EY Tax and Regulatory Alert

June 2018

Prepared for ACMA

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Indirect Tax

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

Judicial Precedents

1. M/S Honda Siel Cars India Limited Vs Commissioner of Central Excise, Noida

[2018-VIL-376-CESTAT-ALH-CE]

Background and facts of the case

- Issue in the present case is whether the discount allowed by the appellants/ manufacturer to its authorized dealers in respect of "Demo Cars" have been rightly disallowed by the lower authorities by adding back in the assessable value

- Show Cause Notice dated 1 December 2006 was issued for the period 14 November 2005 to 31 August 2006 on the appellants who are manufacturers of passenger cars. It appeared to Revenue that they have evaded the payment of Central Excise duty by short payment of duty amounting to Rs.47,45,127/- on the clearances of passenger cars, described as "Demo Cars", contravening the provisions of Rule 4, 6, 8 of the Central Excise Rules, 2002 read with Section 4 of the Central Excise Act, 1944

- The appellant in response to enquiry, informed the Range Superintendent of Central Excise that in their business, it is imperative for their dealers to show the cars to the end customers in their show rooms and to provide the facility of test drive, before the customer is able to make their decision to purchase the car

- They further informed that their dealers are therefore required to keep some stock of cars owned by them (called "Demo Cars") in their show rooms, specifically for this purpose

- The cars for the purpose of demonstration are required to be available in the showroom condition (i.e. in immaculate condition) to attract the customers. Process of keeping Demo cars in good condition definitely means a substantial cost to the dealers. To meet a part of such cost at one hand and encouraging them to maintain the requisite number of Demo Cars, the appellant offered them a fixed monetary benefit

- It was further emphasized that the discounts offered is not only passed on to the dealer, but also ultimately passed on to the final customer. Further the amount received from the dealer is the sole consideration of sale of such Demo Car. Further, the discount amount is duly reflected in the invoices and the Demo Car is identifiable with its engine and chassis numbers for internal control purposes. It was further emphasized that the discount is uniformly given to all the dealers of the appellant company in India. While the overall discount amount is fixed, however, the discount rooted through the invoices will vary, depending upon the duty structure from time to time

- It has been alleged in the said Show Cause Notice that the appellant kept paying Central Excise duty on the assessable value of the excisable goods, which did not include amount of discount and therefore contravened under Section 4 of the Central Excise Act, 1944 by removing the excisable goods without payment of appropriate duty payable thereon and also appear to have contravened the provisions of Rule 6 of the Central Excise Rules, 2002 by not correctly assessing the duty payable on the excisable goods and Rule 8 of the Central Excise Rules, 2002 by not paying the appropriate duty payable on the goods removed during a particular month

- It is further alleged that the appellant was intimated by the Jurisdictional Superintendent of Central Excise by letter dated 16/12/2005, that in view of non-compliance by them, the clearance of "Demo Cars" shall be treated as removal without payment of appropriate duty intentionally and render such dispatches and the person responsible for such dispatches liable to be proceeded against as per the Central Excise Act, 1944 and Central Excise Rules 2002

- The CBEC Circular No. F6/40/2003–CX1 dated 01/04/2003 has clarified that Central Excise payable on the "Demo Cars" would be the same as what is payable on normal cars

- Accordingly, the differential duty/short paid was demanded, involved on the "Demo Cars" cleared

- Subsequently, corrigendum to the Show Cause Notice was issued on 20/12/2006, acknowledging that the appellant has deposited the amount as mentioned in the Show Cause Notice prior to issue of the SCN, in September, 2006 and further the name of the appellant/noticee was corrected

- The SCN was adjudicated on contest vide OIO dated 31st January, 2008 confirming the proposed duty allegedly short paid along with equal amount of penalty under Rule 25 of the Central Excise Rules, 2002.

- Being aggrieved by the said order the appellant preferred appeal before ld. Commissioner (Appeals) who vide the impugned order was pleased to uphold the OIO, only modifying the penalty imposed, observing that it is admitted fact that the appellant had informed the Department regarding the sale of "Demo Cars" at a discounted price to the dealers. Further, during investigation the appellant deposited the differential duty on such clearances under protest. There being no element of fraud, collusion, willful mis-statement, etc. and further the appellant themselves have intimated their business policy of clearing the "Demo Cars" on discount

Held by CESTAT

- Tribunal further find that the Show Cause Notices are against the concept of transaction value under Section 4 of the Act. It is further noticed by the Tribunal that <u>the discount has been given by the appellant in terms of the business policy, which was widely known as "Trade Discount" and they had also made adequate disclosures to the Revenue</u>

- CESTAT further find that the trade discount under dispute was known to all, prior to removal of the goods, and the same have also been given at the time of clearance. Accordingly, we hold the same is permissible under Section 4 of the Act. We find that the facts herein are squarely covered by the ruling of the Apex Court in the case of Union of India Versus Bombay Tyres International Pvt. Ltd. (supra)

- Accordingly appeal was allowed with consequential benefits to the appellant. The impugned orders are set aside

2. M/S Northern Motors Private Limited Vs Commissioner of Central Excise & Service Tax, Ludhiana

[2018-VIL-342-CESTAT-CHD-ST]

Background and facts of the case

- Brief facts of the case are that the appellant is registered with the department under the category of Authorized Service Station. The appellant received certain amounts from the manufacturer M/s. Hindustan Motors Limited under 'Serve to Win' (hereinafter referred to as 'STW') reward scheme for the free services provided by them

- The department took a view that the appellant had received this amount in lieu of free services provided by them to the buyers of the vehicles. Accordingly, department issued two show cause notices alleging that such amount is liable to service tax as the same has been received in lieu of free service provided by the appellant and was taxable under the Authorised Service Station category

- Learned advocate for the appellant has made a written request dated 26 April 2018 that the appeals be decided on the basis of written submissions made on 24 January 2017

- In the written submissions, the appellants pleaded that the department has misunderstood the STW scheme which is a kind of reward for 100% satisfaction to the customers and to achieve certain standards as pre-delivery inspection, initial three free services and for maintenance of complete control system to provide better service to the customers. Contention is that the department admits in the show cause notice that the entire cost is borne by the appellant and there is no reimbursement being received from the manufacturers or charged to the customers but the amount received under the STW reward scheme is being treated as service provided by the appellant. Further contention is that the cost of free service is included in the sale price of the car and there is no separate price charged for providing free services

- It is also contended that STW scheme is at the discretion of the manufacturer and one such claim was rejected by M/s Hindustan Motors Limited on 10 November 2008

Held by CESTAT

- On hearing both the sides, CESTAT held that the appellants are providing three free services during the warranty period. Admittedly, the entire cost of free service is borne by the appellant and no reimbursement is being received from the manufacturers or is being charged to the customers. The free services are being provided in pursuance to the obligation cast on the appellant by the manufacturer of the vehicles. The department while accepting this position has alleged that amount received by the appellant under STW scheme is a compensation for the services provided and was thus liable to pay service tax

- In this context, from the findings of the Commissioner (Appeals), it is not clear on what basis the ld. Commissioner (Appeals) has concluded that what is being received under STW scheme is actually against the taxable service. The adjudicating authority has also observed that the amounts are being received as reimbursement of the amount by the manufacturer on account of services provided by the dealer to the consumer. However, no basis for such a conclusion has been provided in the adjudication order

- CESTAT also held that in the constitutional scheme of things, there is mutual exclusivity between the taxability of sale of goods, which is charged to sales tax by the State; the excise duty on manufactured goods which is levied by the Centre; and the tax on services, which is also levied by the Centre

- The impugned amount in question is a part of the dealers' margin which has been recovered by the appellants as a part of the sale value of the cars from the customers and the entire amount has been subjected to sales tax by the concerned State Government authorities

- When the appellants sold the cars and recovered the amount including the dealers' margin, the dominant intent, was to sale the goods, namely, cars and not to provide free after sales service. In our view, the entire amount including the dealers' margin has been rightly taxed to sales tax representing the value of the cars

- The provision of free servicing is merely incidental and intended to promote the sale of the cars. Hence, CESTAT is of the view that no service tax can be levied on the amount representing the dealers' margin or any part of it which already has been subjected to sales tax. Consequently, the impugned order is set aside

3. M/S Yash Motors Vs Commissioner of Central Excise, Jaipur-II

[2018-VIL-366-CESTAT-DEL-ST]

Background and facts of the case

- The brief facts of the matter are that the appellant are selling vehicles of M/s Tata Motors to various customers and they are getting such vehicles registered with the local RTO on behalf of customers, for facilitating the customers, with regard to getting the vehicle registered with the RTO and to cover other minor expenditures relating to such activity, the appellant are collecting some amounts from the customers. The amount charged for such facilitation is in lump-sum manner and no headwise expenditure is being shown by them. The fact of the matter is that after bearing the expenditure for registration of the vehicles with the RTO and other minor expenses relating to the registration some amount get saved with the appellant and this amount is duly accounted for, in their financial accounts. The Department is of the view that the amount as retained by the appellant on account of RTO handling charges is liable to service tax under Business Auxiliary Service

- The basic argument of the learned Advocate appearing for the applicant is that the extra amount retained from the expenditure charges collected by the appellant from the customer for the registration purpose is being charged from the customer to whom no service which falls under the category of Business Auxiliary Service is being provided by the applicant and, therefore, not chargeable to service tax

- CESTAT is of the view that helping the purchaser with registration with the RTO, cannot be considered by Business Auxiliary Service, in view of the foregoing, we hold the Service Tax demand of the amount retained by the appellant in respect of RTO registration fees is not sustainable. The impugned order is set aside. This Bench in the case of Wonder Cars Pvt. Ltd. v. Commissioner of Central Excise, Pune-I - 2016-TIOL-190-CESTAT-MUM = 2016 (42) S.T.R. 1055 (Tri.-Mum.) - 2015-VIL-710-CESTAT-MUM-ST, has held that amount collected as extra charges for RTO registration is

not covered under "support services of business and commerce"

- In view of the foregoing, the Service Tax liability confirmed under Business Auxiliary Service for the amount of RTO registration fees is not maintainable. As regards the penalty imposable, we find the Service Tax liability of the amounts received from the various financial institutions, whether is taxable otherwise was settled by the Larger Bench, there were two different streams of the decisions contradicting each other. As the issue needs to be settled by the Larger Bench, the appellant having discharged Service Tax liability and interest thereon, this is a fit case for invoking Section 80 of the Finance Act, 1994 to set aside penalties. Invoking the provisions of the Section 80 of the Finance Act, 1994, we set aside the penalties imposed by the adjudicating authority"

- Since the facts of the case at hand are similar to that of M/s Arpanna Automotive Pvt. Ltd. vs. CC & CE – 2016 (43) S.T.R. 397 (Tri. – Mumbai), following the above decision of this Tribunal, CESTAT hold that the charges received and retained by the applicant from the customers for facilitating RTO registration is not chargeable to service tax under business auxiliary service category and, therefore, the order-in-appeal is set aside and allow the appeal

Key Indirect Tax updates

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

1. **Advance Ruling issued by the Authority for Advance Ruling (Telangana) in the case of M/s Macro Media Digital Imaging Private Limited ('Applicant') wherein it has been held that:**

   a) Printing advertisement materials manufactured and supplied by the applicant are classifiable as 'supply of goods'

   b) The printed advertisement material are classifiable under chapter heading 4911 of the GST Tariff and the rate of tax applicable is 6% CGST + 6% SGST

Issues on which advance ruling was sought

- Whether the printed advertisement materials classifiable as 'supply of goods'?
- If yes, whether it is classifiable under chapter heading 4911 of first schedule to Customs Tariff Act.

The key highlights of the Ruling

- The Applicant is in the business of manufacturing and sale of digital printed materials like banner flex. The preparation of such printed material would be undertaken as per the customer specification wherein customers specify the sizes of the advertising material, location of the advertising material to be displayed etc
- All required material for the preparation of the advertisement material are procured by the applicant only (i.e. customer does not provide any material)
- Applicant also recovers the cost incurred towards transportation, installation, packing etc
- In pre-GST regime, the applicant has been paying applicable VAT and filed VAT returns accordingly
- The Applicant in support of its contention (i.e. printed material supplied shall be treated as supply of goods) submitted the following additional grounds :

  a) That Sl. No. 1(a) of Schedule II to the CGST Act, 2017 provides that any transfer of title in goods is 'supply of goods'

  b) That Para 5 of the TRU clarification vide circular No. 11/11/2017-GST dated 20-10-2017 clarified that printing contracts similar to the instant case constitute 'Supply of goods'.

  c) That the instant case of printed advertisement materials is being used for trade advertising and not covered under any other heading of Chapter 49 thereby falls under the chapter heading 4911 of Customs Tariff Act, 1975 (made applicable for GST classification). The chapter note 5 to Chapter 49 also supports the same.

- AAR held that as per Section 7 of CGST Act, 2017 read with Schedule-II Sl. No. 1(a) of CGST Act, *"any transfer of the title in goods is a supply of goods"*

  In the instant case, the applicant is engaged in the business of manufacturing and sale of digital printed materials, wherein preparation of such printed material would be undertaken as per the

customers specification. Except specifying the specifications and designs to be printed, clients/customers of applicant does not provide any materials and all required materials for the preparation of the advertisement materials are procured by the applicant only. The applicant is transferring the title in the goods i.e., printed advertisement materials. Therefore, instant case of supplying printed advertisement materials amounts to supply of 'goods' only

- Further, AAR held that printed advertisement material are classifiable under Tariff heading 4911 in accordance with the rules for the interpretation of the First Schedule to the Customs Tariff Act, 1975, including the Section and Chapter Notes and the General Explanatory Notes of the First Schedule as made applicable for the interpretation and classification of goods under GST Tariff as under :

Sl. No	Chapter / Heading / Sub-heading / Tariff item	Description of Goods	Rate
132 Sch-II of notification 1/2017 - Central Tax (Rate)	4911	Other printed matter, including printed pictures and photographs such as Trade advertising material, Commercial catalogues and the like, printed Posters, Commercial catalogues, Printed inlay cards, Pictures, designs and photographs, Plan and drawings for architectural engineering, industrial, commercial, topographical or similar purposes reproduced with the aid of computer or any other devices	CGST 6% + SGST 6%

2. CBIC issued Explanatory Notes to scheme of classification of services, Clarification on 'Place of Removal and certain issues under GST

Explanatory Notes to Scheme of Classification of Services

- The CBIC has released explanatory notes to scheme of classification of services under GST regime. Such explanatory notes are modified version of United Nations Central Product Classification ('UNCPC') notes indicating the scope and coverage of the heading, group and service codes of the scheme of classification of services

- The purpose of such explanatory notes is to be used as a guiding tool by the assesse and tax administration for classification of services. Further, it has been clarified that where a service is capable of differential treatment for any purpose based on its description, the most specific description shall be preferred over a general description

3. Circular No. 1065/4/2018-CX dated 8 June 2018

- The CBIC has issued a referred circular to provide a guidance note on 'Place of Removal' u/s 4 of Central Excise Act, 1944 and CENVAT Credit Rules 2004 & 2017, in view of SC judgments in M/s Roofit Industries Ltd., M/s Ispat Industries Ltd., M/s Emco Ltd and M/s Ultra Tech Cement Ltd. The circular reiterates as follows:

a) The principle laid down in the case of Ispat Industries Ltd. that the *'place of removal' is required to be determined w.r.t. 'point of sale'* with a condition that same should be referable only to manufacturer's premises and not to the buyer

b) However, as an exception, in case of FOR (Free on Road) destination sale where ownership, risk in transit remains with seller till the goods are accepted by the buyer on delivery, the said principle would not apply, as held by Apex Court in the case of Emco Ltd. and Roofit Industries Ltd

c) As regards CENVAT credit on GTA services, CBIC draws attention to SC decision in Ultra Tech Cement Ltd. wherein it was observed that after amendment to definition of 'input service' under Rule 2(l) of CENVAT Credit Rules w.e.f. 1st March 2008, *service is treated as input service only 'up to the place of removal'*.

d) Accordingly, directs field formations to refer to SC judgments for further guidance in individual cases based on facts and circumstances of each case.

e) Further, it has been directed that any new show cause notice issued on the basis of said circular should not invoke extended period of limitation in cases where an alternate interpretation was taken by the assesse before the date of the Supreme Court judgment as the issue is in the nature of interpretation of law.

4. Circular No. 47/21/2018-GST dated 8 June 2018

The CBIC has issued a referred circular to provide clarifications with respect to GST implications on certain issues as provided below :

- **Whether moulds and dies owned by Original Equipment Manufacturers ('OEM') that are sent free of cost (FOC) to a component manufacturer is leviable to tax and whether OEM are required to reverse input tax credit ?**

a) Moulds & dies supplied by OEM to component manufacturer (unrelated person) on FOC basis does not constitute a supply as there is no consideration involved. Accordingly, no GST liability would be applicable on such supply

b) Further, it has been clarified that since the moulds & dies are provided on FOC basis in course or furtherance of OEM's business, there is no requirement for reversal of Input Tax Credit ('ITC') by OEM

c) It has also been clarified that while calculating the value of supply by the component manufacturer, the value of moulds and dies supplied by OEM (FOC basis) shall not be added to the value of such supply

d) However, if the contract between OEM and component manufacturer was for supply of components made by using the moulds/ dies belonging to the component manufacturer. But the same have been supplied by the OEM to the component manufacturer on FOC basis. In such case, the amortised cost of such moulds/dies shall be added to the value of the components. Also, the OEM would be required to reverse ITC availed on such moulds/ dies as the same would not be considered to be provided by OEM in the course or furtherance of the OEM's business

- **How is servicing of cars involving both supply of goods (spare parts) and services (labour), where the value of goods and services are shown separately, to be treated under GST ?**

a) The taxability of supply would have to be determined on a case to case basis looking at the facts and circumstances of each case

b) It has been clarified that where a supply involves supply of both goods and services and the value of such goods and services supplied are shown separately, the goods and services would be liable to tax at the rates as applicable to such goods and services separately

- **In case of transportation of goods by railways, whether goods can be delivered even if the e-way bill is not produced at the time of delivery?**

It has been clarified that the railways shall not deliver the goods unless the e-way bill is produced at the time of delivery

- **Whether e-way bill is required where goods transit through another State while moving from one area in a State to another area in the same State and where goods move from a DTA unit to a SEZ unit or vice versa located in the same State?**

a) It has been clarified that e-way bill generation is not dependent on whether a supply is inter-state or not, but on whether the movement of goods is inter-state or not. Therefore, if the goods transit through a second state while moving from one place in a state to another place in the same state, an e-way bill is required to be generated

b) Where goods move from a DTA unit to a SEZ unit or vice versa located in the same state, there is no requirement to generate an e-way bill, if the same has been exempted under rule 138(14)(d) of the CGST Rules

5. Amendment in CGST Rules,2017 related to Inverted Duty Structure

- Amendments have been introduced in the Central Goods and Service Tax Rules, 2017 relating to refund formula and format of statement to be submitted in case of refund being claimed on account of inverted duty structure vide **Notification 26/2017 dated 13 June 2018.** There is no change in the refund formula which was amended previously *vide* Notification no 21/2018-Central Tax dated 18 April 2018, as mentioned in

the trailing email and the same was applicable with effect from 18 April 2018

- However, *vide* **Notification no 26/2017 dated 13 June 2018**, the government has made applicable above amendment in refund formula **with effect from 1 July 2017** and also, there is slight change in the Statement to be submitted with the application

6. Central Goods and Services Tax (Fourth Amendment) Rules, 2018

- **Revised formula for calculation of refund on account of inverted duty structure by substituting rule 89 (5) of CGST rules 2018 as follows:-**

Refund Amount = {(Turnover of inverted rated supply of goods and services*) x Net ITC** ÷ Adjusted Total Turnover} - tax payable on such inverted rated supply of goods and services***

* *turnover of inverted rated supply of services has now been **included** in the amended rules*
** *the calculation of Net ITC has been amended to **exclude** credit availed on input services*
*** *tax payable on inverted rated supply of services has now been **included** in the amended rules*

Earlier Rule: The refund amount was being granted for input tax credit availed on **inputs and input services** in respect of turnover of inverted rated supply of goods only. The relevant formula has been mentioned as hereunder:-

Maximum Refund Amount = {(Turnover of inverted rated supply of **goods**) **x Net ITC****** ÷ Adjusted Total Turnover} - tax payable on such inverted rated **supply of goods**

**** Net ITC was defined to include the input tax credit availed on **inputs and input services**

The impact of the changes has been illustrated below:

ITC availed on inputs = 18; ITC availed on input services = 18;
Turnover of inverted rated supply of goods (5%) = 100; Tax payable on such goods = 5
Turnover of inverted rated supply of services (5%) = 100; Tax payable on such services = 5

Refund amount as per Earlier Rule	Refund amount as per Amended Rule
Refund= {Net ITC) X Turnover of inverted supply of goods÷ Adjusted Total Turnover} - tax paid on such supply of goods. Refund= {(18+18) * 100/200} - 5 Refund= INR 13	Refund Amount= {(Net ITC) X Turnover of inverted rated supply of goods and services ÷ Adjusted Total Turnover} - tax payable on such supply of goods and services. Refund = {18 *200/200}- 10 Refund = INR 8

Conclusion: This change may have been introduced for passing on refund benefit to inverted supply of services also along with the inverted supply of goods, however, it seems that there is a flaw in drafting the definition of Net ITC available since exclusion of ITC on input services is further reducing the amount of refund which should have increased to INR 26***** (calculation shown below) instead of getting reduced to INR 8. Hence, the intent of increasing the refund on account inverted rated supply of services have not been achieved

*****Refund = {(18+18)* 200/200}-10 to be INR 26

- Release of format of Final Return in Form GSTR-10 to be furnished by every registered person who is required to furnish FORM GSTR-3/3B and whose registration has been cancelled within 3 months of the date of cancellation or date of order of cancellation, whichever is later

7. Roll-out of e-Way Bill system for Intra-State movement of goods in Delhi

The Commissioner of State Tax *(Delhi)* by virtue of powers given under Rule 138(14)(d) of Delhi Goods & Services Tax Rules,2017 *vide* Notification No.3/2018 dated 15 June 2018 has rescinded the erstwhile notification which prescribed an exemption for requirement of generation of e-waybill for intra-state movement of goods. ***Therefore, w.e.f 16 June 2018, it is mandatory to generate e-way bill for intra state movement of goods in the state of Delhi if consignment value exceeds INR 1,00,000***

8. CBIC's interim solution for IGST refunds stuck due to non-transmission of data from GSTN to Customs EDI System

As per Circular no. 12/2018-Customs, issued by Central Board of Indirect taxes and Customs, the following procedures have been provided by the authority for sanctioning the refund:

Case I : No short payment i.e. where total IGST paid (i.e. export and domestic inter-stare supply) for the period July 2017 to March 2018 mentioned in GSTR-3B is greater than or equal to IGST mentioned in GSTR-1 for the respective period

- Custom Policy wing will prepare a list of exporters whose total IGST paid in GSTR-3B is greater than or equal to that mentioned in GSTR-1, and will send it to GSTN. GSTN, in turn, will send the confirmatory e-mail to such exporters for the transmission of records to Custom EDI system
- Exporter, whose refunds are processed/sanctioned, would be required to submit a CA certificate to the Customs office at the port of export before 31st October 2018 to state that there is no discrepancy between the IGST paid on export and the amount refunded during the mentioned period. Also, where the exports are from multiple ports, the exporter can submit the CA certification at any port of export
- Also, a copy of the certificate would need to be submitted with the jurisdictional GST office (Central/State).The Circular also mentions that non submission of these CA certificates may also affect the future IGST refund of such exporters

Case II : Short payment i.e. where the total IGST paid (i.e. export and domestic inter-stare supply) for the period July 2017 to March 2018 mentioned in GSTR-3B is less than IGST mentioned in GSTR-1 for the respective period

- Custom Policy wing will prepare the list of such exporter and will send it to GSTN. GSTN, in turn, shall send the confirmatory e-mail to such exporter to inform that their records are held up due to short payment
- Exporter would have to make the short payment of IGST in the subsequent month so that the refund amount claimed is paid
- Proof of payment(i.e. self-certified copy of challan) is required to be submitted to the AC/DC of customs in charge of port from where the exports are made, where the amount of IGST refund amount is upto INR 10 Lakh. However, where the IGST refund amount is more than INR 10 Lakh, CA certificate shall also be required stating that the shortfall amount has been liquidated along with the proof of payment

Also, where the exports are from multiple ports, than exporter can submit the CA certificate at any port of export.

- Exporter will be required to give an undertaking to make the payment of refund amount realised where it is found to be not due to them at a later date
- List of such exporter will be sent to the GSTN as per the prescribed process
- Exporter, whose refunds are processed/sanctioned, would be required to submit a CA certificate to the Customs office at the port of export before 31 October 2018 to state that there is no discrepancy between the IGST paid on export and the amount refunded during the mentioned period

Also, where the exports are from multiple ports, than exporter can submit the CA certificate at any port of export

- A copy of the certificate would need be submitted to the jurisdictional GST office (Central/State)
- Non submission of the CA certificate will also affect the future IGST refund of such exporters

Post refund audit

- Post Refund audit will be conducted in relation to such exporter in the manner specified in the said circular

Direct Tax

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

Judicial Precedents

1. Supreme Court rules on length of tax holiday period under section 80-IC for units set up outside North Eastern region

Background and facts of the case

- The Taxpayer engaged in the business of manufacturing polythene, had setup an industrial undertaking in state of Himachal Pradesh. Such unit was eligible for tax holiday benefit under erstwhile S.80IA(2)(iv)(b) from the tax year 1997-98 onwards. Thus, for the tax years 1997-98 and 1998-99 (first and the second year respectively), the Taxpayer claimed 100% deduction under section 80IA.
- S.80IA was split up between S.80IA and S.80IB from tax year 1999-2000 onwards. Hence, Taxpayer claimed deduction under S.80-IB from third year onwards till tax year 2004-05 (eighth year).
- Subsequently, in the tax year 2005-06 (ninth year), the Taxpayer undertook substantial expansion by way of investment in the plant and machinery exceeding 50% of book value as on first day of the ninth year. The Taxpayer treated tax year 2005-06 as 'initial year' qua an existing unit which completes substantial expansion and started claiming 100% deduction on the profits of the unit from tax year 2005- 06 onwards.
- The Tax Authority allowed claim of 100% tax holiday for tax years 2005-06 and 2006-07 (ninth and tenth year from setting up of unit)
- Dispute arose when Taxpayer continued claiming 100% tax holiday for tax years 2007-08 and 2008-09 (eleventh & twelfth year from setting up of unit)
- The tax holiday claim made in various years is tabulated as below:

Tax Year	Section under which deduction claimed	Total no. of years deduction claimed
1997-98 & 1998-99	80-IA	2 years (First and second year)
1999-00 to 2004-05	80-IB	6 years (Third to Eighth year)
2005-06 to 2008-09	80IC	4 years (Ninth to Twelfth year)

- There was neither any dispute on compliance with any other condition of S.80-IC nor any dispute on the fact that expansion implemented by the Taxpayer qualified as "substantial expansion". Also, the proposition that the term 'initial year' refers to the year in which substantial expansion has been completed was also accepted by the Tax Authority.
- While Tax Authority allowed 100% deduction for tax years 2005-06 and 2006-07 (being the ninth and tenth year of the unit), the deductions for the subsequent years (being eleventh and twelfth year) were disallowed on the ground that total period of tax holiday claim cannot exceed a maximum of 10 years as per S.80IB(6).
- The First Appellate Authority and Tribunal ruled against the Taxpayer and upheld the Tax Authority's action of restricting the total period of tax holiday claim to a maximum of 10 years.
- On appeal before the HP HC, the HC clubbed Taxpayer's case with many other taxpayers who had set up units and completed 'substantial expansion' during different time periods.
- The categories of taxpayers before the HC were as follows :-

  a. The unit was set up outside North Eastern Region prior to 7 January 2003 and it was claiming deduction under S.80IB before undertaking substantial expansion (i.e. Taxpayer's case)

  b. Existing units set up prior to 7 January 2003 but not claiming any deduction before undertaking substantial expansion

  c. New unit set up post 7 January 2003 and claiming deduction under S.80IC before undertaking substantial expansion

- The HC clubbed all the cases together and first dealt with principal issue of impact of 'substantial expansion' in case of third category i.e. new unit set up post 7 January 2003 which was claiming deduction under S.80IC before undertaking substantial expansion. For this category, the HC held that, having claimed 100% deduction for first five years, if the substantial expansion is completed in sixth year, the taxpayer can claim 100% deduction from sixth to tenth years. But in view of limitation of S.80IC(6), it cannot claim deduction beyond tenth year.

- For the second category where existing unit was set up prior to 7 January 2003 but not claiming any deduction before undertaking substantial expansion, the HC held that it was eligible for deduction under S.80IC @ 100% for first five years and @25% for next five years from the year of substantial expansion.

- On the first category (which covered Taxpayer's case) the HC held that if the unit is established prior to 7 January 2003 and was claiming deduction under S.80IB and it carries out substantial expansion before cut-off date of 31 March 2012, it would be entitled to deduction under S.80IC for the remaining period which on combined basis cannot exceed ten years from year of set up of unit. Hence, the HC dismissed Taxpayer's appeal for claiming deduction for eleventh and twelfth years as reckoned from year of set up of unit.

- Being aggrieved, the Taxpayer appealed before the SC.

- Before the SC, the Tax Authority raised an alternative argument that by merely making substantial expansion, the Taxpayer cannot be regarded as eligible for claiming S.80IC deduction since it does not result in new and identifiable undertaking separate and distinct from existing business. For this proposition, the Tax Authority relied on earlier SC ruling in the case of Textile Machinery Corporation Ltd v. CIT

Issue before the SC

What is the length of tax holiday period available to a taxpayer who set up unit prior to 7 January 2003 in industrially backward state other than North Eastern Region and was claiming deduction under S.80IB, if he completes 'substantial expansion' post 7 January 2003?

Supreme Court ruling

The SC ruled in favour of the Taxpayer and permitted a tax holiday claim of 100% even in the eleventh and twelfth year by holding that the ceiling of combined period of ten years as provided in section 80-IC(6) did not apply to the Taxpayer in eleventh and twelfth years since the Taxpayer's unit was located in Himachal Pradesh and not in North Eastern Region.

The SC held as under:

- S.80IC provides for ceiling of combined period of ten years of tax holiday in following circumstances:
  - When deduction under section 80-IC itself is allowed for a total period of ten years
  - When the deduction is allowed under second proviso to S.80IB(4) for units set up in North Eastern Region.
  - When deduction is allowed under S.10C for certain industrial undertakings in North-Eastern Region.

- In the present case, Taxpayer started claiming deduction under section 80-IC only from tax year 2005-06 onwards on completion of 'substantial expansion'. Hence, total period for which deduction was claimed under S.80IC did not exceed ten years in tax years 2007-08 and 2008-09.

- Further, since Taxpayer's unit is not established in North-Eastern Region, the combined limitation of ten year period under second proviso to S.80IB(4) and S.80IC did not apply.

- The HC failed to appreciate that for the purpose of counting combined period ten years under S.80IB and S.80IC, the inclusion of period for which deduction was claimed under Section 80-IB is limited to those industrial undertakings or enterprises which are set-up in the North-Eastern Region. The limitation did not apply for units claiming deduction under S.80IB set in up areas other than North- Eastern Region.

- The SC observed "By making specific provision of this kind, the Legislature has shown its intent, namely, where the industry is not located in North- Eastern Region, the period for which deduction is availed earlier by an Taxpayer under Section 80-IA and Section 80-IB will not be reckoned for the purpose of availing benefit of deduction under Section 80-IC".

- The SC also rejected the alternative argument made by Tax Authority by relying upon Textile Machinery's case (supra) that by merely making substantial expansion, the Taxpayer cannot be regarded as having set up new and identifiable unit separate from existing business on the following grounds :-

  - The SC in Textile Machinery's case was concerned with the condition laid down in S.15C of 1922 Act viz. 'not formed by reconstruction of business already in existence'. On the other hands, the words used in S.80IC are 'substantial expansion'. Hence, discussion contained in the said ruling would have no application to the instant case.

  - Insofar as factum of substantial expansion of Taxpayer's unit in tax year 2005-06 is concerned, it is not subject matter of any controversy. The Tax Authority has accepted that the Taxpayer had carried out substantial expansion. Precisely for this reason, the Tax Authority allowed 100% deduction in tax years 2005-06 and 2006-07 under S.80IC. Hence, the issue is not whether there is a substantial expansion or not. The issue is only as to how the combined period of ten years of tax holiday is to be calculated for the purpose of granting deduction under S.80IC.

- Hence, it was wrong on part of Tax Authority not to allow deduction under S.80IC for tax years 2007-08 and 2008-09.

Source: Recent ruling in the lead case of Mahabir Industries [[2018] TS - 256-SC-2018 (SC)] (Taxpayer) wherein the issue before the Supreme Court

2. Mumbai Tribunal upholds absence of withholding obligation in absence of ultimate income recipients' identity

Background and facts of the case

- Securities Lending and Borrowing Scheme ('SLB') is a scheme formulated by SEBI for lending and borrowing of securities through an approved intermediary. One of the approved intermediaries is National Securities Clearing Corporations Ltd. ('NSCCL').

- SLB clarifies and provides for the following –

  - The entire transaction relating to lending and borrowing of securities has to be mandatorily carried out through the approved intermediary.

  - Lending of security through approved intermediary shall not amount to disposal of security by the lender.

  - Borrower has to pay fees for borrowing securities (borrowing fees).

  - There shall be no direct agreement between the lender and the borrower for lending or borrowing of security.

  - The beneficial interest arising out of the securities lent through the approved intermediary along with corporate benefit shall accrue to the lender.

- The Indian Tax Laws (ITL) obliges payer of "interest" to deduct tax at the time of credit (including credit to a "suspense" account) or payment, whichever is earlier. Interest is defined widely to include any interest payable in any manner in respect of monies borrowed or debt incurred. In case of default in withholding tax, the payer can be regarded as "assessee-in-default" and, thereby, made liable to pay tax and interest thereon as also penalty, if there is no reasonable cause for default.

- The Taxpayer is a stock market broker and is also engaged in other activities related to securities business. The Taxpayer entered into agreement with NSCCL, being the approved intermediary, for lending and borrowing of securities under SLB. The Taxpayer borrowed securities under SLB to settle its short sale transactions and paid borrowing fees to NSCCL.

- The Taxpayer did not withhold tax on borrowing fees on the ground that NSCCL was merely acting as an intermediary and such payment did not constitute income in the hands of NSCCL. Secondly, given the mechanics of SLB, there is no direct privity between lenders and borrowers and, hence, identity of the lenders to whom the borrowing fees are ultimately paid or credited by NSCCL is not known. Therefore, it was not possible to withhold tax at source at the time of payment of borrowing fees to NSCCL. The Taxpayer placed reliance on the Mumbai Tribunal ruling in the case of Industrial Development Bank of India v. ITO for this proposition.

- The Tax Authority did not accept the above grounds and held that the Taxpayer was

"assessee-in-default" for not deducting tax on the payment of borrowing fees to NSCCL for following reasons :

- The borrowing fees paid to NSCCL constituted "interest" as per its wide definition under the ITL since it was paid for borrowing of securities.
- NSCCL had neither obtained a NIL deduction certificate under the ITL nor was the payment to NSCCL exempted from withholding under any specific statutory provisions or through any Circular or Notification issued under delegated powers to the Central Government.
- The nature of receipt in the hands of the recipient is immaterial insofar as the tax withholding provisions are concerned.
- The Taxpayer had paid interest to NSCCL and the identity of the ultimate lender to whom NSCCL would pay was not relevant.

- The Taxpayer filed an appeal before First Appellate Authority. The First Appellate Authority held that the borrowing fee was in the nature of "interest" but did not constitute income in the hands of NSCCL, since NSCCL merely acts as an intermediary and facilitator of the transaction. However, since the transaction is undertaken through NSCCL, all details of the transaction and persons involved is available with NSCCL; there is no uncertainty in respect of the liability to pay borrowing fees and, hence, the Taxpayer was liable to withhold tax thereon in the name of ultimate lenders by obtaining requisite information from NSCCL.
- Being aggrieved, the Taxpayer filed further appeal before the Tribunal.

Issue before the Tribunal

- Whether the Taxpayer was liable to withhold tax on payment of borrowing fees to NSCCL under SLB?

Tribunal's ruling

The Tribunal ruled in favour of the Taxpayer and held that that there is no withholding obligation on the Taxpayer if the lenders are not identifiable at the time of making payment. The Tribunal adopted the following reasoning for its conclusion:

Whether borrowing fees constitutes income in the hands of NSCCL

- The SLB provides that both lender and borrower shall separately enter into agreements with the approved intermediary for depositing the security for the purposes of lending and borrowing. There is no direct agreement between the lender and borrower.
- The borrowing fee does not constitute income of NSCCL since it is under obligation to disburse them to lenders. The borrowing fee collected is shown as liability by NSCCL in its books.
- The ultimate beneficiary of the payment are lenders of the securities borrowed by the Taxpayer through the approved intermediary.

Whether absence of identity of payees relieves the withholding obligation for the payer

- Tax withholding provisions apply where amount is credited or paid in favour of an identifiable payee. The payer is required to deduct tax, pay to the Government and issue a certificate in the name of the payee.
- The SLB mandates that the lender and borrower of securities will have to enter into separate agreements with the approved intermediary for lending and borrowing of securities. The SLB specifically prohibits any direct agreement or contact between the lender and the borrower for lending and borrowing of securities.
- In fact, the code of conduct for approved intermediary clearly states that the approved intermediary shall maintain confidentiality of information about lender or borrower, which the intermediary possess, as a consequence of dealings with it and shall not divulge the same to other clients, the press or any other interested parties. Thus, on a reading of SLB as a whole, it appears that the lender and borrower of securities have no contact with each other as the entire transaction is regulated through NSCCL.
- If the identity and other details of the lender to whom the borrowing fee was ultimately paid by the NSCCL is not known at the time of making payment of borrowing fees, it is impossible for the Taxpayer to comply with the withholding provisions.
- Since the Tax authority did not conduct any factual enquiry with NSCCL to find out whether the details of lenders were available or not with the Taxpayer, the Tribunal remanded the matter back to the Tax Authority for verification of facts.

- Nevertheless, the Tribunal directed that if it is ultimately found that at the time of making payment, the Taxpayer was unaware of the identity and other details of the lenders, then the Taxpayer cannot be fastened with the withholding tax obligation.

- The Tribunal did not adjudicate upon the issue whether borrowing fees was in the nature of "interest". It held that this issue depended upon the outcome of the Taxpayer's claim that the ultimate payees are not identifiable. Hence, the Tribunal restored this issue to the Tax Authority to decide afresh, if warranted.

Source: Recent ruling in the case of JM Financial Services Ltd. [TS-262-ITAT-2018(Mum)] (Taxpayer) wherein the issue before the Tribunal

3. Delhi Tribunal upholds rejection of merchant banker's share valuation report for levy of "angel tax" on peculiar facts

Background and facts of the case

- Section 56(2)(viib) (Section) of the Indian Tax Laws (ITL) (popularly known as the "angel tax" provision) provides that when a closely-held company (CHC) issues shares (including preference shares) to a resident at a premium and receives consideration which is in excess of the FMV of the shares, the amount received in excess of the FMV is assessed as "Income from other sources" in the year of issue of the shares by the company.

- The FMV for purposes of this Section is the higher of:

  (i) The value as per the valuation rules prescribed in Rule 11UA of the Income Tax Rules, at break-up value or DCF value as certified by a Category I Merchant Banker or Chartered Accountant.

  (ii) The value that the company is able to substantiate to the satisfaction of the Tax Authority, basis the holding of various intellectual property rights (IPRs) like goodwill, know-how, patents, copyrights etc.

- Under the DCF method, the FMV is determined by discounting the projected cash flows of the company, using the cost of capital as the discount rate. The cost of capital is determined considering the rate of risk free return, risk premium and company specific risk.

- The Taxpayer, being a CHC, is engaged in the business of investing in shares and securities. In its third year of existence, the Taxpayer allotted equity shares of face value INR10 each at a premium of INR40 per share to a resident, aggregating to INR-50 per share.

- On being asked by the Tax Authority to justify the valuation of the shares at INR50 each, the Taxpayer furnished a merchant banker's report which had applied the DCF method to arrive at the value of INR50 per share.

- The Tax Authority rejected the valuation citing many infirmities in the report, as follows:

  - Despite incurring losses in the earlier two years, free cash flows were taken at positive figures for future years. The future years' cash flows, as projected, were not realistic, considering the evidence of actual data available for such years.

  - Risk-free return taken at 9.04%, is unrealistic for a company which came into existence just two years back and was unprofitable since inception.

  - Expected market return taken at 15.80%, as per BSE 500 return, is also unrealistic for a newly incorporated company having losses since inception.

  - Beta measures the risk of the company relative to the risk of the stock market in general. Larger the risk undertaken by the company, higher is the beta. But, the Taxpayer was investing only in group companies with negligible risk. Hence, the beta should have been taken at negative, instead of the average beta of one adopted by the merchant banker.

  - The merchant banker had issued a disclaimer in the valuation report. An extract reproduced by the Tribunal from the Tax Authority's notice is as follows:

    "In preparing the Final Report, SPA has relied upon and assumed, without independent verification, the truthfulness, accuracy and completeness of the information and the financial data provided by the company, SPA has therefore relied upon all specific information as received and declines any responsibility should the results presented be affected by the lack of

completeness or truthfulness of such information."

- Despite the Tax Authority's request for evidence of the correctness and reliability of the financial data adopted in the valuation report, the Taxpayer could not provide the same.

- The Tax Authority adopted the break-up value as per Rule 11UA of the Income Tax Rules, which came to INR9.60 per share and, hence, made an addition of the balance INR49.40 per share.

- The Taxpayer appealed before the First Appellate Authority which sustained the Addition, since the Taxpayer did not produce any evidence to substantiate the basis of the projections in the cash flow.

- Being aggrieved, the Taxpayer appealed further to the Tribunal.

- Before the Tribunal, the Taxpayer argued that the merchant banker's report was binding on the Tax Authority. According to the Taxpayer, if the DCF method adopted by the merchant banker was not acceptable to the Tax Authority, it ought to have referred the valuation to the Tax Department's Valuation Officer (DVO).

Tribunal's ruling

The Tribunal upheld the addition made by the Tax Authority and held that the Tax Authority was right in rejecting the merchant banker's valuation report and adopting the break-up value, for the following reasons:

- Despite the Tax Authority raising several objections and providing an opportunity to furnish evidence, the Taxpayer could not bring anything on record to meet the Tax Authority's objections.

- Even before the First Appellate Authority, the Taxpayer did not produce any evidence to substantiate the projections, but simply argued that the report was binding on the Tax Authority.

- Despite several opportunities, the Taxpayer was unable to rebut the objections of the Tax Authority.

- Under the circumstances, the Taxpayer's argument that the valuation report was binding on the Tax Authority and the Tax Authority ought to have referred the matter to the DVO, was unacceptable.

- Unless the Taxpayer produces evidence to substantiate the basis of the cash flow projections, it is not possible even for the DVO to conduct any exercise of verification of the value determined by the merchant banker.

- The merchant banker issued a long disclaimer that no independent enquiry was made by the merchant banker to verify the accuracy/reasonableness of the figures furnished by the Taxpayer, even on a test case basis. The long disclaimer showed that the merchant banker merely relied on data provided by the Taxpayer and applied the formula, without reflecting upon its expertise.

- Therefore, it is not possible to brush aside the Tax Authority's contention of a possibility of the data being tailored by applying reverse engineering to arrive at a pre-determined value.

Source: Recent ruling in the case of Agro Portfolio Pvt. Ltd. [ITA No. 2189/Del/2018, (2018) 53 CCH 0043DelTrib] (Taxpayer) wherein the issue before the Tribunal

4. Delhi Tribunal rules that activities of distributor in India constitutes DAPE for the parent in India

Background and facts of the case

- An enterprise may have a permanent establishment (PE) within a source state even without having a fixed place of business in that state – through an agent who acts on behalf of that enterprise. The India-Japan DTAA provides for various forms of permanent establishment (PE), including DAPE.

- A dependent agent which satisfies the specified conditions would constitute a PE of the enterprise as per Article 5(7) of the India-Japan DTAA. A DAPE is created when a dependent agent who has, and habitually exercises, an authority to conclude contracts on behalf of the principal or habitually maintains stock of goods or merchandize from which it regularly delivers goods or merchandize on behalf of the principal or habitually secures orders almost wholly or wholly for the principal.

- It expressly excludes an agent of independent status as covered under Article 5(8) of India-

Japan DTAA.

- Taxpayer, a Japanese company was engaged in the business of development, manufacture, assembly and supply of air conditioning and refrigeration equipment. During the year, Taxpayer sold air-conditioners in India. Sales were made directly to third party Indian customers (direct sale) as well as to an Indian distributor, ICo who was the wholly owned subsidiary of Taxpayer in India.

- In addition to acting as the distributor of Taxpayer's products in India, ICo entered into a commission agreement with the Taxpayer to act as a communication channel between the Taxpayer and its customers in India.

- In terms of the agreement, ICo was responsible for forwarding the customers' request to the Taxpayer as well as forwarding Taxpayer's quotations and contractual proposals to the customers in India. In consideration of the said services, ICo charged a commission of 10% on direct sales made by the Taxpayer in India.

- During the assessment proceedings, Tax authority sought information on the role played by the Taxpayer and ICo in making direct sales to third party Indian customers in India along with documentary evidence. Taxpayer failed to furnish such information.

- On failure of the Taxpayer to produce the evidence to show its involvement in the marketing of products sold by way of direct sales in India, Tax authority held that the activities of identifying customers, approaching, presentation, demonstration, price catalogue, negotiation of prices and finalization of prices etc. were carried on by ICo on behalf of the Taxpayer in India, in addition to the activities set out in commission agreement. Consequently, it was held that ICo constituted a Dependent Agent PE (DAPE) of the Taxpayer in India under India-Japan DTAA.

- Taxpayer on the other hand contended that role of ICo in direct sales was limited only to the liaising activities as set out in the commission agreement and the other crucial activities of identifying customers, negotiating and finalizing prices with customers in India etc. were exclusively done by the Taxpayer directly from Japan. Without prejudice, even if it is accepted that ICo constituted DAPE of the Taxpayer in India, there could not be any further attribution to the DAPE as the commission paid to ICo was at arm's length.

- The first appellate authority upheld Tax Authority's contention. Aggrieved, the Taxpayer filed an appeal before the Income Tax Appellate Tribunal (ITAT).

ITAT's ruling

Dependent Agent PE

ITAT noted the following facts;

- The air-conditioning and refrigeration industry in which the Taxpayer was involved was highly competitive and tremendous efforts are required for effecting sales in such market.

- ICo had to incur huge selling and distribution expenses for selling the same products in its capacity as a distributor.

- The content of the emails exchanged between the Taxpayer and ICo demonstrated that the entire deal was negotiated and finalized by Indian customers with ICo and the role of ICo was not confined merely to a communication channel.

Having noted the above facts, ITAT concluded that ICo constituted DAPE of the Taxpayer in India under India-Japan DTAA. ITAT adopted the following reasoning for its conclusion;

- It is hard to comprehend that the Taxpayer managed to make direct contact with customers, scattered all over India for effecting sales to them directly, without any marketing efforts.

- The contention of the Taxpayer that the customers were directly approaching the Taxpayer in Japan de hors any evidence of any marketing efforts made by it, is devoid of any merit. It also raises questions on the correctness of Taxpayer's contention that ICo merely acted as a communication channel between the Taxpayer and customer.

- In absence of any evidence indicating direct involvement of Taxpayer in marketing activities in relation to direct sales in India and the emails indicating the involvement of ICo in finalizing the deals with customers in India, the inescapable conclusion is that the entire activity starting from identification of customers, approaching them, negotiating prices with them and finalisation of prices was done by ICo in India not only for the products sold by them as distributor, but also for the direct sales made by the Taxpayer.

- Although ICo did not have an authority to finalize the contract of direct sales in India, but the substantial activities of any sale transaction like the activities of negotiating and finalizing the contracts were performed by ICo.

- Thus ICo was habitually exercising an authority to conclude contracts in India on behalf of the Taxpayer. The mere fact that the Taxpayer was formally signing the contract of sale does not alter this position in any manner.

- Also, ICo was securing orders in India 'almost wholly' for the Taxpayer as all the substantive parts of the key activities in making sales were carried on by ICo in India.

- Exclusion of independent agent activities is not applicable as the Taxpayer had not contested the dependent status of ICo.

Attribution of profits on determination of ALP

- Admittedly, Taxpayer did not maintain transfer pricing documentation nor did it furnish the transfer pricing report. The contention of the Taxpayer that the payment of commission is at arm's length cannot be accepted when the Taxpayer has neither reported it as an international transaction nor carried on benchmarking of such transaction.

- SC in the case of Morgan Stanley held that there can be no further attribution to DAPE, if the dependent agent has been remunerated at arm's length by taking into account all the risk taking functions of the enterprise. SC further held that if the TP analysis does not reflect the functions performed and risks assumed by the enterprise, then additional profits are to be attributed to the PE by taking into account the functions and risks that are not considered for TP analysis.

- The commission agreement between the Taxpayer and ICo dealt with only two services viz: forwarding the customers' requests to Taxpayer and forwarding the quotations and proposals of the Taxpayer to the customers. The commission of 10% was also paid only for such services.

- However, evidences in the form of emails correspondences between Taxpayer and ICo as well ICo and customer support that the functions performed by ICo were beyond the two services covered by the commission agreement and included all the activities in relation to negotiation and finalizing the price and other contractual terms of the customer contracts.

- The determination of arm's length commission of 10% thus did not reflect the functions performed and the risks assumed by the PE. Therefore in light of the SC decision, additional profits would need to be attributed to the DAPE for the additional functions carried on by ICo in India.

Source: Recent ruling in the case of Daikin Industries Limited [TS-274-ITAT-2018(Del)] (Taxpayer) wherein the issue before the Tribunal

5. Jaipur Tribunal rules no blanket disallowance for expenses in cash in excess of specified limit, genuine and bonafide transactions protected

Background and facts of the case

- The ITL contains a specific provision (viz. section 40A(3)) which provides that no deduction shall be allowed if the aggregate payment for any expenditure is made otherwise than by an account payee cheque, bank draft or through electronic clearance system to a person in a single day exceeding INR10,000 (disallowance provision).

- With a view to provide for mitigation, the said disallowance provision empowers Central Board of Direct Taxes (CBDT) to prescribe cases and circumstances in which, having regard to the nature and extent of the banking facilities available, considerations of business expediency and other relevant factors, the disallowance provision would not apply. Pursuant thereto, a specific rule (i.e. Rule 6DD) was inserted which provides for a list of such cases and circumstances which are exempted from the disallowance provision.

- One of the exceptions to the disallowance provision which was operated during the period from 1970 till its withdrawal in July 1995 was as under.

  - A case where the taxpayer satisfied the Tax Authority that the payment could not be made by use of banking facilities due to exceptional or unavoidable circumstances or because the payment though banking channel was not practical or would have caused genuine difficulty to the payee having regard to the nature of transaction and necessity of expeditious settlement (specific clause in Rule).

- In light of the above, the CBDT issued Circular No. 220 dated 31 May 1977 (Circular) providing for an illustrative list of "exceptional cases" where cash payment would not trigger disallowance. One such case was where the seller refuses to accept the payment in cheque and purchaser's business would suffer due to non-availability of goods from such seller.

- While the aforesaid clause in the specific Rule stood withdrawn in July 1995, the Circular continues to remain in force and is not withdrawn as yet.

- During the relevant tax year 2012-13, the Taxpayer firm, which was engaged in the business of real estate, purchased 26 pieces of plot of land during the period of April and May 2012 from different persons for a total consideration of INR25 million. Part consideration of about INR17 million was paid in cash beyond the limit prescribed under the disallowance provision. Plots were registered in the name of the Taxpayer after payment of stamp duty and registration fees.

- The Tax authority invoked the disallowance provision to disallow the cash payments. The Tax authority also held that the Taxpayer's case did not fall in any of the exceptions prescribed under the specific Rule so as to exclude applicability of the disallowance provision.

- The First Appellate Authority upheld the Tax Authority's view.

- Being aggrieved, the Taxpayer filed an appeal before the Income Tax Appellant Tribunal (Tribunal).

Issue for consideration

- Whether cash payment exceeding the threshold limit made for purchase of plot of land held as stock-in trade, can be disallowed under the disallowance provision where neither the identity of seller is disputed nor genuineness of transaction is in doubt?

Taxpayer's contentions

- The Taxpayer contended that the plots were originally purchased as capital asset and within a short period, in June 2012, the plots were converted into stock-in-trade. The disallowance provision which may apply to purchase of stock-in-trade did not apply to purchase of capital asset.

- Even if the purchase of plot of lands is treated as stock-in-trade, the disallowance provision cannot be invoked in a blanket manner for all the cash payments. In the present case, cash payment was made on a specific demand by sellers and was paid by the Taxpayer as a result of business expediency.

- Non-payment of consideration in cash would have hampered business interest of the Taxpayer. Further, it is not in dispute that the lands were purchased through registered sale deed, identity of the seller and genuineness of the transaction are fully established.

- The Taxpayer relied upon Supreme Court (SC) ruling in the case of Attar Singh Gurmukh Singh wherein the SC held that the object of the disallowance provision is to enable the Tax Authority to ascertain whether the payments are genuine and are made out of disclosed sources. The SC also held that terms of the disallowance provision are not absolute. Consideration of business expediency and other relevant factors are not excluded. Genuine and bonafide transactions are taken out of the sweep of the disallowance provision.

- Support is drawn from Punjab & Haryana High Court (P&H HC) ruling in the case of Gurdas Garg which allowed claim for deduction of cash payments exceeding the threshold limit in the tax year 2008-09 on the ground of exceptional and unavoidable circumstances even after the withdrawal of this specific clause in Rule in 1995. The Rajasthan HC in the case of Harshila Chordia also held that list of exceptions provided in the specific rule is not exhaustive.

- Reliance was also placed on certain Tribunal rulings wherein it was held that even if the case of taxpayer does not fall in any of prescribed circumstances under the specific Rule, applicability of the disallowance provision can be dispensed with even after deletion of the specific clause in Rule in 1995 if taxpayer is able to prove the business expediency for payment in cash and genuineness of transaction.

- In any case, in case of conflicting views, view favourable to the taxpayer needs to be adopted.

Tax Authority's contentions

- The Tax authority rejected the Taxpayer's contention of plot of land being purchased as

capital asset by noting that the Taxpayer was engaged in the real estate business. Also, the Taxpayer's contention that cash payments were made on account of business exigency contradicted its own contention of purchasing plots as investments.

- The specific rule contains a list of cases and circumstances where the disallowance provision is not triggered; having regard to the nature and extent of banking facilities available, considerations of business expediency and other relevant factors. The Taxpayer's case did not fall within any of the specified cases and, hence, disallowance provision would trigger.

- In the present case, there were banking facilities in the city and there was no reason to make payment in cash to seller.

- Further, the Taxpayer did not provide any documentary evidence to support the fact that sellers insisted on cash payment and that failure to make cash payment would have led to cancellation of the deal.

Tribunal's ruling

The Tribunal ruled in Taxpayer's favour and allowed deduction of cash payment made for purchase of plot of land held as stock-in-trade for following reasons:

- Following the ratio of the SC ruling in the case of Attar Singh Gurmukh Singh and Rajasthan HC ruling in the case of Harshila Choralia, the Tribunal noted that the disallowance provision is not intended to restrict business activities/freedom of trade but the only intention is to curb the use of black money and to ensure the genuineness of cash payments. There is no change in the disallowance provision since its inception so far as the consideration of business expediency and other relevant factors are concerned and, hence, genuine and bonafide transactions are protected even under the present provision.

- The specific rule providing for list of exceptions is not exhaustive and the Tax Authority should ensure that genuine business expenditure is not disallowed even if a particular case is not specifically covered by the prescribed circumstance. It is a well-settled principle that a rule, being a delegated legislation, is to be interpreted in a manner so as to advance and not to frustrate the object of the legislature to curb the use of black money.

- Adverse consequences on account on non-observation of the disallowance provision would trigger only if it defeats the object of the disallowance provision viz. to avoid tax evasion. Therefore, genuine transactions free from the vice of tax evasion are protected.

- The Tribunal also relied on P&H HC ruling in case of Gurdas Garg (supra) and Gujarat HC ruling in the case of Anupam Tele Services wherein, in the context of the disallowance provision post deletion of residuary exception in the specific Rule, the HCs held that the specific rule providing for mitigating circumstances is not exhaustive. The principle of business expediency is to be taken into account before invoking the disallowance provision. Once a transaction is accepted as genuine and the business necessity of cash payment is explained, the disallowance provision is not applicable.

- Reference to the expression "the nature and extent of banking facility, consideration of business expediency and other relevant factors" in the disallowance provision suggests that the object of the specific provision is not to disallow a cash payment which are to be made by the Taxpayer on account of business expediency.

- In the present case, the identity of the sellers was known, genuineness of the purchase transaction was substantiated by registered sale deeds and the same was not disputed by the Tax Authority. Further, the Tribunal noted that the Taxpayer had no other option but to make the payment in cash in order to secure the land deal. Cash payments were made by drawing amount from bank. Thus, it was clear that the Taxpayer had sufficient bank balance and only at the insistence of the specific seller that the Taxpayer had withdrawn requisite cash amount to make the payments to the seller. Thus, business expediency and source of cash payment was clearly identifiable. Since the intent and purpose for which the disallowance provision has been introduced is satisfied in the present case, being a case of genuine transaction, no disallowance is triggered under the specific provision.

Source: Recent ruling in the case of M/s. A Daga Royal Arts [ITA No.1065/JP/2016] (Taxpayer) wherein the issue before the Tribunal

6. AAR rules on taxability on foreign company's income from content delivery solution under a reseller agreement

Background and facts of the case

- The Taxpayer, a company incorporated in US, is engaged in the technology business for providing accelerated content and business processes online (referred to as "Solutions"). To cater the said solutions the Taxpayer has built a Platform, comprising of 73,000 secure servers equipped with proprietary software and deployed in 70 countries. The platform pulls content from the customer's web server by replicating the data therefrom, and continually monitors the Internet traffic, trouble spots and overall conditions. This information is used intelligently to optimize routes and replicate content for faster, more reliable delivery. The Solutions facilitates customers who have web based applications/websites, to help deliver the web content faster and more reliably, as also handling specific requirements of the customers.

- The Taxpayer entered into re-seller service agreement with an Indian company (I Co). Under the agreement, I Co is appointed as a non-exclusive reseller authorized to resell the Solutions directly to customers in India. I Co is required to collect the payments from Indian customers and remit the same to the Taxpayer. Under the agreement, I Co would not have any rights, title and interest in any intellectual property/ software of the Taxpayer including on the platform.

- Taxpayer sought a ruling from the AAR on taxability of its income under the Reseller Agreement under the ITL as well as the DTAA.

- Before the AAR, Taxpayer argued non-taxability of its income based on following :

  - Income does not amount to FTS since Solutions is a 'standard facility' without involvement of any human element.

  - Drawing support from India-US memorandum of understanding, the make available criteria is not satisfied since services rendered by the Taxpayer do not enable end-users to apply the technology contained therein.

  - Income does not qualify as 'royalty' since the reseller agreement does not envisage use of any right, property, or information to I Co or end users. There is no access given to Platform or any software to avail the services of the standard facility. Reliance placed on Klaus Vogel's Commentary on the issue of distinction between rendering services using his own assets vis-à-vis granting right to use the assets to the payer.

  - Taxpayer does not have a PE in absence of any physical presence and agency relationship with I Co in India, since I Co is functioning on an independent basis.

- As against above, tax authority argued as follows :

  - Income is FTS/ FIS - Solutions is provision of technical services which accelerate the performance of the websites, and the services rendered are also technical in nature. Physical presence of humans to render the services is not required and also, the development of the software and solutions cannot happen without human involvement. Taxpayer needs the technical expertise and a setup to perform the services which are 'made available' to Indian customers either through I Co or directly.

  - Income qualifies as Royalty - Transaction involves transfer of right in copyright in form of computer software; right to use to use Trademarks and Brand Features as per specific clause regarding marketing/ publicity in the reseller agreement. Transactions amount to grant of distribution rights, involving transfer of rights in process.

AAR's ruling

AAR held that the payments received by the Taxpayer from I Co would not be taxable in India under the ITL as well as the DTAA for the following reasons:

- Income does not qualify as FTS/ FIS

  - Solutions provided by the Taxpayer for accelerating delivery of content to all end-users are neither specialized nor exclusive and do not cater to individual requirements of any user. Solutions offered remain the same for all end-users irrespective of the business/website content.

  - Solutions do not require any human intervention. AAR held that it is important to consider whether there is any human intervention while rendering the services. The Solutions operate on an automatic basis and hence, cannot be treated as provision of technical services.

- Solutions provided by the Taxpayer enable only faster content delivery of the customer's website and do not provide the customers/ end users with any technological knowledge/ skills which enables the end users to apply the solutions on its own, to enjoy faster content delivery without recourse to the Taxpayer. Hence, make available criteria of FIS is not satisfied under the DTAA.

- Income does not qualify as Royalty
  - The business model of the Taxpayer is different from a regular software reseller or distributor. Taxpayer is a technology company which addresses internet access issues by using its own network of hardware and proprietary software to provide facilities to end users.
  - Taxpayer's software is always housed in its own network and the end-users or I Co are not provided with any software either on a tangible medium like a CD nor any link through which the computer software is accessed/ downloaded by the end user.
  - Solutions provided by taxpayer do not involve distribution of computer software as well as use of any such software by anyone. In absence of a computer software, computer programme, there is no copyright involved in the transaction.
  - I Co/end-users are not granted any right to use any equipment. Taxpayer itself uses the equipment (Platform) to provide Solutions to I Co which is resold to end users. I Co/ end-users do not have possession and control over the platform/ website/ server/ any other tangible property used in provision of solutions.
  - Payments under Reseller Agreement are not towards any IPR / Trademarks. Further, there is no transfer of right in the "process" nor is there any use of "process" as is required under the DTAA. If at all there is a process which is "used", it is by the Taxpayer itself.

- Taxpayer does not create a PE in India
  - There is no fixed PE since taxpayer does not have any office or any other establishment in India. Further, no employees / personnel of taxpayer visit India to provide any services to end-users.
  - As per reseller agreement, taxpayer and I Co do not create a principal-agent relationship. They act as independent contractors, neither party has power to direct or control day-to-day activities of the other or create any obligations for the other. Further, I Co does not conclude any contracts or maintain any stock on behalf of taxpayer. I Co secures orders and conclude contracts on its own account. Hence, no Agency PE is created.
  - Once income is not taxable as Royalty/ FTS/ FIS in the hands of the Taxpayer the issue of PE of the Taxpayer, becomes irrelevant and academic, as no income can be attributed to the PE.

- Withholding on payments made to Taxpayer
  - Since no income arises in India for the Taxpayer, I Co is not required to withhold tax on the payments made to the Taxpayer.

Source: Recent ruling in the case of Akamai Technologies Inc. [A.A.R. No 1107 of 2011] (Taxpayer) wherein the issue before the A.A.R

7. AAR rules 'absolute control over operations and management of client's business' creates a fixed place PE

Background and facts of the case

- As per the provisions of tax treaty, a non-resident enterprise creates a PE in another country (source country) if, inter alia, it carries on business through a fixed place in the source country. This is referred to as Fixed PE. In such case, profits attributable to the PE are taxable in the source country. Further, NR's other income like Royalty/FTS from the source country, if effectively connected to a PE would be taxable in the hands of such PE on net basis of taxation.

- Applicant, a company incorporated in Luxembourg), is the principal operator company of a Group which is a leading international hotel chain engaged in development, operation and management of hotels, resorts, and branded residences.

- Applicant provides service in connection with management and operation of hotels (such as establishing standards and policies, sales and marketing, centralised reservations, purchasing etc.) and other services as per the operational requirement of the hotel owner. Majority of the hotel properties managed under the different brand names are owned by third party

independent hotel owners and Applicant (or its Group company) provide brand license and other services in relation to operation and management of these hotel properties as per Applicant's brand standard.

- The Applicant is engaged by an Indian company (I Co) for development and operation of its Hotel in India (the Hotel). Pursuant to above, Applicant and I Co entered in to the following service agreements –

  - Hotel management Services Agreement (HMA) – Principal Agreement to obtain Applicant's expertise in connection with day-to-day operation and management of the Hotel. Other agreements were ancillary to this principal agreement.

  - Global Reservation Services (GRS) Agreement – to facilitate reservation / booking of rooms, banquets etc. in the Hotel

  - Centralized Services Agreement - miscellaneous support services as required by I Co, illustratively, global sales & marketing, finance support, human resources support, operations support, and technology support

  - Corporate Design & construction Services Agreement - technical and advisory services in connection with development of Hotel as per Applicant's brand standard, any capital improvements in relation to the Hotel, including refurbishing, maintenance, repairs or other capital improvement etc.

- Applicant was compensated by ICo under each agreement. In some, compensation was fixed as a percentage of revenue/ market fee/ construction costs and for technical services, Applicant was paid a lump sum consideration.

Question before AAR

- Whether payment under the GRS Agreement would be chargeable to tax in India as 'FTS' or Royalty' under the ITL as well as the Tax Treaty?

AAR ruling

Power of AAR to deal with matters other than questions raised in the application –

- Taxpayer contended that AAR's ruling should be limited to issue of whether its income under the GRS Agreement can be royalty/ FTS and issue of existence of PE is not raised before the AAR. According to Applicant, it did not have a PE in India.

- While the issue raised is on taxability of income under the GRS agreement, the agreement cannot be viewed on a standalone basis. Activity of the Applicant is integrated and different agreements are part of the wholesome arrangement of operation and management of the Hotel. Further, these agreements contain references to each other at several places and are co-terminus with each other as well. Hence, AAR ruling should not be restricted to GRS Agreement alone.

- The AAR (Procedure) Rules 1996 explicitly indicates that AAR has not only the power but the duty to look at "all aspects of the questions set forth" which would enable it to pronounce a ruling "on the substance of the questions posed for its consideration".

- Ruling only on a certain stream of income without reference to other business operations and leaving the other provisions open for regular assessment, would render the whole exercise of approaching AAR futile.

- Applicant is in the business of operation of hotels. Even royalty/ FTS, if effectively connected with PE, is taxed as a business income under the DTAA. Thus, the present application does call for an adjudication on the issue of existence of PE.

Emergence of fixed place PE

It is well-settled that a fixed place PE arises on the fulfilment of the following three
conditions –

- **Existence of a 'fixed place'** - There is no doubt that the Hotel is a fixed place.

- **Fixed place being at the disposal of the non-resident (Applicant)**

  Various agreements support that the Hotel is at the complete disposal of Applicant. Following facts were noted in this regard –

  - At the very stage of inception, i.e. the construction of the Hotel, the Applicant is called upon to oversee the design and construction of the property to ensure that it is compliant with the brand standards of the Applicant.

- Basis progress reports of construction submitted by I Co., the Applicant marks out the deficiencies as it deems fit. Such deficiencies are to be rectified by I Co within the designated period.

- Once the hotel is constructed, its operation and management rests with the Applicant. I Co has undertaken that it will not interfere in the Applicant's exercise of the exclusive authority over such operation and management. Right from the employment of the hotel staff to taking decisions over capital improvements, every possible operational right stands vested in the Applicant.

- As noted from HMA, Applicant shall have exclusive control, discretion, responsibility and authority for operation of the Hotel. Applicant and its affiliates shall have right to access all parts of the Hotel to the extent and at the times deemed appropriate by Applicant. I Co cannot interfere with Applicant's rights and responsibilities. The agreement is for 10 years extendable by another 40 years.

- The fact that I Co is barred from even contracting directly with the hotel staff reflects the extent of Applicant's absolute control over the management and operation of the hotel. Applicant has also designated a suitable vendor for purchasing services.

- Some of the core functions of the operation of the hotel such as sales and marketing, reservation etc. have also been outsourced to the Applicant. For providing such services, I Co is required to arrange for visas, licenses, authorisations for the Applicant, its employees, consultants etc. to allow the same to carry out such services at the hotel premises.

- The Applicant has further undertaken to "advise" the owner with all the critical aspects of the hotel operation such as training of staff, preparing of budget, carrying out capital improvements etc. However, the the final decision making power with regard to these aspects is also with the Applicant.

- Under the construction agreement, Applicant shall visit the project site at intervals appropriate to the stage of construction for observation of progress and quality of work and construction.

- **Non-resident carrying on its business (wholly or partly) through such fixed place**

  - The Applicant is admittedly engaged in the business of operation and management of the hotels. As a result of the above agreements, the Applicant has, in substance, taken over all the important functions in relation to the operation and management of the Indian hotel as a whole, irrespective of its different nomenclature in different agreements.

  - Considering the final decision making authority, risks, control, autonomy borne/ enjoyed by the Applicant, it is clearly a principal to principal agreement constituting Applicant's business in India. It is not a case that the Applicant is performing the aforesaid services in the capacity as agent of ICo.

  Based on the above factors, AAR confirmed that the Hotel constitute a fixed place PE of the Applicant.

On royalty/ FTS

Since the income from GRS is taxed as 'business profits', the question whether such services are taxable as FTS or royalty becomes academic and even if the income is classified as either of the two, the income would still be taxable as 'business profits' as per the provisions of Tax Treaty.

Source: Recent ruling in the case of FRHI Hotels & Resorts S.a.r.l. [TS-283-AAR-2018] (Applicant) wherein the issue before the A.A.R

8. Mumbai Tribunal allows deduction under S.10B for profits earned from export of dossier

Background and facts of the case

- The ITL provides various tax holiday benefits for the profits derived from export and other qualifying activities subject to compliance of certain conditions. Section 10B of the ITA provides deduction in respect of profits and gains derived by a 100% Export Oriented Unit (EOU) from exports of articles or things or computer software, subject to conditions specified therein.

- Taxpayer is engaged in the business of manufacturing & trading of pharmaceuticals. The Taxpayer had a contract manufacturing and research division (R&D division), where the

Taxpayer carried out activities such as pharmaceuticals business process outsourcing facility , Analytical Method Development, stabilities studies, clinical studies, valuation method etc .

- R&D Division would develop a process for manufacturing of generic formulation products. This process is embedded in a document called a 'Dossier' which provides the technical data necessary for manufacturing product. The Dossier would include compilation of the data relating to development work including the manufacturing of the exhibit batch indicating the stages of production.

- Dossier can either be sold as such, or can be commercially exploited by Taxpayer itself either through granting of right to use or licensing the Dossier. In either cases, the buyer / licensee of dossier is to enter into a Product supply agreement with Taxpayer to source the product from the taxpayer for a certain specified period.

- The Taxpayer claimed the deduction for profits earned on production and export of 'dossier' as per the provisions of section 10B of the ITA. The Taxpayer contended that the dossier was used for getting sanction from various regulatory authorities in different countries for manufacture of the pharma products and hence 'dossier' would satisfy the criteria as per clause (i) to S. 10B (2) and be considered as goods and would fall within the definition of manufacture or production of article or thing, to be eligible for the deduction.

- The Tax Authorities denied deduction on the basis that the Taxpayer has merely granted license to manufacture products by utilizing the dossier and the activity of preparation of dossier cannot be treated as 'manufacture or production of an article or thing'.

- The Dispute Resolution Panel (DRP) also ruled in favour of the Tax Authority and held that the Taxpayer would not be eligible for the deduction since the income received by the Taxpayer was for granting of license for manufacture of pharma products and producing the dossier is only an intermediary process for which the deduction shall not be granted.

- Aggrieved by the DRP order, Taxpayer appealed to the Tribunal.

- There are multiple issues raised by taxpayer before the Tribunal. However, the alert is restricted to the issue of eligibility of deduction u/s 10B of the ITA for production and export of 'dossier'.

Tax Authority's contentions:

- Taxpayer's activity constituted development of generic version of pharmaceutical products as proto-type and compiling of data relating to such product as dossier which is used for getting sanction from regulatory authority.

- Development of a 'process' is not an article or thing but is only method of manufacturing product. Dossier is not an end product in itself.

- Taxpayer did not sell the dossier, but merely grants license for manufacture of pharma products, by use of the process in certain territories. The deliverable under the contract is grant of license and not the dossier.

- The immediate source of the fee being received, is grant of the license and not the dossier. The licence does not answer to description of 'manufacture or production of an article or thing'. Also, income received from license does not meet with first degree nexus test as propounded by SC in Liberty India3 to qualify for profit linked deduction.

- The issue is not whether or not the dossier is a product involving manufacture of article or thing but whether license can be a product.

Taxpayer's Contentions:

- The Taxpayer is a registered and approved EOU and has been allowed permission to manufacture pharma products. Further the contracts with the customers also indicate that contract is for production of dossiers, which can be used to obtain regulatory approvals. There could be different dossiers for different markets.

- The dossier explains how the development activity has been carried out at each stage, along with the details of production. Dossier is result of manufacturing of exhibit batches which is undertaken at taxpayer's manufacturing facility.

- Dossier would also involve product development activities which would include collecting and correlating various data inputs by conducting stability studies and bio-equivalence studies. Thus, the process involves compilation of data.

Tribunal ruling:

Tribunal accepted taxpayer's claim and allowed benefit of S. 10B deduction to production and export of dossiers, on the following grounds.

- Tribunal noted the following in relation to dossier and other manufacturing activities undertaken by taxpayer.
  - The taxpayer develops generic version of products by re-formulating an existing innovative product which is initially produced/ manufactured in the R & D facility as a "prototype". All the technical and other data relating to such product is compiled in the form of a "dossier" and submitted to the regulatory authorities. On receipt of approval, the product is sold as a generic version in the market on commercial terms.
  - The dossier is the culmination of various activities which are primarily manufacturing of 'development and exhibit batch' supported by data collection, stability studies and bio-equivalence studies.
  - The dossier documents the detailed method followed in the manufacture of a product, right from sourcing the raw material to the final product manufactured.
  - The major activity involved in creating dossier is manufacturing which starts from the R & D Facility and ultimately takes place in the plant, the production normally takes place at the R&D unit up to the development batches and thereafter, the exhibit batch manufacturing takes place in the regular production plant under supervision of the R&D team.
  - The dossier is prepared for a particular product and the same is sold for certain or all markets. For each market, a separate dossier is prepared.
  - The process of preparing dossier cannot be completed without completing the process of manufacture of exhibit batches. The Exhibit batch is a commercial size batch which is a final product and is in a finished form capable of being sold.
  - Exhibit batch belongs to the customer. Further, the taxpayer sells the dossier to customers.
  - The cost associated with developing of dossier is borne by taxpayer. The cost incurred is recovered from the customer which is a commercial price for sale of dossier.
- Fundamental requirement in all the agreements, is creation of dossier which involves compilation of technical knowledge to enable manufacture of product. Creation of dossier entails the actual production of the formulation initially in the laboratory and therefore upto a batch size. Thus, dossier has all the attributes of product being an article or thing.
- In similar circumstances, SC in the case of Scientific Engineering House Pvt Ltd. held that compilation of technical knowhow is an article to be considered as capital asset eligible for depreciation. Mumbai Tribunal in the case of ISBC Consultancy Services held that customization of software amounted to manufacture and was entitled to deduction u/s 10A of the ITA which is also on a similar footing.
- Further, reference was made to Bangalore Tribunal's ruling in the case of Syngene International Ltd. where the Tribunal had considered the SC ruling in the case of N.C.Budharaja & Co and Delhi HC ruling in the case of HLS India and Madras HC ruling in the case of N Venkatraman and had held that processing of data or information will tantamount to manufacture or production of article or thing.
- Considering the facts, the Taxpayer is entitled for deduction u/s 10B of the ITA as it has established that dossier involves production of article or thing.

Source: Recent ruling in the case of Strides Shasun Limited [ITA No. 8614/Mum/2011] (Taxpayer) wherein the issue before the Tribunal

9. AAR rules no PE in case marketing and support services provided by subsidiary to its foreign parent

Background and facts of the case

- As per the provisions of the tax treaty, a foreign enterprise (FE) creates a PE in another country (source country) if, inter alia, it carries on its business through a fixed place in the source country (Fixed Place PE) or renders services to its customers in source country through its employees or other personnel for a specified time threshold (Service PE) or through a dependent agent in source country performing

specified activities (Agency PE). In case PE is created, profits attributable to the PE are taxable in the source country.

- In facts of the case, the Applicant, a tax resident of Saudi Arabia, is a state owned Oil Company in the business of oil exploration, production, refining, chemicals, distribution and marketing. All these activities are monitored by the Saudi Arabian Ministry of Petroleum and Mineral resources together with Supreme Council of Petroleum and Minerals (referred to as 'the Ministry'). Applicant is the world's largest crude oil exporter and is making offshore crude oil sales to Indian refineries on Free on Board (FOB) basis such that the title passes outside India and payment is also made outside India.

- To expand its India operations and for having a long term presence in India, Applicant established a subsidiary company in India (I Co). Directors of I Co are also employees, part of high management of Applicant. Applicant and I Co had entered into a Service Agreement in 2013 under which I Co is obligated to provide procurement support services to Applicant (the Agreement). Now an Addendum is proposed to this agreement (Proposed Addendum) under which I Co proposes to provide business support and marketing support functions to the Applicant for which I Co will be remunerated at an arm's length price (ALP).

- Broadly, I Co will be providing the following services under the Proposed Addendum –

  - Procurement, Sourcing and Logistic Support
  - Quality Inspection Support
  - Business support/ marketing support function
  - Strategic sourcing and registration of major manufactures and EPC contractors
  - Performing engineering and inspection evaluations,
  - Plant audits for identified manufacturers and suppliers
  - Market research and collation of data
  - Create awareness through various channels (image protection and intelligence gathering)
  - Gathering information on pricing
  - Ascertaining quality of crude oil
  - Promoting awareness, arranging meetings, maintaining databases
  - Information of competitors
  - Protecting Applicant's market share by building business relationships.
  - Seeking and facilitating new opportunities.

Issue before AAR

Based on the nature of activities proposed to be undertaken by I Co, AAR ruling was sought whether I Co create a PE for the Applicant under the India-Saudi Arabia Tax Treaty?

AAR's ruling

- **Maintainability of the Application on a proposed transaction** – Purpose of AAR is to give a ruling in advance to remove uncertainly and eliminate the possibility of dispute regarding not only past transactions but also proposed or intended transactions. Thus, the Proposed Addendum can be considered before the AAR. Also, once an application is admitted and posted for hearing by the AAR after examining the application and the relevant records, the said application cannot be revoked.

- **Power of AAR** – AAR has not only power but the duty to look at 'all aspects of the questions set forth' which would enable it to pronounce a ruling 'on the substance of the questions posted for its consideration'. Thus, AAR's examination should not be restricted to the Proposed Addendum as contemplated by the Applicant since Addendum is an integral part of the Service Agreement and all services, whether related to the Service Agreement or the Proposed Addendum, should be considered together to determine whether the Applicant has a PE in India.

- **Emergence of PE** – AAR has relied on the SC rulings in the case of Formula One (394 ITR 80) and eFunds (86 taxmann.com 240) to come to its conclusion. It held that activities of I Co, would not create a PE for the Applicant, on the basis of the following:

  - **Whether subsidiary automatically becomes PE of parent?** – Unless specific tests of PE are evaluated, I Co, as a subsidiary of Applicant, does not automatically become PE of Applicant. I Co has its own board of directors and is/will carry out its own business in India. Support was drawn from certain rulings which laid down the principles that companies are separate legal and economic entities for tax purposes. Parent and subsidiary are distinct taxpayers. **It would be inconceivable that parent would not at all be involved in the decision making of its subsidiary whose activities have to be in consonance with the overall goals of the holding company.**

Further, it cannot be expected that Directors of Subsidiary would act with such independence that the overall objective of holding companies get compromised.

- **Fixed Place PE** – Applicant does not have a fixed PE at I Co's establishment. This is based on following –
  - I Co is utilising its establishment to provide support services to the Applicant and it is carrying out its own business in India.
  - Applicant's business is carried on in and from Saudi Arabia and is monitored by the Ministry. Hence, the question of any main or core business activities of Applicant being carried on at I Co's establishment does not arise.
  - I Co's establishment is not placed at disposal of the Applicant. There is no material on record to indicate that the I Co is or will be manned by employees or personnel of the Applicant.
  - Services provided by I Co are support services for which it is remunerated at ALP. Such support services do not constitute main business of the Applicant (which is exploration, production, refining, and distribution of crude oil).
  - The fact that I Co is remunerated at ALP does not have a bearing on whether Fixed PE exists or not.
- **Service PE** – Service PE emerges due to rendering of services by FE in the Source State by making available its personnel for providing such services4. Applicant does not have a Service PE based on the following–
  - Applicant is not rendering any services to any customer in India, either directly or through I Co. It is I Co which is providing support services, that too to Applicant and not to customers of Applicant.
  - AAR rejected Tax Authority's contention that entire control and management of I Co is under the Applicant through its Directors and such Directors are employees of Applicant who will be visiting India to conduct meetings with government officials, customers etc. As per AAR, it is not relevant if directors of I Co are employees of the Applicant or what is period of their stay in India since they would be discharging their duties as directors of I Co and not for the Applicant. Further, the relationship of such directors with Applicant in past years is not relevant.
- **Agency PE** – I Co does not create an Agency PE for Applicant based on the following-
  - I Co is a separate legal and taxable entity. The Proposed Addendum expressly prohibits I Co from carrying out any activities that can make it an agent of the Applicant. Service Agreement also requires the parties to perform as an independent contractors and not as an agent.
  - The Proposed Addendum expressly prohibits I Co from carrying out such activities which can make him an agent i.e.
    - I Co cannot represent itself as agent of Applicant;
    - I Co has no authority to negotiate any business terms or conditions for or on behalf of Applicant or bind Applicant on any commercial terms. Further,

The Applicant has retained with itself the authority, regarding its main business, to finalise its marketing strategies, finalise terms of the contracts directly with the customers, and to accept or reject offers of customers. Aramco is only permitted to provide support services as per the Proposed Addendum.

Since the activities/ transactions under the Proposed Addendum are yet to commence, it is not possible to reach any adverse conclusion that the limitations/ preventive clauses/ exclusions in the agreements would not be adhered to.

  - Agency PE provision of the treaty, relating to 'obtaining orders' covers obtaining orders for sales and not for procurement/ purchase. In any case, I Co cannot enter into any such agreement of a binding nature on behalf of the Applicant.
  - The following was noted in relation to specific terms of Addendum –
    - While negotiating could mean entering a contract, the words used in the agreement are "engaging with" which

only imply having discussions or being involved in. It does not indicate an authority of binding nature to conclude contracts.

- The words "ensuring" compliance by Indian suppliers and "controlling" only imply that I Co is expected to do its work diligently and with responsibility. It does not grant a legal right or authority. Ensuring compliance and controlling, and inspecting quality are exercises prior or subsequent to conclusion of a contract for procurement or supply.

- Tax Treaty refer to "authority" with reference to concluding contracts in the name of the foreign enterprise, and not to public relations or meeting important people.

- Activities like allocations, claims, communication of customers' concerns, and maintaining business relationships doesn't mean concluding contracts or habitually obtaining orders on behalf of the foreign enterprise

- **Preparatory/ auxiliary exemption** – PE exemption is relevant only if otherwise there is a PE created in India. Nevertheless, AAR rejected Tax Authority's contention that I Co's activities like market research, facilitating opportunities, acting as communication channel, does not fall within PE exemption. Services such as market research, identifying new customers would be 'preparatory' in nature.

- Further, the following activities are only support services for which I Co is remunerated at ALP

  - Acting communication channel,
  - Ensure competitiveness by studying market,
  - Gathering customer feedback and on that basis which sugget/ communicate a quality and pricing structure to Applicant
  - Communication of sales related information to Applicant
  - Follow up of orders, coordination, arranging shipments, building relationships, monitoring quality and performance of third party inspectors.

- **Binding nature of AAR** - AAR emphases that since the transaction is proposed and there are no facts contrary to the agreement, the ruling is based no clear exclusions or prohibitions incorporated in the clauses of the agreement and the ruling will not be binding on the Tax Authority should they subsequently find that the facts actually differ from the agreement.

Source: Recent ruling in the case of Saudi Arabian Oil Company [TS-302-AAR-2018] (Applicant) wherein the issue before the A.A.R

10. Special bench Tribunal holds that mere performance guarantee for subsidiary's installation activities cannot give rise to a permanent establishment for a foreign enterprise

Background and facts of the case

- The Taxpayer a Finnish company was engaged in the business of manufacture and sale of advanced telecommunication systems and equipment (GSM equipment consisting of hardware and software components) used in fixed mobile and telephone networks.
- Taxpayer entered into agreements (sales contracts) with Indian telecom operators (customers) for sale of GSM equipment. The GSM equipment supplied by the Taxpayer under the contract were embedded with a software. Some of these sales contracts also required the Taxpayer to install the equipment in India

- Apart from the sales agreement, Taxpayer also entered into separate contracts for installation of the GSM equipment (installation contract) with some of its customers. In February and March 1995, Taxpayer signed two installation contracts. Taxpayer set up a liaison office (LO) in India on 30 March 1994 for the execution of the installation activities. One of the terms of the contract specified that interest @18% will be charged for delayed payment by customers. These contracts were signed by the country manager of LO, Mr A.

- Subsequently, in May 1995, Taxpayer, incorporated a wholly owned subsidiary in India, ICo. After incorporation of ICo, Mr. A was appointed as the Managing Director (MD) of ICo from 1.1.1996 to 31.7.1999.

- Post establishment of ICo, all the installation activities of the Taxpayer including under the contracts signed by Mr A were either assigned or new agreements were entered into by ICo with the customers on an independent basis.

- Until the incorporation of ICo, certain expatriates, i.e., the employees of the Taxpayer had visited India in respect of LO to undertake network planning, negotiating and signing the contracts on behalf of the Taxpayer.

- In addition to the above, two other agreements were entered into by the Taxpayer and ICo:

  - Marketing Support Agreement between the Taxpayer and ICo in terms of which ICo provided marketing services to Taxpayer and

  - Technical support Agreement between ICo and customers in respect of GSM equipment installed under the installation agreement. Taxpayer provided performance guarantee to the customers to ensure that ICo would discharge its obligations under the technical support agreement. Taxpayer also provided an undertaking that it would monitor the business of ICo and would not dilute its stake in ICo below 51% without written permission of the customers until the commitments under such contract are performed by ICo.

Litigation so far:

- During the assessment proceedings, the assessing officer (AO) held that:

  - LO as well as ICo constituted PE of the Taxpayer in India.
  - Total consideration payable for the supply of GSM equipment was segregated into hardware and software component. While, some portion of the income relating to supply of hardware was attributed to the PE and was subjected to tax in India, the income relating to supply of software was taxed as royalty under the ITA as well as the DTAA.
  - Basis the interest clause in the contracts signed by Taxpayer with the customer, AO imputed certain income as interest from delayed payments from customers.

- The contentions of the AO were upheld by CIT(A). From there the matter travelled before the special bench of Tribunal in the year 2005 which held as follows:

  - The LO, neither constituted a business connection under ITL nor a PE under the Finland DTAA.

  - Sale of hardware took place outside India and no income from such sale accrued to Taxpayer in India. Supply of software was an integral part of supply of the GSM equipment and hence was not taxable as 'royalty' under the ITL as well as the DTAA.

  - Taxpayer's undertaking to its customers that it will not dilute its stake in ICo was an indicator of the fact that ICo was under the control of Taxpayer. For constitution of a PE it is not necessary that there should be actual or direct control .What is relevant is only the perception that ICo was a projection of Taxpayer whether or not in fact the activities were being controlled/ monitored by Taxpayer . Thus, ICo was held to be the virtual projection of Taxpayer in India and Taxpayer was held to have a PE in India in the form of ICo.

  - ICo was Since the offshore supply contract provided for payment of interest on delayed payments, such interest expense accrues to the Taxpayer and hence taxable in India

- Aggrieved by the order of the SB, the Tax Authority and the Taxpayer filed cross appeals before the Delhi HC.

- Delhi HC confirmed that the Taxpayer's LO did not constitute a business connection or PE and also held that the payment for supply of GSM equipment was made outside India and hence was not taxable in India. Further since software was integral to such supply, even payment for such software was not taxable as 'royalty'. However, having noted the fact that certain factual inaccuracies had crept into the earlier order of SB the matter was remanded back for fresh consideration by Tribunal on certain specific issues.

- The specific issues which were remanded back to Tribunal were as follows:

  - Whether ICo creates a business connection or a PE of Taxpayer in India.
  - Whether any profits could be attributed on account of signing, network planning and negotiation of off-shore supply contracts in India could be attributed to such business connection/ PE
  - Whether notional interest on delayed consideration is taxable in the hands of Taxpayer as interest from vendor financing

Tax Authority's contention:

On the issue of business connection and fixed PE

- The activities done through LO were continued by ICo. The Country manager of Taxpayer also became the managing director of ICo. The office of the LO and ICo were co-located at the same premises and all employees of LO were absorbed by ICo. Thus the entire identity of Taxpayer and ICo got blurred such that ICo practically became virtual projection of the Taxpayer in India

- Setting up of GSM network being a complex exercise, was carried on by specialised employees or expatriates sent to India. This indicated presence of Taxpayer in all activities of ICo.

- The undertaking given by the Taxpayer to customers that it will not dilute its stake in Ico, indicates that ICo was under the control of the Taxpayer. This indicated that Taxpayer was responsible for services provided by ICo to the customers. Further the fact that ICo was the subsidiary of Taxpayer also indicated that the Taxpayer was in a position to control and monitor ICo's activities.

- ICo was undertaking a variety of activities in India for the Taxpayer such as providing commercial and industrial information to Taxpayer in the field of market development, liasoning with customers, providing information and technical assistance to the customers in India and marketing of the products of Taxpayer in India

- Further, the expatriates who visited India, carried on the core activities of negotiations and network planning activity on regular basis from the premises of ICo.

- ICo provided certain facilities like telephone, fax, etc. to the employees of Taxpayer who visited India. This shows that premises of ICo was at the disposal of the employees of Taxpayer

- Mr A was working both for ICo and Taxpayer and his activities resulted in a fixed place PE in India

On DAPE

- ICo was fully dependent on Taxpayer not only for entering into contracts with customers but also for everything after it came into existence. Thus, ICo did not act as an independent contractor while dealing with customers.

- Supply contracts and related installation contracts were signed by the employees of Taxpayer in India. While offshore supply contract was between Taxpayer and customers, any notice under the installation contracts was also required to be sent to the Taxpayer despite ICo having taken the responsibility of installation.

- All the equipment supply contracts were signed in India and the employees of ICo have attended the meetings and acted as witnesses while signing and finalisation of such contracts.

- Although installation contracts have been signed between ICo and customers, the performance guarantee provided by the Taxpayer to customer, indicated that Taxpayer was responsible for that contract. Thus, responsibility and liability for all the services provided to the customers in India was taken over by the Taxpayer.

Interest on delayed payments

- Interest from vendor financing and delayed payment of consideration on account of specific clause in the offshore supply contracts would amount to commercial income and be liable to tax in India.

Taxpayer contentions before Tribunal

On Business connection and Fixed PE

- Mr A became the MD of ICo in May 1995 post which there was no evidence furnished to indicate that Mr A negotiated or signed any sale contract with customers in India.

- The installation activities were carried on by ICo as an independent activity and on principal to principal basis and Taxpayer had no role in such activities. Income from such activities were also subjected to tax in India.

- Supply of GSM equipment was done outside India and no activity qua such supply was carried on in India by ICo, to support that ICo created business connection for the Taxpayer in India.

- Marketing services were rendered by ICo under a separate and independent contract for which an ALP consideration was paid to ICo by the Taxpayer.

- No evidence was brought on record to suggest that premises of ICo was at the disposal of Taxpayer.

- Expatriates/employees seconded to India were

working as employees of and under the control and supervision of ICo in India and rendered only installation and marketing activities on behalf of ICo. The employees were not involved in negotiating the sale agreement or in sale of offshore equipments on behalf of Taxpayer in India.

- Mere parental control over subsidiary does not result in creation of a PE.

On DAPE

- ICo did not negotiate or conclude any sale contract in India for the Taxpayer. The contracts signed by MR A were in his capacity as employee of the LO and not ICo. Further such contracts were signed even before ICo came into existence. Post appointment as MD, MR A did not sign any sale contract. The contracts signed by him were limited to installation contract which were also on behalf of ICo.

- The activities of assigning of contract, network planning and negotiation being preparatory and auxiliary in nature and hence do not create a DAPE for Taxpayer.

On attribution

- Without prejudice, if Taxpayer has a PE in India, even then no profits can be attributed to the PE as no activity in relation to supply of GSM equipments was carried on in India.

- As indicated by SB, attribution is to be evaluated only in respect of 3 activities viz: signing, network planning and negotiation of offshore sale agreement. However, since these activities are preparatory and auxiliary in nature, no income accrues to the Taxpayer in India.

- The title to the GSM equipment was passed from outside India, and no activities in relation to such supply took place in India. Hence no income can be attributed to India, even if it is accepted that there is a PE in India.

On Notional interest

- On principles of real income theory, no income accrues to the Taxpayer on account of delayed payments or vendor financing.

Tribunal's ruling

A Special Bench of Tribunal consisting of 3 judges was constituted wherein the majority ruled in favour of the Taxpayer. However, dissenting from majority view, the minority ruled against the Taxpayer and gave a separate ruling on the issue of business connection and creation of PE. The conclusions of the majority is summarised as follows:

Whether ICo constitutes a Fixed place PE

An enterprise is said to have a Fixed place PE under the DTAA it has certain specified place at its disposal through which its business is wholly or partly carried on.

- ***On disposal test***
  - The concept of 'fixed place' alludes to some kind of a location, physically located premise or some place in physical form. Thus facilities in the form of telephone or fax or conveyance cannot be equated with a fixed place.
  - There is no evidence to suggest that a physically located premise or some place in physical form was available at the disposal of the Taxpayer for executing the offshore supply contract in India.
  - The alleged co-location of earlier LO office and the Indian subsidiary was only in the initial year of 1995. As evident from the statement of the Managing Director, the LO has later moved out.

- ***On business activity test***
  - The installation contracts were signed by ICo independently with the Indian customers on a principal to principal basis and the income from such contracts was subjected to tax in India in the hands of ICo.
  - The expatriates were present in India to assist ICo in execution of the installation activities and not to carry out the business of ICo. Thus the premises of ICo were not being used by the expatriates for carrying on the business of the Taxpayer. Thus the allegation that the use of premises of ICo by the expatriates results in a fixed place PE of the Taxpayer is not acceptable.

- ***P&A Activities***
  - It is undisputed that the activities carried on in India were limited to signing of contracts, network planning and negotiation of off-shore contract in India. Even if is accepted that Taxpayer has fixed place at his disposal in

India, such fixed place cannot be treated as fixed place PE as the activities carried out in India are preparatory and auxiliary in nature.

- *Fixed PE due to activities of MR A/expatriates*

  - Even if it is accepted that Mr A was deputed to ICo; that would not lead to an inference that Taxpayer had a PE in India, if MR A worked under the control of ICo. This would be the conclusion even where Mr A continues to have a lien on the Taxpayer

  - Without prejudice, the fact whether Mr A was acting on behalf of Taxpayer or not, from whom he was receiving salary, etc. becomes relevant only while evaluating Service PE and not fixed place PE. Similarly, the contention that some of the expatriates/ technical persons were working on installation contract of ICo for which salaries were paid by Taxpayer would assume significance only while deciding whether Taxpayer has a 'Service PE', Since there is no concept of Service PE under the then existing India-Finland DTAA, entire thrust of this argument simply whittles down.

On ICo constituting DAPE for Taxpayer

- Under Article 5(5) of the DTAA, an Agent is treated as being dependent on an enterprise if the activities of the agent are subject to instruction or comprehensive control by the enterprise and the agent does not bear any entrepreneurial risk.

- For evaluating legal independence the determinative factors are whether commercial activities of agent are subject to detailed instructions or comprehensive control by the principal or not; or to what extent the agent exercises freedom in the conduct of his business on behalf of principal; or whether the agent's scope of authority is affected by limitations on the scale of business conducted by the agent. On the other hand for evaluating economic independence, the factors such as the extent of 'entrepreneurial risk" or "business risk" borne by agent as well as the extent of integration of agent's activities with those of the principal are relevant.

- A dependent agent may create a PE for the enterprise if the has an authorization to act on behalf of the enterprise so as to conclude the contracts on behalf of the enterprise.

- Following factors have no relevance in determining whether Taxpayer has a DAPE in India.

  - Provision of performance guarantee by Taxpayer with regard to contracts concluded by ICo with Indian customers for ensuring the performance of the installation contract in India.

  - Allegation that the overall responsibility of execution of installation contract lies with Taxpayer.

  - Employees of ICo attending the meetings with customers in India, without any authority to conclude contract

  - Even if the contention that ICo is subject to significant control by Taxpayer is accepted, the control is only in relation to the activities carried out by ICo in India i.e. installation activities. Since no income accrues to Taxpayer from such activities, the control exercise by Taxpayer does not have any relevance for evaluating DAPE.

  - Installation activities of expatriates, even if they are considered as employees of the Taxpayer, would amount to provision of necessary assistance, information, knowledge and expertise to ICo to carry on the installation work. Such activities are relevant only for evaluating 'service PE'.

- Having noted the above, Tribunal held that ICO did not qualify as a DAPE of the Taxpayer in India basis the following reasoning:

  - ICo bears the entrepreneurial risk and hence qualifies as an independent agent

  - No material was brought on record to show that ICo negotiated or concluded any contract of supply of GSM equipment which were binding on the Taxpayer.

  - The title to the GSM equipment was passed on to the customers directly outside India and ICo neither participated in any negotiation process of such contracts nor assisted in the delivery of GSM equipment.

  - The offshore supply contract was executed by Taxpayer outside India and nothing was performed by ICo in India as an agent of the Taxpayer qua such contract.

- The installation contracts were signed by Mr A in its capacity as the country manager of the LO at a time when ICo was not in existence. Post the incorporation of ICo. Mr A became its managing director. While Mr. A was the managing director of ICo, he signed installation contracts on behalf of ICo, however, no evidence was brought on record to indicate that Mr A had signed any contract with Indian customers for offshore supply of GSM equipment.

- Even the assignment contract between the Taxpayer and ICo was signed by Mr A before ICo was established. Thus even if it is alleged that Mr A exercised an authority to conclude contract on behalf of the Taxpayer, such authority was not exercised on behalf of the Taxpayer vis-à-vis the customers.

- Whether or not an agent creates a DAPE has to be evaluated basis the activities of the agent. ICo was performing installation, technical support, and none of these activities resulted in generation of any income for the Taxpayer. These activities were carried on by ICo for the customers and not on behalf of the Taxpayer. Marketing agreement was also entered into with the Taxpayer on an independent basis. None of these activities related to the supply of GSM equipment. Thus the activities of ICo cannot be said to be carried on wholly or almost wholly on behalf of the Taxpayer in India.

- Further income from such activities was already subjected to tax in India in the hands of ICo. Thus even if ICo is considered as DAPE of the taxpayer, no income can be attributed to the PE in India.

On wholly owned subsidiary being regarded as virtual projection of Taxpayer:

- Article 5(8) of the DTAA clarifies that a subsidiary cannot be treated as a PE of its parent, merely because it is controlled by the parent.

- Having regard to the ratio laid down by SC in Formula One (supra) and AP HC in Vishakhapatnam Port Trust, the concept of 'virtual projection' cannot be in vacuum de-hors other parameters of PE.

- In other words, the concept of 'virtual projection' has to be seen in relation to either a fixed place or in relation to any other parameters or conditions envisaged in Article 5.

- Thus, if on facts there is no establishment of a fixed place and disposal test is not satisfied, then virtual projection itself cannot be held to be a factor for creation of a PE.

Whether Taxpayer had business connection in the form of ICo

- Since the transaction in question is supply of goods, the relevant factor for determination of taxability of income arising from supply of goods is the place where the property in such goods passes to the customers.

- The place where the contract is signed and the fact that sale of such goods is subject to an acceptance test, is not relevant in view of the Delhi HC. Since the title in the goods passed outside India, it was held by HC that income from such supply is not taxable in India.

- HC had concluded that the activities of LO did not result in a business connection or a PE of the Taxpayer in India. Similar conclusion should apply even in respect of ICo as the terms and conditions for supply of GSM equipment remains unchanged.

- Without prejudice, even if business connection is established in India with respect to off shore supply to Indian customers, there must be some activity carried out in India relating to the off-shore supply so as to trigger taxability in India. Reliance in this regard was placed on the case of Nortel Networks India International Inc.

- With regard to offshore supply of equipment, all activities except marketing activity was carried out outside India. Further marketing support activities were carried on vide a separate agreement between the Taxpayer and ICo and income arising there from has been offered to tax in the hands of ICo.

On interest from vendor financing

- Nothing has been brought on record to show that Taxpayer had charged any interest on delayed payment or any customer has paid any such amount for delay in actual payment. Even the conduct of the parties show that such a clause even though may have been agreed upon has never been enforced or acted upon by the parties.

- For an income to be taxed, Taxpayer should have

either received or acquired a right to receive the income. Unless a debt has been created in favour of the Taxpayer, it cannot be said that the income has accrued to it or the Taxpayer has received the income.

- As the Taxpayer has neither treated an amount as legally recoverable from customers nor acknowledged the debt or any corresponding liability of the customers to pay such amount, it cannot be held that interest accrued to the Taxpayer. Hence such notional interest cannot be taxable in the hands of the Taxpayer.

Source: Recent ruling in the case of Nokia Networks OY [TS-289-ITAT-2018(DEL)] (Applicant) wherein the issue before the SB (special bench) of ITAT

11. AAR rules receipt of non-compete fee forming part of agreement for sale of shares is business income

Background and facts of the case

- As per the specific provision of the ITL, the following sums, whether received or receivable in cash or in kind, under an agreement (popularly known as non-compete receipts), are taxable as business income:
  - Sums received for not carrying out any activity in relation to any business or profession (except where it is received on transfer of the right to manufacture, produce or process any article or thing or right to carry on any business or profession which is chargeable as capital gains).
  - Sums received for not sharing any know-how, patent, copyright, trademark, licence, franchise or any other business or commercial right of similar nature or information or technique likely to assist in the manufacture or processing of goods or provision for services.
- In the present case, the Applicant, a UK-based company, is the holding company of a leading international publisher of books and journals.
- The Applicant held controlling interest (61.46%) in I Co, an Indian listed public company, engaged in providing support services for book publishing.
- The Applicant entered into an SPA dated 11 October 2011 with the Buyer (an Indian company) for the transfer of its entire shareholding in I Co. The sale price of shares was fixed at the prevalent market price determined in accordance with a Circular issued by SEBI . In addition, the Buyer also agreed to pay a separate non-compete fee to the Applicant over and above the sale price of shares, under a separate clause of the same SPA.
- The relevant clause of the SPA provided for the following:
  - The Applicant, due to the nature of its association with I Co, had confidential and proprietary information relating to the business and operations of I Co, disclosure or unauthorized use whereof shall cause substantial loss and harm to I Co and its shareholders.
  - The Applicant shall not, directly or indirectly, carry on or engage in or compete with the business of I Co in India or solicit or entice away or offer employment to any employee of I Co for a period of three years from the completion date of the SPA.
- The Applicant sought an advance ruling by filing an application before the AAR in order to determine the taxability of the non-compete fee received by the Applicant.
- The Tax Authority contended before the AAR that the said receipt is taxable as capital gains since it was for transfer of the right to carry on business, which got transferred by way of extinguishment through the SPA. It further contended that the specific provision is attracted only when the non-compete fee is received by a person carrying on the same business. As an alternative argument, it also contended that a part of the non-compete receipt should be allocated to the transfer of controlling interest by the Applicant and treated as capital gains, as held by the Delhi High Court (HC) in the case of CIT v. Shiv Raj Gupta.

Issue under consideration

- Whether the non-compete fee received by the Applicant pursuant to an SPA is assessable as business income and, in the absence of any PE of the Applicant in India, the said receipt is not taxable in India.

AAR's ruling

- The AAR upheld the Applicant's submissions and ruled in favor of the Applicant that the receipt of the non-compete fee separately agreed in the SPA (in addition to the sale price of shares) is taxable as business income, and not as capital gains, and since the Applicant does not have any PE in India, the non-compete fee is not taxable in India for the following reasons:

  Non-compete fee is not taxable as capital gains:

  - **No capital asset in the nature of right to carry on I Co's business held by the Applicant:** The Applicant possessed shares of I Co, but did not have the right to carry on the business of I Co. It is well settled that shareholders and the company are different legal entities and they enjoy different rights and obligations. Hence, the Applicant, as a mere shareholder, cannot be said to be carrying on business of I Co. As a shareholder, the Applicant only enjoys the right to profits, right to dividend, right to vote etc., arising from the shares. Consequently, no legally enforceable right to carry on business, which can be treated as a "capital asset", existed in the hands of the Applicant, which could be transferred to the Buyer.

  - **Non-compete fee was received for a restrictive/negative covenant and not to transfer any positive right:** The SPA explicitly states that the consideration is paid to the Applicant for agreeing to not carry on or be engaged in or compete with I Co's business in India for a period of three years. The Applicant imposed a self-restriction since it was in possession of confidential and proprietary information relating to I Co's business operations. Use of such information could cause substantial harm and loss to I Co and its shareholders since the businesses of the Applicant and I Co were interconnected and they belonged to the same industry, if not the same business. The Buyer entered into a non-compete arrangement to protect its own interest and customer base and not for gaining any rights of carrying on business and, thus, the non-compete fee received by the Applicant was for a negative covenant.

  - **No "transfer" of any right to carry on business:** To fall within the realm of "transfer" of capital asset by way of extinguishment, there should be extinguishment of a capital asset and "extinguishment" implies that the right is destroyed in perpetuity. However, in the present scenario, the Applicant's right shall be revived after three years from the date of the SPA and the same cannot be said to be permanently destroyed or irrevocably transferred. Reliance was placed on the Amritsar Income Tax Appellate Tribunal's (Tribunal) decision in the case of Dy. CIT v. Max India Ltd. , wherein the Tribunal held that the negative covenant not to carry on manufacture or trade in a product for certain period of time amounts only to self-imposed restriction, and not a transfer. Hence, this is not a case of transfer.

  Non-compete fee is taxable as business income:

  - **Positive right v. negative covenant:** Receipt of non-compete fee arising out of a negative covenant not to carry on a business, is taxable as business income. Reliance was placed on rulings of the Special Bench of the Hyderabad Tribunal in the case of ACIT v. Late Dr. B.V.Raju and the Madras HC in the case of CIT v. Chemech Laboratories Ltd., which had held that if non-compete fee is paid to the transferor for "giving up his right to carry on business", the same is chargeable as capital gains, whereas if the transferor receives any non-compete fee for "not carrying out any activity in relation to any business" which he is not already carrying on, the same is chargeable as business income. Thus, receipt of non-compete fee for a negative covenant, as against transfer of positive right to carry on a business, is taxable as business income.

  - **No requirement to be engaged in any existing/same business:** The AAR held that there is no ambiguity in the ITL provisions and it is very clear that for taxability of non-compete fee as business income, it is not necessary that the taxpayer must already be carrying on business which it has agreed not to carry on further. Accordingly, the fact whether the Applicant was carrying on any business and/or whether it was carrying on the same or different business from that of the Buyer, is totally irrelevant while considering taxability of non-compete fee as business income. This position is confirmed by judicial decisions in both of the following scenarios:

    - Where a taxpayer was carrying on a particular business and received non-compete fee for agreeing not to carry on the same business.

- Where a taxpayer was carrying on a particular business and received non-compete fee for agreeing not to carry on some other business.

- **Decisions relied by the Tax Authority are distinguishable:**

  - If lump sum consideration is received for both sale of shares and non-compete, the whole of the consideration is liable to tax as "capital gains".
  - The head of income has to be determined based on the principles laid down by Supreme Court for classification of income.

- **The AAR held that these are not relevant to the present issue since:**

  - In the Applicant's case, the non-compete fee was received as a separate consideration in addition to the sale price of shares.
  - Furthermore, if the facts of a case squarely fall within the wordings used in the provisions under the ITL, there is no requirement to apply any principles for classification of income.

- **No part of the non-compete fee can be allocated to transfer of controlling interest:** In the present case, the sale price of listed shares was fixed at the prevalent market price calculated as per the the SEBI Circular. The non-compete fee was paid separately in addition to the sale price of shares. It is well settled that when the document is plain and clear and the legitimacy/genuineness of the same has not been questioned, the legal character of the transaction cannot be suspected.

- Also, the decision in Shiv Raj Gupta's case (supra), relied on by the Tax Authority, is distinguishable since it pertained to tax year prior to 2002-03 when non-compete receipt was not taxable and, hence, the taxpayer artificially allocated higher consideration to the non-compete fee (to claim it as non-taxable capital receipt) and lower consideration to the sale price of shares (offered to tax as capital gains). The HC held that the real and true nature of the transaction was sale of shares and transfer of control and management, which were camouflaged as non-compete fee since the non-compete fee was almost 10 times higher than the consideration for transfer of shares. However, in the facts of the present case, the consideration for transfer of shares and non-compete is clearly defined and separately agreed.

- In the absence of any PE in India, the non-compete fee assessable as business income is not taxable in India: Relying on the decision of the Kolkata Tribunal in the case of Trans Global PLC (supra), which also dealt with similar facts, the AAR ruled that the non-compete fee assessable as business income is not taxable in India by virtue of Article 7 of the DTAA which provides that business income of a UK resident shall be taxable only in the UK in the absence of any PE in India.

Source: Recent ruling in the case of HM Publishers Holdings Ltd. [A.A.R. No 1238 of 2012] (Applicant) wherein the issue before the A.A.R

Key Direct Tax Developments

1. Central Government modifies conditions for availing exemption from "angel tax" provision

Background and facts

- Section 56(2)(viib) (Section) of the Indian Tax Laws (ITL) (popularly known as the "angel tax" provisions) is an anti-abuse provision which applies when a CHC issues shares (including preference shares) to a resident at a premium and receives consideration which is in excess of the FMV of the shares. The excess amount so received is deemed as income from other sources in the hands of the CHC in the year of issue of the shares.

- Rule 11UA of the Income Tax Rules (Valuation Rules) prescribes the valuation methodology for determining the FMV of various types of assets (including unquoted equity shares), not only for the purposes of the angel tax provision, but also for other anti-abuse provisions involving transfer of assets without consideration or at a value less than the FMV.

- The FMV of unquoted equity shares for the purpose of the angel tax provision read with Rule 11UA is the higher of the following:

  - Net asset value as reflected in the audited

- balance sheet of the CHC (break-up value method)

  OR

- The DCF value as determined by a Category-I MB or Accountant

  OR

- The value that the company is able to substantiate to the satisfaction of the Tax Authority, basis the holding of various intellectual property rights (IPRs) like goodwill, know-how, patents, copyrights etc.

- In case of unquoted shares and securities other than equity shares in a company not listed in any recognized stock exchange, as per Rule 11UA, the FMV is the estimated open market value as may be determined by a Category I MB or Accountant. This rule applies to both angel tax and other anti-abuse provisions.

- Prior to the Valuation Notification, the term "Accountant" was defined as under:

  - For angel taxation: In case of valuation of unquoted equity shares, an Accountant is a Fellow CA who is not appointed as a tax auditor under the ITL or as a statutory auditor under the Companies Act, 2013.

  - For other anti-abuse provisions: Any CA in practice who can act as an Authorized Representative for the taxpayer and fulfils the independence criteria as prescribed under the ITL.

Changes brought about by the Valuation Notification are as follows:

- The Valuation Notification has withdrawn the option given to the taxpayer to obtain a valuation report from a CA for determining the FMV of unquoted equity shares based on the DCF method for the purpose of the angel tax provision. As a consequential amendment, it has also omitted the definition of "accountant".

- Thus, where the taxpayer wishes to rely on the DCF method, it can now obtain a DCF valuation report only from a Category 1 MB. A valuation report from a practising CA will no longer be a valid compliance for the angel tax provision.

- However, it may be noted that the above change applies only to the valuation of unquoted equity shares required for the angel tax provision by adopting the DCF method option. For shares other than unquoted equity shares (like preference shares), the taxpayer continues to have the option to obtain a valuation report from either a Category I MB or a CA.

- The aforesaid amendment comes into force from the date of publication in the official gazette i.e., 24 May 2018.

Exemption from the angel tax provision for eligible "start-ups"

- The angel tax provision does not apply to shares issued by a venture capital undertaking to a venture capital fund or a venture capital company.

- In addition, the provision does not apply when shares are issued to a class or classes of persons as notified by the CG. Pursuant to exercise of this power, the CG issued the following notifications with corresponding reference to the DIPP notifications.

- The additional conditions imposed by the 2018 DIPP Notification for start-up companies are:

  - A cap of INR100m on the aggregate of paid-up share capital and share premium post issue of shares.

  - Requirement to furnish a valuation report obtained from a Category I MB specifying the FMV of the shares, in accordance with Rule 11UA.

- As per the 2018 DIPP Notification, the conditions required to be fulfilled by the investor are, either:

  - Average returned income of INR2.5m or more for the preceding three financial years.

    OR

  - Net worth of INR20m or more on the last date of the preceding financial year.

- The Start-up Notification aligns with the 2018 DIPP Notification and provides that where shares are issued at premium for a consideration in excess of the FMV, the angel tax provision shall not apply on such consideration received from an investor by a start-up company, in accordance with the approval granted by the IMB under the 2018 DIPP Notification.
- This change comes into force retrospectively from 11 April 2018, being the date on which the 2018 DIPP Notification was issued/published in the official gazette.

(Source: CBDT draft Notification No. 23 and 24 of 2018 dated 24 May 2018)

Key Regulatory amendments

This section summarizes the regulatory updates for the month of June 2018.

Notifications/ circulars issued by Reserve Bank of India (RBI)

1. Furnishing of Permanent Account Number (PAN) while remitting funds under Liberalised Remittance Scheme (LRS) and definition of 'relative'

- RBI has decided that furnishing of PAN which hitherto was not to be insisted upon while putting through permissible current account transactions of up to USD 25,000, shall now be mandatory for making all remittances under LRS.

- Additionally, with reference to the definition of 'relative' under the LRS guidelines, the same has been aligned with the definition given in Companies Act, 2013 instead of Companies Act, 1956.

Source: A.P. (DIR Series) Circular No. 32 dated 19 June 2018

2. RBI revised the norms for foreign portfolio investments (FPI) in debt securities and withdrew the earlier circulars issued

- RBI vide its notification dated 27th April, 2018, amended on 1st May, 2018 has relaxed their terms of investments in corporate bonds by FPIs.

- RBI has now decided to withdraw the aforementioned circulars and issued a revised circular on investments by FPI in debt securities.

- The key changes/ amendments made in the revised consolidated circular vis-à-vis recently issued RBI circulars on 'investments by FPIs' are set forth below:

  - The terms 'short-term investments', 'multilateral financial institutions', 'Security Receipts (SRs)' 'related FPIs' and 'entities related to the corporate' have been categorically defined for the purpose of investments by FPI. It has also been clarified that issuers that are owned or controlled by the Government of India or State Government shall be exempted.

  - The condition that short term investments in corporate bonds by an FPI shall not exceed 20% of the total investment of that FPI would not apply to investments in SRs by FPIs.

  - The requirement that short-term investments shall not exceed 20% of total investment by an FPI in any category applies on an end-of-day basis.

  - Short-term investments by an FPI may exceed 20% of total investments, only in cases if the short-term investments consist entirely of investments made on or before 27 April 2018.

  - New investments in corporates made after April 27 would be exempt from this requirement till 31 March 2019.

  - Further, to facilitate newly registered FPIs to build up a diversified portfolio, FPIs registering after 27 April 2018 are permitted to comply with this requirement by 31 March 2019, or six months from the date of registration, whichever is later.

  - The requirements of single/group investor-wise limits in corporate bonds would not be applicable to investments by Multilateral Financial Institutions and investments by FPIs in SRs.

  - 'Pipeline investments' would mean investment transactions by FPIs in corporate bonds that were under process but had not materialized as on 27 April 2018 would not require to comply with the single/ group investor-wise limits in corporate bonds subject to the satisfaction of the custodian of FPI.

Source: A.P. (DIR Series) Circular No.31 dated 15 June 2018

3. RBI introduced Single Master Form (SMF) for reporting of various types of foreign investment in India

- In terms of the extant reporting framework, the RBI provides different forms for reporting issue/transfer of instruments for various foreign investment in India.

- RBI has provided an interface to the Indian entities, to input the data on total foreign investment (including indirect foreign investment) in a specified master format which will be available on the RBI website from June 28, 2018 to July 12, 2018.

- Indian entities have to submit the information in the said master format and failure to comply with the same will restrict ability to receive future foreign investment and will be considered as noncompliant with the exchange control regulations.

- Further, Form DI for reporting of downstream investment for indirect foreign investment within 30 days of allotment of capital instruments has been introduced. Information sought in the Form DI is in line with the extant reporting requirements provided for reporting to Department of Industrial Promotion & Policy (DIPP).

- Form InVi has been introduced for reporting the details of foreign investment in investment vehicle which needs to be reported by the investment vehicle receiving investment by a person resident outside India within 30 days of the date of issue of units. Earlier there was no prescribed form for foreign investment in investment vehicle.

- Form FC-TRS would be required for reporting of cross border transfer of capital instruments of Indian company and also required to be filed in case of gift of capital instruments of an Indian company. In addition, details in relation to deferred arrangement, indemnity arrangement, escrow arrangement, etc. in a transfer transaction needs to be suitably provided in the FC-TRS.

- Form FC-GPR, required for issue of capital instruments, inter-alia, will include the details pertaining to refund of share application money, if any, conversion formula for issuance of convertible instruments.

- Other forms like form LLP-I, LLP-II, ESOP, DRR have also been simplified and streamlined seeking relevant details.

- Certificate from Company secretary, inter-alia, needs to certify that Investment/ Shareholder agreement between the investee and investor is in compliance with the extant foreign investment regulations.

Source: A.P. (DIR Series) Circular No.30 dated 07 June 2018

4. RBI modified format of monthly reporting through ECB 2 Return

- In terms of the extant exchange control regulations, the reporting arrangement for ECBs is undertaken through ECB-2 Return on monthly basis. RBI has now decided to capture the details of the hedges for ECBs as well through a simplified format of ECB 2 Return.

- Accordingly, Part E of the Return, accordingly, is modified so as to include only standard information on hedged/ unhedged ECB exposure.

- Additionally, the aforementioned changes have also been captured in the extant Master Direction on reporting dated 01 January 2016 and revised monthly reporting format of ECB 2 Return would be applicable from month-end June 2018.

Source: A.P. (DIR Series) Circular No.29 dated 07 June 2018

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