the ITL are complete but a notice for recovery of dues under the ITL has not been served by the Tax Recovery Officer (TRO), sale or transfer of an immovable property by taxpayer in favour of any other person is "void" to the extent of the arrears under the ITL, except under the following circumstances specified in proviso to section 281 of the ITL (saving clause):

  - The sale or transfer made with the previous permission of the Tax Authority; or

  - The sale is made for adequate consideration and the purchaser had no knowledge of the arrears payable by the seller under the ITL or pendency of proceedings against the seller under the ITL

  Before amendment vide Taxation Laws (Amendment) Act, 1975, section 281 of the ITL applied if transfer of immovable property was made with an intention to defraud the Revenue. This condition is no longer present in the amended provision, and instead, the taxpayer may obtain previous permission of the Tax Authority for effecting a transfer.

- The ITL also has a separate scheme of provisions in Second Schedule, which is applicable if there is transfer or alienation of immovable property after a notice for recovery of dues under the ITL has been served by TRO. The Second Schedule provides the following sequence of procedure for attachment and sale of immovable property:

  - If taxpayer has committed a default in payment of tax, the TRO shall prepare and sign a certificate specifying the arrears due under the ITL from the taxpayer.

  - TRO shall issue a notice to the taxpayer, requiring payment of the arrears as specified in the recovery certificate within 15 days from

the date of service of the recovery notice to the taxpayer.

- Once the recovery notice is served by TRO, the taxpayer is not competent to transact in immovable property, except after obtaining TRO's permission. The attachment of immovable property also relates back to date of service of notice by TRO.

- In case of default in payment of tax as per the notice issued by TRO, the TRO may realize the arrears by attachment and sale of the taxpayer's immovable property. The process of attachment involves prohibiting the taxpayer from transferring or creating a charge on the property, which is eventually followed by sale of the immovable property through public auction to the highest bidder.

- If any person (other than the taxpayer) objects to the attachment of the immovable property by the TRO, the TRO is required to investigate into the objection. The person is required to establish that, as on the date of service of notice by TRO to the taxpayer, the person validly had some interest in, or had possession of, the immovable property being attached.

- The objection shall be rejected if the TRO is satisfied that, on the date of service of notice by TRO, the immovable property was in the possession of, and was owned by, the taxpayer and not by the person making the objection.

- In case the objection is rejected by TRO, the person aggrieved by the attachment may file a suit in a Civil Court to establish his right to the immovable property. Till such decision by the Civil Court, the attachment of immovable property by the TRO shall be conclusive.

Ratio of SC ([1998] 234 ITR 188) ruling in case of TRO v. Gangadhar Vishwanath Ranade [Gangadhar case] (approving underlying Bombay HC ruling ([1989] 177 ITR 176))

The SC was concerned with an assessment year before amendment by Taxation Laws (Amendment) Act, 1975, when section 281 of the ITL contained relief provision as per which, alienation cannot be considered to be void if there was no intent to defraud the Revenue; or, if the purchaser was bona fide and had acquired the property for valuable consideration and without notice of the pending proceedings. There was, during that assessment year, no provision for obtaining specific approval from the Tax Authority for the purposes of relief from applicability of s. 281 of the ITL. The issue before SC was whether TRO has right to consider a transaction of transfer of property to be void under the powers specified under Second Schedule

SC held as under:

- Section 281 of the ITL does not grant powers to Tax Authority to pronounce upon validity of transfer by himself.

- The TRO also cannot, as part of recovery procedure under Second Schedule, declare any transfer as void on the ground of being made with an intention to defraud the Revenue.

- The Tax Authority or TRO was duty bound to approach the Civil Court for a declaration that the transfer is void. The Tax Department is in the position of a creditor and has to follow the process which is otherwise normally applicable to any other creditor under Transfer of Property Act, 1882 (TOPA).

- In Second Schedule, TRO has limited jurisdiction of examining if, a person objecting to the attachment by TRO, had some interest in, or had valid possession of, immovable property, on date of service of recovery notice to taxpayer. In such case, if after examination, the person objecting to the attachment is found to be in valid possession, TRO is obliged to release the attachment and Tax Department may file a suit before a Civil Court to have transfer declared void on ground of being made with an intention to defraud the Revenue.

- On the other hand, if TRO rejects the objection, an affected purchaser may file a suit before a Civil Court to have the attachment released on the ground of having validly acquired possession from the taxpayer as on the date of service of notice by TRO to the taxpayer.

- The recovery procedure under Second Schedule is similar to provisions under TOPA for declaring a transfer of immovable property made by a debtor with an intention to defraud a creditor as voidable against the creditor. According to legal jurisprudence in the context of TOPA, a creditor has no quasi-judicial powers to declare a transfer as void, and may only file a suit in a Civil Court to have the transfer declared void. According to SC, the same position is applicable vis-à-vis the Tax Authority insofar as recovery of dues under the Second Schedule or s. 281 of the ITL is concerned.

Facts of case before AP HC:

- Section 230A of the ITL prohibited registration of transfer of immovable property unless the seller obtained a certificate from Tax Authority to the effect that:

  - Seller has paid or has made satisfactory provision for payment of dues under the ITL; or

  - Recovery of any dues under the ITL is not prejudicially affected.

Section 230A of the ITL was deleted from ITL vide Finance Act, 2001 with effect from 1 June 2001.

In the present case, following sequence of events occurred:

  - May 2000 : Request made to Tax Authority for issuance of certificate under section 230A of the ITL for effecting transfer of two immovable properties by The Prudential Construction Co. Ltd. (Seller) to Petitioner

  - 18 September 2000 : Tax Authority refused to issue above certificate, as Seller had outstanding tax demand

  - 1 June 2001 : Repeal of section 230A of the ITL which required Seller to obtain certificate from Tax Authority for effecting transfer of immovable property

  - 20 and 22 June 2001 : Registration of transfer of immovable properties by Seller to Petitioner

  - 12 April 2005 : Tax Authority passed an order applying section 281 of the ITL and declaring transfer of immovable properties made in June 2001 as void; citing that transfer was made with an intention to defraud the Revenue and was for inadequate consideration

  - 10 May 2007 : TRO attaches the immovable properties and subsequently, Petitioner files a writ petition to AP HC challenging order under section 281 of the ITL and also order of attachment by TRO

- The date as to service of notice by TRO to the Petitioner under Second Schedule is not known. It is also not clear whether, the transfer stood complete before the date of service of notice by TRO under Second Schedule.

Petitioner's arguments before AP HC:

- Having regard to SC ruling in Gangadhar case, neither section 281 of the ITL nor the Second Schedule provides jurisdiction for the Tax Authority or the TRO to declare a transfer as void. If Tax Department finds that transfer is with an intention to defraud the Revenue, recourse shall be taken to file a suit before Civil Court for obtaining a declaration that the transfer is void.

- Recovery procedure for attachment and sale of immovable property under Second Schedule may apply only if immovable property belongs to the Seller. In present case, immovable property stood transferred to the Petitioner, and hence, TRO had no jurisdiction of attachment.

TRO's arguments before AP HC:

- Recovery procedure under Second Schedule provides for investigation by TRO into validity of an objection raised against the attachment. Only after TRO has investigated and rejected the objection, an affected purchaser may file a suit in a Civil Court to release the attachment. However, in the present case, Petitioner has objected to the attachment at the outset even before investigation could commence by TRO. The investigative powers of TRO cannot be aborted through a writ petition.

AP HC's ruling:

The AP HC dismissed the writ petition and upheld validity of attachment by TRO, for the following reasons:

- **In case of statutory declaration of transfer being void in taxing statutes, there is no necessity of judicial declaration:**

  - Once section 281 of the ITL statutorily declares a transfer as void, HC cannot impose burden on the Tax Department to approach Civil Court to seek a declaration to that effect. There cannot be a judicial declaration over and above a statutory declaration.

  - In case of transfer of immovable property involving private parties, a mere declaration by statute of contract being void may not be sufficient and judicial declaration by a Civil Court may be

required. However, same logic may not apply in case of a taxing statute such as ITL.

- **Similarity of section 281 of ITL with other statutes that have a statutory effect of voiding a transfer:**

  - There are similar provisions in insolvency statutes such as Presidency Towns Insolvency Act, 1909 (1909 Act) and Provincial Insolvency Act, 1920 (1920 Act). The 1909 Act declares the transfer as void, if transferor turns insolvent within 2 years after date of transfer. The 1920 Act has a variation in language, it declares the transfer as "voidable", and also provides that the transfer "may be annulled by the Court".

  - The above insolvency statutes also contain specific provisions for protecting other creditors as against transfer by an individual with a view to give fraudulent preference in favour of any particular creditor. The 1909 Act states that such transfer shall be void; while the 1920 Act additionally provides that such transfer "shall be annulled by the Court".

  - AP HC noted that, the above distinguishing features in 1909 Act and 1920 Act have been considered in the past by the judiciary (Official Receiver, Guntur v. Narra Gopalakrishniah (AIR 1945 Madras 66)) while interpreting the provisions of these insolvency statutes. In case of RM. NL. Ramaswami Chettiar v. The Official Receiver (AIR 1960 SC 70), the SC observed that, having regard to provision contained in the 1920 Act, a transfer becomes void only if it is annulled by the Court and till such annulment by the Court, the transfer remains valid.

  - AP HC, drawing inference from above distinction in language of both insolvency statutes, held that, as compared to 1920 Act, in section 281 of the ITL, the transfer is declared void by statute, it is not "voidable" at the option of Tax Authority, and hence it is also not necessary that the transfer should be annulled by the Court for operation of section 281 of the ITL.

- **As per AP HC, rulings of Bombay HC and SC in Gangadhar case are contrary to scheme of section 281 of ITL:**

  - Bombay HC, with great respect, fell into an error in comparing section 281 of the ITL with provisions in TOPA. While section 281 of the ITL declares the transfer as "void", TOPA only makes the transfer "voidable" at the option of the affected creditor. Further, the position of the Revenue has status of a crown debt and cannot be equated with an ordinary creditor whose interest is sought to be protected under TOPA. To say that the Tax Department, like any ordinary creditor, may need to obtain declaration from Civil Court to give effect to the voiding provision in ITL is irreconcilable with the scheme of the ITL.

  - Second Schedule of ITL clearly states that attachment by TRO shall be conclusive and a purchaser whose objection is rejected by TRO may approach the Civil Court. This also supports that, according to scheme of ITL, Tax Department cannot be made to approach the Civil Court. According to AP HC, decision of SC in Gangadhar case that TRO needs to approach the Civil Court goes contrary to scheme of Second Schedule in ITL.

  - Further, SC was concerned with a period before amendment of section 281 of the ITL, when section 281 of the ITL applied if transfer was made with an intention to defraud the Revenue, and hence, declaration by a Civil Court was considered necessary by SC. However, post amendment, this requirement is no longer present under the existing section 281 of the ITL and hence, it is up to the Petitioner to approach the Civil Court for proving that the transfer is entitled to benefit of proviso to section 281 of the ITL.

According to AP HC, if there is attachment by TRO after declaring a transfer as void under section 281 of the ITL, the Second Schedule does provide remedy to a bona fide purchaser to release that attachment by moving the Civil Court.

- In the present case, once the transfer is declared void under section 281 of the ITL, the immovable property is owned by the Seller and not the Petitioner, and hence, attachment by TRO was valid.

- **Petitioner's case is not protected by saving clause in proviso to section 281 of the ITL:**

The AP HC held that the Seller and Petitioner were not entitled to benefit of proviso to section 281 of the ITL, for the following reasons:

  - The sequence of events shows that, after Tax Authority had refused to issue a certificate under section 230A of the ITL for effecting

transfer to the Petitioner due to outstanding tax demand, the Seller, soon after deletion of section 230A from the ITL, proceeded to effect transfer to the same Petitioner while demand continued to remain outstanding.

- To take benefit of saving clause, purchaser has to acquire the immovable property without notice of outstanding tax demand payable by seller. However, in present case, the Seller and the Petitioner were parties to refusal order by Tax Authority under section 230A of the ITL. Hence, the Petitioner, being aware of outstanding tax demand of Seller, could not avail benefit of the saving clause.

Source: Shriya Bhupal v. ACIT (Writ Petition 11629 of 2007; order dated 2 May 2018; 2 Judge Bench; AP HC)

Key Direct Tax Developments

1. Indian Tax Administration invites public comments on the proposal to amend the rules on "secondary adjustment" provisions in case of Advance Pricing Agreement (APA) and Mutual Agreement Procedure (MAP)

Background

The provisions relating to "secondary adjustments" are applicable in the case of primary TP adjustments made from Financial Year (FY) 2016-17 onwards. These provisions are primarily intended to ensure that profit allocations between the AEs are consistent with the primary TP adjustment. A "secondary adjustment" has been defined to mean an adjustment in the books of accounts of the taxpayer and its AE to reflect that the actual allocation of profits between the taxpayer and its AE are consistent with the transfer price determined as a result of primary adjustment. The primary adjustment is defined to mean the determination of the transfer price in accordance with the arm's length principle resulting in an increase in the total income or reduction in the loss, as the case may be, of the taxpayer.

The secondary TP adjustment is required where a primary adjustment to the transfer price occurs in one of the following circumstances:

- Voluntarily made by the taxpayer in the tax return
- Made by the tax officer and accepted by the taxpayer
- Determined by an APA entered into by the taxpayer
- Made as per the safe harbour rules
- Resulted from a MAP resolution

The primary adjustment, if not repatriated to India within the prescribed time, shall be deemed to be an advance made by the taxpayer to such AE. Also, interest on such advance shall be computed in the hands of the taxpayer in such manner as prescribed.

The Indian Tax Administration, through its notification dated 15 June 2017, had issued rules prescribing the time limit for repatriation of a primary adjustment as well as the applicable interest rate for the purpose of interest computation in cases where the primary adjustment is not repatriated to India.

However, during the course of implementing these provisions, certain difficulties were noted in respect of the primary adjustment that arises on account of an APA entered into by the taxpayer or on account of an agreement reached under the MAP. Accordingly, in order to remove these difficulties, on 19 June 2018, the Indian Tax Administration issued Draft Rules pertaining to the application of "secondary adjustment" provisions in the case of an APA or MAP.

A summary of the proposed changes are as follows:

Scenario under which primary adjustment is determined	Time limit for repatriation	
	As per the current rules	As per the Draft Rules
Adjustment pursuant to APA	On or before 90 days from the due date of filing income tax return	On or before 90 days from the date on which the APA has been entered into by the taxpayer
Adjustment pursuant to MAP	On or before 90 days from the due date of filing income tax return	On or before 90 days from the date of giving effect by the tax officer to the resolution reached under the MAP

No changes have been proposed in other scenarios under which the "secondary adjustment" provision gets triggered.

(Source: Draft Rules by The Indian Tax Administration dated 19 June 2018 - Transfer Pricing)

2. Central Board of Direct Taxes (CBDT) notifies modifications for application of Indian tax laws to first time Place of Effective Management (POEM) resident foreign companies

Background

A foreign company is treated as a resident of India if its POEM during a given year is in India w.e.f. tax year 2016-17, as compared to the earlier test of whole of "control and management" being in India.

The insertion of revised residence rule raised concerns among stakeholders in respect of certain issues arising in the application of the ITL to a foreign company that is treated as a resident of India on account of its POEM being in India. The stakeholders' concerns emanated from the fact that some of the provisions of ITL applicable to a resident would not have been complied by a foreign company which is treated as a POEM-resident of India, especially where the determination of POEM materializes during the assessment proceedings undertaken some years after the relevant tax year for which the foreign company is treated as POEM-resident of India.

Acknowledging these concerns, Finance Act 2016 introduced an enabling provision in ITL [Section 115JH] (transitional provision) granting a right to the Central Government (CG) to notify the Exceptions, Modifications and Adaptations (EMAs) subject to which the provision of ITL will apply to POEM-resident foreign companies. The provision applies to the tax year in which the foreign company is regarded as resident for the first time and it also extends to the previous years which end on or before the date on which the assessment proceedings (in which POEM is considered to be in India) are completed.

On 15 June 2017, the CBDT, by adopting a consultative approach, had issued Draft Notification (F No. 370142/19/2019-TPL) (the Draft Notification) specifying certain EMAs applicable to the POEM-resident foreign company and invited public representations and comments on the specified EMAs.

Pursuant thereto, on 22 June 2018, the CBDT issued Final Notification specifying EMAs relating to various provisions of ITL dealing with adoption of (Written Down Value) WDV for depreciable assets, brought forward and set-off of losses and unabsorbed depreciation, withholding provisions, preparation of financial statements, relief under tax treaty, etc. The specified EMAs are applicable to POEM-resident foreign companies retrospectively from 1 April 2017. The CBDT has also clarified in the Explanatory Memorandum to the Final Notification that such retrospective operation of the Final Notification does not have any adverse impact on any person.

Provisions of Final Notification:

General

- The EMAs in the Final Notification shall be applicable only to a foreign company which is treated as a resident of India on account of its POEM being in India if such foreign company was not a resident in India for any of the preceding tax years. However, EMAs shall not apply to income which would even otherwise be chargeable to tax in India in the hands of the foreign company, in circumstances where its POEM was not in India.
- The Final Notification shall be deemed to have come into force from 1 April 2017.
- All transactions of such POEM-resident foreign company with other person or entity under the provisions of ITL shall not be altered only on the ground that the said foreign company has turned a POEM-resident of India.

Contents Overview:

The EMAs as prescribed in the Final Notification are explained below:

(a) Computation of WDV of a depreciable asset:

- **If foreign company is assessed to tax in the foreign jurisdiction (The Final Notification defines the scope of foreign jurisdiction to mean the place of incorporation of the company):**
  - WDV as per tax records in the foreign country on the first day of the tax year (for which assessment as a POEM-resident is made) to be adopted as the opening WDV of the said tax year.
  - In the absence of availability of WDV as per tax records in foreign jurisdiction, the WDV is computed as if the asset was installed, utilized and depreciation is actually allowed as per the laws of the foreign jurisdiction. The computed WDV so arrived is considered as opening WDV for the said tax year.
- **If foreign company is not assessed to tax in the foreign jurisdiction:**

WDV on the first day of the tax year (for which

assessment as a POEM-resident is made) as appearing in the books of accounts maintained in accordance with the laws of that foreign jurisdiction to be adopted.

(b) Computation of brought forward loss and unabsorbed depreciation:

- **If foreign company is assessed to tax in the foreign jurisdiction:**

    - Brought forward loss or unabsorbed depreciation as per tax records shall be determined year-wise on the first day of the tax year in which it is first said to be resident in India.

    - Such loss or unabsorbed depreciation so determined shall be deemed to be loss or unabsorbed depreciation brought forward on the first day of the tax year (i.e. 1 April) for which it is considered resident and the same shall be allowed to be set off and carried forward for the remaining period as per provisions of ITL from the year in which the loss was first incurred by the company.

- **If foreign company is not assessed to tax in the foreign jurisdiction:**

    - Brought forward loss or unabsorbed depreciation as per books prepared in accordance with the laws of that foreign jurisdiction shall be determined year-wise on the first day of the tax year in which the foreign company is said to be resident in India.

    - Such loss or unabsorbed depreciation so determined shall be deemed to be loss or unabsorbed depreciation brought forward on the first day of the tax year (i.e. 1 April) and the same shall be allowed to be set off and carried forward for the remaining period as per provisions of ITL from the year in which the loss was first incurred by the taxpayer.

- The losses and unabsorbed depreciation of the taxpayer shall be allowed to be set-off only against such income which becomes chargeable to tax in India due to the foreign company becoming resident in India on the basis of POEM rule. Such losses or unabsorbed depreciation cannot be set-off against income which was nevertheless chargeable to tax in India, if the foreign company was not resident in India. Thus, losses or unabsorbed depreciation can be set-off against the additional income becoming taxable in India due to the company becoming resident and not in respect of the income where, even as a non-resident, source taxation was triggered in India.

- The amount of losses and unabsorbed depreciation so recognized by the POEM-resident foreign company can be revised or modified for the purpose of set-off or carry forward, if the amount of losses and unabsorbed depreciation is revised or modified by any tax or legal authority in foreign jurisdiction.

(c) Preparation of financial statements (Profit and loss account and Balance Sheet) in cases where accounting year of the foreign company does not end on 31 March:

The foreign company shall be required to prepare financial statements for the following periods:

- **Period prior to 1 April of the tax year for which the foreign company is considered POEM-resident:**

If the accounting year of the foreign company does not end as at 31 March, the foreign company shall be required to prepare financial statements for two periods:

a) Period immediately following the said accounting year up to the beginning of the tax year (i.e. 1 April) for which the foreign company is held to be a POEM- resident of India;

b) Tax years for which the foreign company is held to be a POEM- resident of India.

This can be explained below:

Illustration (a): If the accounting year is calendar year (i.e. January- December):

If the foreign company is regarded as a POEM-resident for tax year 2017-18, the company would be required to prepare financial statements for the period from 1 January 2017 to 31 March 2017, being the period from the end of earlier accounting year up to the beginning of the tax year (for the period of three months) in addition to the accounts for the tax year.

Illustration (b): If the accounting year is from July–June:

If the foreign company is held to be a POEM-resident for tax year 2017-18, the company would be required to prepare financial statements for the period from 1 July 2016 to 31 March 2017 (for the period of nine months) in addition to the accounts for the tax year.

- **Period on or after 1 April of the tax year for**

which the foreign company is POEM- resident:

The foreign company shall be required to prepare financial statements for each succeeding period of 12 months for each tax year for which the foreign company is held to be a POEM-resident.

- **Tax year for the purpose of carry forward of loss and unabsorbed depreciation:**

  - For the purpose of determining the year-wise brought forward loss and unabsorbed depreciation, in case where there is a mismatch between India tax year and the accounting period followed by the foreign company, and the mismatch is less than six months, such period (the mismatch period) would be included as part of the accounting year immediately preceding the tax year in which the foreign company is held to be a POEM-resident in India. This can be understood by way of following illustration:

    In illustration (a) above, the accounting year preceding the tax year for which the foreign company is held to be a POEM-resident would be considered from 1 January 2016 to 31 March 2017 (period of 15 months) for year-wise determination of brought forward loss.

  - However, if the mismatch is six months or more, that period would be treated as a separate accounting year.

    In illustration (b) above, the period from 1 July 2016 to 31 March 2017 (period of nine months) would be regarded as a separate accounting year for computing the year-wise brought forward loss.

  - The quantum of brought forward losses and unabsorbed depreciation adopted from tax records or books of accounts shall be computed on proportionate basis where the accounting year followed by the foreign company is other than year ending 31 March.

(d) **Provisions relating to withholding taxes:**

- Where more than one provision of ITL relating to withholding tax obligation apply both to a "foreign company as a resident" as well as to a "foreign company", the provision as applicable to "foreign company" alone shall apply.

- Compliance of provisions of ITL relating to withholding tax obligation as applicable to foreign company prior to it becoming resident shall be considered as sufficient compliance.

- Any person making payment to the POEM-resident foreign company can determine the tax withholding quantum as per the facility available to such payer when it makes payment to non-resident.

(e) **Provisions relating to relief/deduction of taxes paid outside India:**

- The POEM-resident foreign company shall be entitled to relief or deduction of foreign taxes paid in accordance with the provisions of ITL.

- In case where the income on which foreign tax has been paid or deducted is offered to tax in more than one year, credit of foreign tax shall be allowed across such years in the same proportion in which the income is offered to tax or assessed to tax and shall be in accordance with the provisions of the Indian Income Tax Rules relating to foreign tax credit.

(f) **Applicability of rate of exchange for conversion of income earned in foreign currency into Indian Rupee:**

The provisions of the Indian Income Tax Rules which provide for the rate of exchange for conversion into rupees of value expressed in foreign currency shall apply.

(g) **Applicability of EMAs to tax years subsequent to the year when the foreign company becomes resident for first time:**

- The transitional provision of ITL carves out an exception that the EMAs as notified shall be applicable to the tax years subsequent to the tax year in which the foreign company becomes resident for the first time. Such exception applies where the residential status of the foreign company is being determined during assessment proceedings.

- The Final Notification also prescribes that all the EMAs specified shall be applicable to tax year immediately succeeding the year of POEM residency and if during such immediately succeeding tax year, the foreign company is a resident of India.

- However, for such immediately succeeding tax year, the WDV, the brought forward loss and unabsorbed depreciation, to be adopted on first day of such tax year shall be those which have been arrived at on the last day of the preceding tax year in accordance with provisions of the Final Notification.

(h) **POEM resident foreign company continue to be treated as "foreign company":**

- Subject to the EMAs provided in the Final Notification, the POEM-resident foreign company shall continue to be treated as a foreign company and consequently:
  - All provisions of ITL as applicable to a foreign company shall apply and, accordingly, the rate of income tax as applicable to a foreign company (corporate tax rate of 40%, as increased by applicable surcharge and cess, shall apply.
  - Provisions of ITL as applicable to a "non-resident" person shall not apply
  - Provisions specifically applicable to "resident" shall apply.
- In case of any conflict between provisions applicable to foreign company as a resident and provisions applicable as a foreign company, then the provisions which apply to a foreign company shall prevail.

Source: Notification No. 29/2018 (the Final Notification) issued by CBDT dated 22 June 2018

3. Indian Tax Administration releases guidance on appropriate use of Country by Country Reports (CbCR)

Background

On 5 October 2015, the OECD released its final report on Action 13, Transfer Pricing Documentation and Country-by-Country Reporting, under its BEPS Action Plan. The report introduced a standardized three-tiered approach to transfer pricing documentation for MNEs consisting of a master file, a local file, and an obligation on certain MNE groups to annually file a CbC report. CbC reporting was one of the four minimum standards of the BEPS Project to which all members of the BEPS Inclusive Framework had committed to consistently implement. To assist and support the consistent and swift implementation of CbC reporting, the OECD has released Guidance on appropriate use of information contain in CbC reports as well as two handbooks, as part of the suite of guidance prepared by the OECD and the BEPS inclusive framework to assist in the implementation and operation of CbC reporting.

In response to the OECD's BEPS project recommendation, the Indian Government through Finance Act, 2016 amended the ITL to introduce provisions for additional TP documentation and CbC reporting to implement the guidance contained in Action 13. Detailed rules for implementation were also released on 31 October 2017 on CbC reporting and furnishing of the master file by way of a notification. Under the ITL, while the master file and local file would be filed the by MNEs locally, the local CbC report filing requirements would arise in a case (A) where the parent entity of an MNE or the alternate reporting entity (ARE) is resident in India or (B) where the home jurisdiction, of the MNE group to which the Indian constituent entity is affiliated, neither have an arrangement for exchange of the CbC reporting with India nor is exchanging information with India even though there is an agreement and this fact has been communicated to the constituent entity by the Indian Tax Administration. In all other cases, every constituent entity resident in India should file CbC reporting notification in India given that the CbC reports would filed in the jurisdiction of tax residence of the ultimate parent entity and shared between jurisdictions through the automatic exchange of CbC reporting information pursuant to government-to-government mechanisms under the Multilateral Convention on Mutual Administrative Assistance in Tax Matters, bilateral tax treaties or Tax Information Exchange Agreements (TIEA).

Since the implementation of the CbC reporting regulations in India, there has been ongoing and increasing activity around CbC reporting as well as concerns around the use of CbC reporting information. Accordingly, India being committed to ensuring appropriate use of the CbC reports, on 27 June 2018 has released Instruction No. 02/2018 (the Guidance) which primarily contains processes and mechanism of CbC reports so as to ensure adequate reference and adherence in relation to appropriate use of CbC reports

What does the Guidance contain?

- **Manner of exchange of CbC reports**

As a BEPS Inclusive Framework member, India has signed the Multilateral Competent Authority Agreement (MCAA) for automatic exchange of CbC reports, in May 2016. Further, India would separately enter into a bilateral competent authority agreements (BCAA) for automatic exchange of CbC reports either based on the existing bilateral tax treaties or the TIEAs where other jurisdictions have not signed/ ratified CbC MCAA. Basis the MCAA or the relevant BCAAs, India will exchange CbC reports filed by a parent entity of MNE group or an ARE resident in India for the financial years starting from 1 April 2016 and will also receive CbC reports of non-resident MNE groups who have constituent entities in India.

- **Access to the CbC reports**

The Guidance states that all the CbC reports filed in India as well as received by India from other jurisdictions would primarily be accessed by the Indian CA and the Director General of Risk Assessment (DGRA). Further, once the case of a constituent entity is selected for audit, the jurisdictional Transfer Pricing Officer (TPO) will have access to the CbC reporting information of that constituent entity. However, the TPO ought to follow the standard operating procedure in this regard, which would be formulated by the Centralized Risk Assessment Unit (CRAU) i.e. part of DGRA.

Appropriate use of the CbC reports

As per the Guidance, the information obtained by the TPOs through the CbC reports shall be used appropriately for broadly 3 purposes in line with Action 13 report viz. (I) High level TP risk assessment (II) Assessment of other BEPS related risks; and (III) Economic and statistical analysis. Further, it is provided that the CbC report information may be used for planning a tax audit; and as the basis for making further enquiries into the MNE group's TP arrangements and tax matters during the course of an audit. However, the use of CbC report information shall be considered 'inappropriate' if (A) such information is used as a substitute for a detailed TP analysis and determination of arm's length price based on a detailed functions, asset & risks analysis and comparability analysis and (B) the information is used as the only material to propose TP adjustment.

I. High level TP risk assessment

As per the Guidance, the CRAU shall first evaluate the CbC reports (both filed and received) which could provide some perspectives on the potential risks arising from the TP arrangements between the Indian constituent entity and its affiliates. This may require further examination which could be planned through selection of that particular constituent entity for audit in respect of relevant financial year. During the course of the audit, the TPO shall make further enquiries using the CbC report information including any other data source which are made available to him during the course of audit. Further, there is no restriction on the TPO's scope that these enquiries should only be limited to the potential risks identified by the CRAU. In line with the Action 13 report, the guidance clarifies that the information contained in CbC report shall not be used as the only material to propose TP adjustments. The TP adjustments shall be made as per the provisions of ITL and rules thereto.

II. Assessment of other BEPS related risks

In line with the Action 13 report, the guidance states that the CbC reports may be used to identify indicators of possible tax risks which are unrelated to TP arrangements; which will lead to examination of such risks through further enquiries during audit so as to arrive at a conclusion on potential BEPS issue. However, the information gathered from CbC reports cannot be considered as 'conclusive evidence' to arrive at the decision that MNE group is engaged in other forms of BEPS.

III. Economic and statistical analysis

As specified in Action 13, the CbC report information may be used for economic and statistical analysis for the purpose of better understanding of the use of CbC reports as well as to identify the features, benefits and risks of the CbC reports and tax systems. Further, the usage of information for such analysis shall be consistent with the provisions of the tax treaties.

Confidentiality of the CbC report

The Guidance recognizes the legal importance & criticality of maintaining confidentiality under tax treaties and also as an international obligation since any breach could impact India's ability to receive CbC reports from other jurisdictions. Therefore, the Guidance provides that all CbC reports, which are filed in India and received from other jurisdictions, are subject to strict confidentiality norms under the provisions of ITL and tax treaties respectively. The Guidance also makes it clear that all officers who are handling the CbC report information exchanged under the tax treaties, must adhere to the confidentially chapter of "Manual on Exchange of Information" as issued by the Government of India. The Guidance also places greater onus on the senior officials within the tax administration to sensitize the officers in their region on the requirements of maintaining confidentiality.

Monitoring, Control and Review

As per the Guidance, the use of CbC report information by the TPO during the TP audits will be monitored by the jurisdictional Commissioner and any breach of appropriate use may be brought to the notice of the Indian CA through proper channel. The Indian CA is committed to disclose such breaches of appropriate use to the Coordinating Body Secretariat in the OECD. Further, it is provided that the respective TPOs shall also report to the jurisdictional Commissioner any concerns raised by the Taxpayers on breach of appropriate use and if the Commissioner does not resolve the issue, the same should immediately be brought to the notice of Indian CA. In line with Action 13 standard, the Guidance reiterates that in case of any adjustments to the income of Taxpayer based on inappropriate use of CbC report information, the Indian CA is committed to promptly concede such adjustment in any mutual agreement procedure proceedings.

Further, a quarterly review mechanism on appropriate use of the CbC reports would be undertaken by the Indian Tax Administration through the Indian CA. Such quarterly review reports from all concerned tax officials should reach the Indian Tax Administration within 30 days from the end of each quarter. The first of such quarterly review is scheduled to be for the quarter January-March 2019 and is due by 30 April 2019.

Source: Instruction No. 02/2018 (the Guidance) dated 27 June 2018

4. Indian tax administration invites stakeholders' comments on Significant Economic Presence

Background

The technological revolution has changed the entire landscape of how one conducts business world over, without actually having any physical presence. These emerging remote business models remained outside the realm of the ITL due to the restrictive scope of the definition of "business connection" (BC) in India, which required physical presence/activities of the non-resident (NR) in India. The current tax treaty provisions also tax business income based on physical presence in the form of a PE and, thus, are inadequate to cover remote transactions.

In order to keep pace with advanced technology and also to ensure that revenue is taxed at the place where the economic activity is conducted, the Finance Act, 2018 expanded the concept of BC to include a new nexus rule based on "Significant Economic Presence" (SEP), wherein the term SEP is defined by considering certain parameters as below:

(a) **Revenue-linked condition:** Any transaction in respect of any goods, services or property carried out by an NR in India, including provision of download of data or software in India, if the aggregate of payments arising from such transaction or transactions during the tax year exceeds the amount as may be prescribed; or

(b) **User-linked condition:** Systematic and continuous soliciting of its business activities or engaging in interaction with such number of users as may be prescribed, in India, through digital means.

Furthermore, SEP will be determined independent of whether the agreement for such transactions or activities is entered into in India or the NR has a residence or place of business in India or the NR renders services in India.

The threshold of "revenue" and "number of users" in India (as stated above in (a) and (b) conditions) were to be prescribed by the CBDT after a consultation process with various stakeholders. Accordingly, in line with the current Government's consultative approach, the CBDT has issued a Notification dated 13 July 2018 inviting suggestions/comments from stakeholders and the general public.

Suggestions/comments are invited on the following aspects:

(a) Revenue threshold of the transaction in respect of physical goods or services carried out by an NR in India.

(b) Revenue threshold of the transaction in respect of digital goods or services or property, including provision of download of data or software carried out by an NR in India.

(c) Threshold for number of "users" with whom an NR engages in interaction or carries out systematic and continuous soliciting of business activities in India through digital means.

(d) Comments and suggestions are to be sent electronically by 10 August 2018 to the email address ustpl3@nic.in.

Source: Notification F. No. 370142/11/2018-TPL issued by CBDT dated 13 July 2018

5. India amends Advance Ruling forms for implementing BEPS Action 5 on tax-ruling exchanges

Background

One of the three key pillars of OECD/ G20's BEPS project is to improve tax transparency in cross border transactions while promoting increased certainty and predictability. In order to achieve such objective, BEPS Action 5- *"Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance"* targeted on improving transparency through a framework of mandatory spontaneous exchange of information (EOI) on certain taxpayer-specific rulings which, in the absence of such EOI, could give rise to BEPS concerns.

According to Final Report on BEPS Action 5, released in October 2015, such EOI on tax rulings need to take place not only with the countries of residence of all related parties with whom taxpayer enters into transaction but also with the country of residence of the immediate parent company and the ultimate parent

company of the NR involved in the transaction. The exchange is intended to resolve the countries' concerns that, if countries have no knowledge or information on the tax treatment of a taxpayer in a specific country, the transactions or arrangements may affect a related taxpayer resident in their home country.

India's commitment to Action 5

India has been an active membership in BEPS project and has implemented many BEPS recommendations such as Equalisation Levy (BEPS Action 1), Significant Economic Presence (BEPS Action 1), Interest Limitation Rules (BEPS Action 4), Country-by-Country Report (BEPS Action 13). Further, while introducing Patent Box Regime in India in Finance Act 2016, India has followed recommendations in BEPS Action 5 which is a minimum standard. In line with its commitment to BEPS Action 5, India is also obligated to participate in EOI on tax rulings.

Under the ITL, the AAR is an independent quasi-judicial body with powers of a civil court set up with the objective of providing certainty on tax issues involving taxation of NR or specified class or category of resident taxpayers. Currently, the forms prescribed for filing an application before the AAR by a resident or an NR do not require an applicant to fill up information in respect of immediate parent company and the ultimate parent company of the NR applicant or of the NR with whom the resident applicant proposes to enter/enters into transaction.

Accordingly, in order to implement recommendations made under Action 5 and to effectively comply with the requirement of EOI on tax rulings, the CBDT had issued the draft notification for public consultation. After considering the suggestions/ comments from various stakeholders, the CBDT has issued its final notification with no major changes from the draft notification. The amended forms capture details such as name, address and country of the residence of NR's immediate parent company and/or ultimate parent company. As per the draft notification, the intention is to capture such details at the application stage itself.

As per the final notification, following additional details are requested:

1. **In the application form by an NR applicant**

   a. Taxpayer Identification Number in the country of resident of the NR applicant;

   b. Name, address, country of residence, Taxpayer Identification Number in such country of residence, Permanent Account Number (PAN) in India (if any) of the immediate parent company of NR applicant;

   c. Name, address, country of residence, Taxpayer Identification Number in such country of residence, PAN in India (if any) of the ultimate parent company of NR applicant.

2. **In the application form by specified category of resident applicant seeking an advance ruling in relation to transaction undertaken/proposed to be undertaken with an NR**

   a. Name, address, telephone/ fax number, Taxpayer Identification Number in such country of residence, PAN in India (if any) of the NR counterpart with whom the resident applicant transaction is undertaken or is proposed to be undertaken;

   b. Same as 1(b) and 1(c) above in relation to the NR counterpart.

The final notification comes into force from 13 July 2018.

Source: Notification No. 31/2018/F. No. 370142/34/2016-TPL (Part) issued by CBDT dated 13 July 2018

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