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November- 2016 Vol . V | No. 2

TAXATION OF ROYALTY AND FTS

- Direct Taxes
- Other Laws
- International Taxation

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- Indirect Taxes
- The Chamber News
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CA Hitesh R. Shah, President delivering opening speech. Seen from L to R : CA Ramesh Iyer, Vice Chairman, CA Dilip Thakkar, Keynote Speaker and CA Ujwal Thakrar, Course Co-ordinator.

CA Ramesh Iyer, Vice Chairman delivering welcome address. Seen from L to R : CA Hitesh R. Shah, President, CA Dilip Thakkar, Keynote Speaker and CA Ujwal Thakrar, Course Co-ordinator

CA Dilip Thakkar inaugurating the course by lighting the lamp. Seen from L to R : CA Hitesh R. Shah, President, CA Ramesh Iyer, Vice Chairman and CA Ujwal Thakrar, Course Co-ordinator.

CA Dilip Thakkar delivering Keynote address. Seen from L to R : CA Ramesh Iyer, Vice Chairman, CA Hitesh R. Shah, President and CA Ujwal Thakrar, Course Co-ordinator.

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Editorial

I am writing this editorial while the discussion in the international arena is regarding the future foreign or world policy of the United States of America and on domestic issues, no doubt, is regarding the demonetisation of currency notes of ` 500/- and ` 1,000/-. The general perception seems to be that the future is uncertain. I beg to differ with this perception on both these issues

At the outset, I congratulate the citizens of a great democracy i.e. the United States of America for celebrating their freedom and democracy. I congratulate the President elect Donald John Trump. The message is loud and clear, whether it's Brexit or recently concluded Presidential elections in the United States of America. The issue of terrorism cannot be dealt with a reformist attitude. The fight has to be on war footing and has to be decisive. The common man is agonised that the unscrupulous elements can lay their hands on the nuclear weapons then the so called civilised and rational world will not get a second opportunity to save itself.

The decision of the Hon'ble Prime Minister to demonetise ` 500/- and ` 1,000/- notes clearly reflects his determination to fight corruption. The corruption is malignancy to the society and the same has made the society vulnerable in many ways. Hence, chemotherapy to deal with it is a necessity. A patient undergoing chemo suffers side effects and for a brief period maybe under the weather but soon he is going to be out of the woods. With this, society has to co-operate with the Government and see to it that the cancer of corruption is eradicated. Here, it may not be out of the place to mention that the fight against corruption is an ongoing process. We professionals who are conscience keepers of the society should not allow the Government and society to lower its guard against corruption. We wish all success to this fight against corruption.

Finally, India is inching closer and closer to the implementation of GST. The GST Council, in its fourth meeting held on 3rd November, 2016, has finalised a four-tier tax rate structure for GST viz. 5%, 12%, 18% and 28%.

The Hon'ble Finance Minister announced that 5% rate shall be levied on items of mass consumption or 'aam aadmi' products. Standard GST rate of 12% and 18% will be levied on other items. Most services will come under 18% GST slab

while other services will be taxed at 12%. It is proposed most white goods would be taxed at 28%. Demerit goods such as tobacco, aerated drinks, pan masala and luxury car will be taxed at 28% with an additional cess. Essential items including food, which presently constitute approximately half of the consumer price index basket, will be taxed at zero rate. The GST rate for gold will be decided later.

The finalisation of GST rate structure is a welcome move and brings us a step closer to GST implementation. The next crucial step would be in bucketing of the goods and services under the above rate slabs.

It is expected that the GST rates would be assigned to various goods and services in the manner that effectively it will be tax neutral. Further, the Government is hopeful that proposed GST rate shall shield the common man from negative price impact and is unlikely to be inflationary for the Indian economy.

The present issue of the Chamber's Journal carries the Special Story on Taxation of Royalty & FTS. Eminent professionals have contributed to this issue. I thank all the professionals for taking out their valuable time to help the Chamber's of Tax Consultants in coming out with this issue of the Chamber's Journal.

K. GOPAL
Editor

The Vedanta recognises no sin it only recognises error. And the greatest error, says the Vedanta is to say that you are weak, that you are a sinner, a miserable creature, and that you have no power and you cannot do this and that.

— ***Swami Vivekananda***

Go on bravely. Do not expect success in a day or a year. Always hold on to the highest. Be steady. Avoid jealousy and selfishness. Be obedient and eternally faithful to the cause of truth, humanity, and your country, and you will move the world.

— ***Swami Vivekananda***

From the President

Dear Members,

I wish all the readers Happy New Year (Vikram Samvat 2073). May this year bring prosperity and happiness! The markets had warmed up to welcome the New Year. I am fascinated with the flickering flame of the small earthen lamp which glows without bothering about enormous darkness around it. By the time this issue reaches, you may have forgotten about the vacation you had during the Diwali festival.

Hon'ble Prime Minister Narendra Modi on Tuesday i.e. 8th November, 2016 took a bold step by declaring a surgical strike on black money by announcing demonetisation of ` 1,000 and ` 500 currency notes from 9-11-2016 . It was a dramatic move aimed at stamping out corruption and draining illicit cash from the economy and will significantly push economic growth of the country.

It means from the midnight of November 8, 2016, ` 500 and ` 1,000 will not be legal tender...these will be just worthless pieces of paper.

Hon'ble Prime Minister in his first telecast address said 'There is a need for a decisive war against the menace of corruption, black money and terrorism... festering wounds which make the country and society hollow from within'.

In the year 1978 similar demonetisation of high denomination notes was done by passing a law, however, this time it was through a notification under section 26(2) of the Reserve Bank of India (RBI) Act. Thus law empowers Government to ban certain specified notes as legal currency. Under both the situations, the objective remained similar, to curb unaccounted wealth and illicit money used for illegal purpose and transaction which are harmful to the economy.

Such an action is overwhelmingly in public interest as it seeks to strike at the very foundation of the parallel economy which is destroying the social fabric.

It is expected that black money held as cash will come into the banking system to be replaced and the Government has an opportunity to utilise the resultant trail to boost its tax collections, at the same time it will choke the flow of fake high value notes used for illegal activities including terrorism and drug trafficking in India. It is expected that as a result of such move, money push inflation will reduce, real

estate price, gold prices will reduce and Government will get more resources to deal with its various initiatives.

We all know cash is widely used in Indian electoral process and that's why elections are a very costly affair in India. Now due to timely announcement of such move, it will severely curb supply of money in poll bound States viz. Uttar Pradesh, Punjab, Uttarakhand and Goa where elections are going to be held in February, 2017. One need to wait and see the impact of demonetisation on the forthcoming elections.

It is right that such move poses a **logistic nightmare** for the banks and where banks are not adequately geared up to deal with situation, given that the total value of currency in circulation is ` 17 lakh crore with around 80% of that in high value currency, banks will have to withdraw over ` 13.6 lakh crore of currency from the public.

The said sudden move has **created panic** amongst the common people. People suddenly realised that they are left with no money and long queues are seen outside banks for deposit and replacement of currency. Further limits of ` 10,000 has been kept for withdrawal at a time and ` 20,000/- in a week, though it is for temporary period. Even use of currency has been banned in all public charitable hospitals where patients have been put to a great amount of hardship and inconvenience. Further statement from Ministry to levy penalty of 200% on such cash deposit has created unnecessary panic in the mind of people. **The process could have been more simplified to avoid maddening rush such as increasing the supply of new currency to overcome the public demand.**

Be that as it may, the battle against black money is worth it if resultant revenue gains are efficiently utilised.

Further there is a dire need to bring agriculture income within the ambit of taxation by putting higher threshold limit for people having exempted income. People having agriculture income must file a return of income irrespective of whether the income is exempt or not. Agriculture is one of the sectors which has been used for conversion of unaccounted income.

In the last month the Chamber had organised workshop on FEMA, on Surveys under Income Tax and TDS Survey at Vapi and also at Delhi on Inbound investments and exit strategy which received good response.

In continuation of Chamber's efforts in digital transformation, the Chamber has launched its first webinar on 26th October 2016 on **"Basics Concepts of GST Law"** addressed by CA Shri Naresh Sheth. The webinar received a very good response and people from various places such as Delhi, Kolhapur, Solapur, etc. participated. With this Chamber has once again crossed a mile stone in digital transformation and has achieved its vision to reach each and every member, wherever they are located.

The Income-tax Department observed **'Vigilance Awareness Week' on 3rd November, 2016.** The objective of the 'Vigilance Awareness Week' was to sensitise its officials to the need for improving quality of public service rendered and mitigate the potential areas

of corruption. During this period interactive session between the senior functionaries of the Income-tax Department and various stakeholders to mitigate potential area of corruption was held, wherein the Chamber was invited. The Chamber has made effective representation on all points including the queries received from its members before various Chief Commissioners and Principal Commissioners during the interactive session. **The Law and Representation Committee also pointed out that holding such awareness is good concept but it should not be a mere formality. Chamber has also pointed out that Vigilance Commissioner has not taken any proactive steps to curb corruption or creating awareness amongst the assessees. Assurance was given that in case of difficulties faced by the members, they can approach Principal Commissioners or Chief Commissioners or Addl. Director of Income-tax (Vigilance) who will certainly take care of problems.**

Law and Representation Committee has made representation before the **Ministry of Finance on 7th November, 2016 for pre-budget recommendation.** The discussion which took place with the authorities was very interactive and they discussed the suggestions made by the Chamber. The Committee submitted exhaustive booklet on representation on pre-budget prepared by it. The Committee also had an opportunity to meet **Revenue Secretary Shri Hashmukh Adhia and discussed issues relating to curbing of corruption and black money. Chamber made a strong representation that it should be made compulsory for all assessees having agriculture income to file return of income irrespective of whether the said income is exempt from Income-tax.**

Chamber has planned various unique programmes such as workshop on Ind AS, GST, Alternative Fund raising Options for Corporates, Surveys under Income-tax & TDS, RRC on Direct Tax and RRC on Indirect Tax with unique features and reputed speakers. These programs have been designed very well and I am sure they will be great knowledge sharing programmes.

At present globalised business environment permits global MNCs to leverage their intellectual property rights (IPRs) to create a source of income in countries across the world. Moreover with an increase in online and mobile commerce, the complexities of cross-border transactions have increased. Taxation of income by way of royalties being income from commercialisation of IPRs therefore assumes significance in India. Keeping in mind complexities involved the Special Story for the month has been designed on **"Taxation of Royalties and FTS" and I am sure readers will be immensely be benefited from this Special Story.**

HITESH R. SHAH
President

Chairman's Communication

Dear Readers,

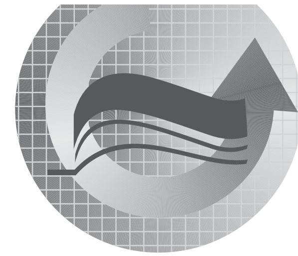
In a bold and historical initiative intended to eliminate black money and the growing menace of counterfeit currency notes, the Union Government, effective midnight of 8th November, withdrew currency notes of ` **500 and** ` 1,000 denomination. Some describe this bold step by the Prime Minister as the Surgical Strike on Black Money! Captains of Industry have also hailed this move as it would give a boost to the formal economy in the long run though it could cause some pin pricks in the functioning in the short term.

'Governance' in general has been much in discussion for the past few weeks be it in the political parties or Corporates. Recent episode of removal of the Chairman of a leading Industrial House and support from set of independent Directors to the same person as Chairman of another Company of the same group, makes one wonder whether the fundamental principles of Corporate Governance are really observed the way it is intended. This episode makes one feel that irrespective of the reputation and legacy of a Company, things appear to be hunky dory until you know the true facts!

The advancement of technology and phenomenal growth in e-commerce have given rise to controversies surrounding taxability of payments made for royalties, technical services, satellite and telecommunication service etc. and therefore taxation of income by way of Royalty and fees for technical service (FTS) has assumed significant importance over a period of time. Therefore the committee thought it appropriate to come out with a special issue on the same. My colleagues in the committee, Anish Thacker, Haresh Kenia and Paras K. Savla have put in lots of efforts for designing the issue and overall co-ordination. Professionals having expert knowledge of the subject matter have been invited to write the articles for the benefit of the readers. I thank and compliment all of them for sparing their valuable time and sharing their knowledge despite their busy schedule.

Government is moving very fast in implementation of GST and therefore, we would be brining out three issues on GST in forthcoming months.

VIPUL K. CHOKSI
Chairman – Journal Committee



CA N. C. Hegde & CA Sandeep Dasgupta

Royalties – General Concept

The context

The world has now become a global village and India has also become an integral part of the same. The present globalised business environment permits global MNCS to leverage their intellectual property rights (IPRs) to create a source of income in countries across the world. In that context India has quickly moved from being a pure importer of technology to slowly developing its own capabilities in technology. Moreover with an increase in online and Mobile commerce, the complexities of cross border transactions have increased. Taxation of income by way of royalties being income from commercialisation of IPRs therefore assumes significance in India. In this backdrop, the ensuing paragraphs attempt to briefly touch upon certain aspects governing and impacting the taxation of royalties in India.

Fundamentally, the taxability of the royalty in India in the hands of non-resident Tax payers depend on provisions of the Income-tax Act, 1961 ('Act') and the relevant Double Taxation Avoidance Agreement ('DTAA' or 'Treaty'), if any. Royalty is one of the main streams of income that non-residents are taxed in India under the deeming fiction/source rule of section 9(i)(vi) of the Act.

Meaning of the term "Royalty"

As per general usage, the term "Royalties (sometimes, running royalties, or private sector taxes) are usage-based payments made by one party (the "licensee") to another (the "licensor") for ongoing use of an asset, sometimes an intellectual property. Royalties are typically agreed upon as a percentage of gross or net revenues derived from the use of an asset or a fixed price per unit sold of an item derived from the use of such asset, but there are also other modes and metrics of compensation"

Royalty — as defined in the Act

Explanation 2 to Section 9(1)(vi) defines 'Royalty' as follows:

"For the purposes of this clause, "royalty" means consideration (including any lump sum consideration but excluding any consideration which would be the income of the recipient chargeable under the head "Capital Gains") for –

(i) The transfer of all or any rights (including the granting of a licence) in respect of patent, invention, model, design, secret formula or process or trademark or similar property;

(ii) The imparting of any information concerning the working of, or the use of, a patent, invention, model, design, secret formula or process or trademark or similar property;

(iii) The use of any patent, invention, model, design, secret formula or process or trademark or similar property;

(iv) The imparting of any information concerning technical, industrial, commercial or scientific knowledge, experience or skill;

(iva) The use or right to use any industrial, commercial or scientific equipment but not including the amounts referred to in section 44BB.

(v) The transfer of all or any rights (including the granting of a licence) in respect of any copyright, literary, artistic or scientific work including films or video tapes for use in connection with television or tapes for use in connection with radio broadcasting, but not including consideration for the sale, distribution or exhibition of cinematographic films; or

(vi) The rendering of any services in connection with the activities referred to in sub-clauses (i) to (iv), (iva) and (v)."

From the above definition of Royalty under the Act, the following points may be noted:

a. Royalty has been defined in an exhaustive manner. One can therefore argue that unless the income is clearly covered within the meaning of Royalty as defined will not be regarded as Royalty for the purposes of the Act, even if the same is covered by the general/natural meaning of the term 'Royalty'.

b. Consideration constituting royalty may be periodic, or a lump sum consideration.

c. Royalty excludes any consideration which would be chargeable under the head 'Capital Gains.

d. The recipient must be the owner/license holder of the asset in respect of which the royalty is received.

It may be noted that in case of *Citizen Watch Co. Ltd. vs. IAC [1984] 148 ITR 774 (Kar.)*, the High Court held that the definition of the term 'royalty' in Explanation 2 to Section 9(1)(vi) is not a general definition applicable wherever that term occurs but is applicable to Section 9(1)(vi) only.

Royalty – As defined in the Model Conventions (MCs):

It is useful to note the definition of Royalty under the OECD MC and UN MC as most of the tax treaties that India has signed would use these models as a guide for the Royalty clause.

Article 12(2) of the OECD MC 2003 [OECD MC] defines the term Royalty as follows:

"The term "Royalties" as used in this Article means payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematograph films, any patent, trade mark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience."

On the other hand Article 12(3) of the UN Model 2001 [UN MC] defines the term Royalty as follows:

"The term "Royalties" as used in this article means payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematograph films, or films or tapes used for radio or television broadcasting, any patent, trade mark, design or model, plan, secret formula or process, or for the use of,

or the right to use, industrial, commercial or scientific equipment or for information concerning industrial, commercial or scientific experience."

The definitions under the different MCs differ from each other as well as the Act, in some respects. Unlike OECD MC, the UN MC includes consideration for the use of, or the right to use, industrial, commercial or scientific equipment within the meaning of 'Royalties'. It may also be pertinent to note that US MC specifically includes consideration received for the use or the right to use computer software in the definition of 'Royalties'. It is important to note that the US MC also includes consideration for the use of or right to use other similar right or property in addition to patent, trademark, design, model etc.

The definition of Royalty under the Act, specifically excludes consideration for the sale, distribution or exhibition of cinematographic films, whereas the definition of royalty under the OECD MC, UN MC and US MC, specifically includes consideration for use of, or the right to use cinematographic films.

Thus the definition in the treaty is different from that in the domestic law and with the widening of the definition of the term in the domestic law, the definition in the treaty becomes all the more important.

Royalty – Source rule:

Having noted the definition of "Royalty" it may be of interest to know how royalty is taxed in other parts of the world. For taxation of Royalty, the most common rule is the residence of the payer ("Payer State Rule"). Several countries also regard the source as the State where the intangible property is utilised ("User State Rule"). In a few cases, it is the residence of the inventor (example: South Africa), or the place where it is developed (example: Argentina) ("Developer State Rule"). It may also be the place of the Royalty agreement, or where the intangible rights are registered or transferable (Registration state Rule).

Section 9(1)(vi) provides for the deeming accrual basis for 'Royalty' as follows:

- Royalty payable by Government shall always be deemed to accrue or arise in India.
- Royalty payable by a Resident shall always be deemed to accrue or arise in India except where it is payable in respect of any right, property, etc. or services utilized for the purposes of/in business or profession carried on by such resident outside India, or for the purposes of making or earning any income from any source outside India.
- Royalty payable by a non-resident shall be deemed to accrue or arise in India if it is payable in respect of any right, property, etc. or services utilised for the purposes of/in business or profession carried on by such non-resident in India, or for the purposes of making or earning any income from any source in India. This source rule for taxing royalty paid by a non-resident to another non-resident is ordinarily referred to as the "secondary source" rule.

Thus the scope of deeming fiction under Section 9 extends to Royalties not only paid by an Indian resident, unless such a payment extended to a business carried out or to any source outside India, but also to royalties paid by the non-residents as long as it was relatable to a business carried on in India or to any source in India. The clear emphasis on taxation is on the basis of usage in business rather than on the basis of residence of the payer.

It is important to bear in mind the fact that taxation of Royalties is not taxation

of business profits of any entity, but, quite contrary thereto, it is taxation of the consideration of a patent or knowhow etc., which belongs to the person who owns the patents. It is thus taxation of income of the person owning the patents and it is taxation in the jurisdiction of end use of patents. The emphasis is on the situs of use of the patent rather than situs of the entity making payment for the Royalty.

It is important to note that not all payments by a resident to a non-resident are taxable as royalty. The section provides an exception in the latter part of clause (b). Talking about the exception carved out in Section 9(1)(vii) which is very similar to an exception contained in section 9(1)(vi), the Supreme Court observed in the case of GVK Industries Limited (371 ITR 453) held that it applies to a situation when fee is payable in respect of services (**intellectual property right or such other payment in the context of section 9(1)(vi)**) utilised for business or profession carried out by an Indian payer outside India or for the purpose of making or earning of income by the Indian assessee i.e., the payer, for the purpose of making or earning any income from a source outside India.

As per Article 12(5) of the UN MC, the Royalty source rule, reads as follows:

"Royalties shall be deemed to arise in a Contracting State when the payer is a resident of that State. Where, however, the person paying the Royalties, whether he is a resident of a Contracting State or not, has in a Contracting State a permanent establishment or a fixed base in connection with which the liability to pay the Royalties was incurred, and such Royalties are borne by such permanent establishment or fixed base, then such Royalties shall be deemed to arise in the State in which the permanent establishment or fixed base is situated."

Transfer of IPR- Capital Gains vs. Royalty

Section 9(i)(vi) defines Royalty to mean consideration (including any lump sum consideration but excluding any consideration which would be the income of the recipient chargeable under the head "Capital Gains.

However Explanation 2 to Section 9(1)(vi) of the Act brings within the ambit of Royalty a wider range of transactions, which would include payments made for transfer of all or any rights or patents, invention, model designs, etc. The said Explanation which defines the term 'Royalty' is, therefore, not restricted to payments based on use of or right to use such right, patent, invention, model, design, secret formula or process or trademark or similar property.

This, therefore leads to a debate of taxability under the domestic law as and when there is a transfer of an intellectual property right.

The Delhi High Court has clarified that in case payment is made for acquisition of a partial right in the intangible property or know-how without the transferor fully alienating as the ownership rights, the payment received would be treated as 'royalty'. Where, however, full ownership rights are alienated as intellectual property of the transferee, the payment made is not royalty, but sale consideration paid for acquisition of the intangible rights. *HCL Ltd vs. CIT [2015] 54 taxmann.com 231 (Delhi HC).*

The position of a transfer being considered as capital gains will be much stronger wherever the taxpayer has an option to rely on the tax treaty as the treaty would not normally rope transfer of rights as Royalty.

Recent amendments in the definition of Royalty under the Act – Genesis and implication

Some of the prevalent issues affecting taxpayers in relation to taxation of Royalty income include characterisation of payments

made towards use of hardware and software, connectivity facility, designs & drawings, access to content/business reports, etc. Out of these, the controversy around software payments has led to a huge cleavage of opinion between judicial forums on the distinction between "use or right to use copyright" *vis-a- vis* copyrighted article.

A taxpayer would normally argue that if a person acquires a copy of a computer programme but does not acquire any of the four below listed copyright rights, he gets only a copyrighted article but no copyright viz.

a) The right to make copies of the computer programme for purposes of distribution to the public by sale or other transfer of ownership, or by rental, lease, or lending.

b) The right to prepare derivative computer programmes based upon the copyrighted computer programme.

c) The right to make a public performance of the computer programme.

d) The right to publically display the computer programme.

Many judicial precedents with the leading one being the Special Bench decision in case of *Motorola (95 ITD 269)* upheld the contention of the taxpayer that what was transferred is neither the copyright in the software nor the use of the copyright in the software, but the right to use the copyrighted material or article which is clearly distinct from the rights in a copyright. The right that is transferred is not a right to use the copyright but is only limited to the right to use the copyrighted material and the same does not give rise to any royalty income and would be business income.

However the tax department did not agree with the distinction sought to be drawn by the taxpayer and would tax the use or the right to use software as royalty. This stand was confirmed in certain rulings including the decision of the Karnataka High Court in the case of *Samsung Electronics Limited (345 ITR 494)* which held that a right to make a copy of the software and storing the same in the hard disk of the designated computer and taking backup copy would amount to copyright work under section 14(1) of the Copyright Act and the payment made for the grant of the licence for the said purpose would constitute royalty.

With a view to get over the rulings which favoured the stand of the taxpayer, the Finance Act 2012 made a series of retrospective amendments to nullify various rulings involving interpretations pertaining to the definition of Royalty. It has now been clarified that irrespective of the medium through which the transfer of all or any right for the use or right to use computer software (including granting of license) would take place, the same would be treated as Royalty.

The law has been amended similarly to provide that the term "process" would include and shall be deemed to have always included transmission by satellite (including up-linking, amplification, conversion for down-linking of any signal), cable, and optic fibre or by any other similar technology, whether or not such process is secret.

Further, it has been clarified by an amendment that the term Royalty includes and has always included consideration in respect of any right, property or information, whether or not.

- The possession or control of such right, property or information is with the payer;
- Such right, property or information is used directly by the payer;
- The location of such right, property or information is in India.

Resort to beneficial treaty provisions : As mentioned above, the payment for the sale or licence of software, would now get covered u/s. 9(1)(vi), if provisions of the Act are to be applied. However, if the provisions of the treaty are beneficial than provisions of Section 9(1)(vi), it will still be possible to contend that payment for software as per the provisions of the treaty is not liable to tax in India.

It is, therefore, important to note here that the taxpayers who are entitled to claim benefit of tax treaty, will still be able to take shelter under the beneficial treaty provisions as the scope of provisions (generally Article 12) under the treaty if it is more beneficial than under the Act.

In the context of the amended Section 9(1)(vi) and the treaty, the Delhi High Court has held in the case of *New Skies Satellites B.V (382 ITR 114)* as under:

"No amendment to the Act, whether retrospective or prospective can be read in a manner so as to extend in operation to the terms of an international treaty. In other words, a clarificatory or declaratory amendment, much less one which may seek to overcome an unwelcome judicial interpretation of law, cannot be allowed to have the same retroactive effect on an international instrument effected between two sovereign states prior to such amendment. In the context of international law, while not every attempt to subvert the obligations under the treaty is a breach, it is nevertheless a failure to give effect to the intended trajectory of the treaty. Employing interpretive amendments in domestic law as a means to imply contoured effects in the enforcement of treaties is one such attempt, which falls just short of a breach, but is nevertheless, indefensible."

Consequently, the High Court held that Finance Act, 2012 will not affect Article 12 of the DTAAs, it would follow that the first determinative interpretation given to the word 'Royalty', when the definitions were in fact *pari materia* (in the absence of any contouring explanations), will continue to hold the field for the purpose of assessment years preceding the Finance Act, 2012 and in all cases which involve a Double Tax Avoidance Agreement, unless the said DTAAs are amended jointly by both parties to incorporate income from data transmission services as partaking of the nature of Royalty, or amend the definition in a manner so that such income automatically becomes Royalty.

Treaty relief on Royalty taxation available to beneficial owners of such income

Article 12(1) of the OECD MC stipulates that Royalties arising in a contracting State and beneficially owned by a resident of the other Contracting State shall be taxable only in that other State.

Correspondingly, Article 12(2) of the UN MC states "However, such Royalties may also be taxed in the Contracting State in which they arise and according to the laws of that State, but if the beneficial owner of the royalties is a resident of the other contracting State, the tax so charged shall not exceed ___ per cent (the percentage is to be established through bilateral negotiations) of the gross amount of the royalties."

The above indicates that treaty benefits are available to the residents of a contracting State only if they are the 'beneficial owners' of Royalty. The term beneficial owner has not been defined in the MCs or tax treaties. The phrase "beneficial owner" is distinct from the phrase "legal owner", although generally other than trust scenarios, most assets/ property are owned legally and beneficially.

According to Article 3(2) of the MCs, any term not defined therein shall, unless the context otherwise requires, have the meaning that it has at that time under the law of that State for the purposes of

the taxes to which the Convention applies. Because of the provision under Article 3(2), there have been differences in opinion as to whether ''beneficial owner'' is a concept of domestic law or tax treaty.

The OECD in its commentary of 2003 clarified that the term 'Beneficial owner' should not be used in a narrow technical sense, rather, it should be understood in the context and in light of the object and purposes of the tax treaties, including avoiding double taxation and the prevention of fiscal evasion and avoidance.

In the context of intellectual property, the Black's Law Dictionary defines beneficial owner as a person or entity who is entitled to enjoy the rights in a patent, trademark, or copyright even though legal title is vested in someone else.

As per Black's Law Dictionary 1214 (9th ed. 2009), a beneficial owner is a person who has some sort of power over, or right to, a thing, the legal title to which does not belong to him, and provides no clue for interpretation of its precise scope.

The OECD commentary states that receipt of income in the capacity of an agent or a nominee does not give rise to double taxation since the income is not liable to tax in the hands of the agent or nominee in the country of residence, and thus relief from source country taxation shall not be allowed in such cases. Further, conduit companies set up as intermediaries receiving income on behalf of other persons who in fact receive the benefit of the income concerned, should also be denied tax treaty relief for not being the beneficial owner of the income. The 2014 update to OECD Commentary states that where the recipient of an income does have the right to use and enjoy the income unconstrained by a contractual or legal obligation to pass on the payment received to another person, the recipient is the 'beneficial owner'.

The phrase "beneficial owner" is extensively used in the international tax law, yet it remains undefined, thus far. Moreover, the phrase is not defined under the Act. The phrase "beneficial owner" finds expression under the Act under Section 2(22)(e) in the context of deemed dividend and yet to be effective Section 102(8) in the context of General Anti Avoidance Rule (GAAR).

It is pertinent to note, that the adjective "beneficial," when added to the word "owner," is normally used in legal contexts "to distinguish a right or power one possesses for his own use and enjoyment from one possessed for the use and enjoyment of another. The primary *locus* for this distinction is found in the law of trusts: the trustee has legal title to the trust property, but he holds it for the beneficiary of the trust, who has the "beneficial interest" in or beneficial enjoyment of the property.

Tax rate on Royalties

Section 115A was introduced by Finance Act 1976 to provide for *inter alia* the rate of taxation of Royalty and fees for technical services (FTS), which are not associated with the business carried out by non-residents through a Permanent Establishment in India. This provision assumes significance since Section 195 of the Act casts responsibility on payer of income chargeable to tax including Royalties / FTS to withhold tax before making payment to non-residents.

From AY 2016-17, the concessional rate of 10% is applicable to any income by way of Royalty or an Indian concern in pursuance of an agreement made by the foreign company with Government or the Indian concern after the 31st day of March, 1976, and where such agreement is with an Indian concern, the agreement is approved by the Central Government or where it relates to a matter included in the industrial policy, for the time being in force, of the Government of India,

the agreement is in accordance with that policy. The requirement of agreement being approved by the Central Government or being in accordance with the industrial policy in force is not necessary for royalty payments in respect of a book or computer software.

Royalty – certain other important judicial precedents

CIT vs. Davy Ashmore India Ltd [1991] 190 ITR 626 (Cal.) – The Court held that consideration received for transfer of designs and drawings cannot be treated as Royalty as per the India-UK tax treaty and is therefore not taxable in India.

CIT vs. Neyveli Lignite Corporation Ltd. [2000] 243 ITR 459 (Mad.) - The Court observed that the term 'Royalty' normally connotes the payment made by a person who has exclusive right over a thing for allowing another to make use of that thing which may be either physical or intellectual property or thing. The exclusivity of the right in relation to the thing for which royalty is paid should be with the grantor of that right.

Qualcomm Incorporated vs. ADIT 56 Taxmann.com 179(Delhi ITAT)

When Royalty is for use of a technology in manufacturing, it is to be taxed at *situs* of manufacturing product and, when Royalty is for use of technology in functioning of product so manufactured, it is to be taxed at *situs* of use

DIT vs. Nokia Networks OY [2013] 358 ITR 259 (Delhi)], there is a distinction between the supply of a copyright and the supply of a copyrighted article. Though Explanation 4 was added to S. 9(1)(vi) by the Finance Act, 2012 with retrospective effect from 1-6-1976 to provide that all consideration for user of software shall be assessable as — Royalty —, the definition in the DTAA has been left unchanged. In *CIT vs. Siemens Aktiongesellschaft* it was held that amendments cannot be read into the treaty. As the assessee has opted to be assessed by the DTAA, the consideration cannot be assessed as Royalty despite the retrospective amendments to the Act.

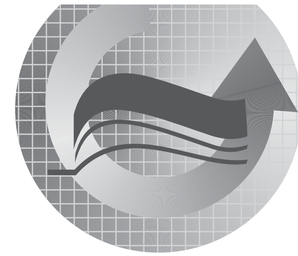
DIT vs. Infrasoft Ltd. [2013] 39 taxmann. com 88 (Delhi) – Amount received by a non-resident company, for granting licence to use its copyrighted software for licence's own business purpose only, could not be brought to tax as 'Royalty' under Article 12(3) of India-US DTAA. In absence of any amendment in DTAA, there was no need to examine effect of subsequent amendment to Section 9(1)(vi) of the Act.

DIT vs. New Skies Satellite B.V. 382 ITR 114(Del HC)

Unless DTAA is amended jointly by both parties to incorporate income from data transmission services as partaking of nature of Royalty, or amend definition in a manner so that such income automatically becomes royalty, Finance Act, 2012 which inserted Explanations 4, 5 and 6 to Section 9(1)(vi) by itself would not affect meaning of term 'Royalties' as mentioned in Article 12 of India-Thailand DTAA, and therefore, income earned by assessee, a Thailand based company, for rendering digital broadcasting services through its satellite, to both residents of India as well as non-residents, was not taxable in India as royalty under section 9(1)(vi) of the Act.

The remedy for weakness is not brooding over weakness, but thinking of strength.

— Swami Vivekananda



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Royalties – Internet, Satellite and Telecommunication Services & Hiring of scientific equipments – ship used on Time charter and bare boat charter, Software (including concept of copyright and copyrighted product)

Introduction

India has always offered growth opportunities to various foreign multinational companies across the world. As a result, India has been at the forefront of attracting large Foreign Direct Investment ('FDI'). FDI in India has come not just in the form of tangibles (i.e. money) but also in the form of intangibles (i.e. technology). The term 'technology' as such is of very wide import and includes software, Information Technology ('IT') infrastructure, IT consulting, IT solutions, IT networking and communication platforms, business process know-how etc. India has always been a net importer of technology and makes payment to foreign multinational companies for using or acquiring the required technology.

In this article, we have attempted to deal with certain identified complex tax issues, faced by companies while making payments towards use of technology. It is expected that Government will take a lead in resolving the ambiguity around taxability of these complex tax issues in line with its intent to have a non-adversarial and predictable tax regime.

Taxability of E-commerce (internet) transaction

In the dynamic world of E-commerce, characterisation of income is one of the most critical aspects as far as taxation of such income is concerned, especially whether such income could be treated as royalty.

In this regard, the OECD had constituted the Technical Advisory Group ("TAG") on DTAA Characterisation Issues arising from E-Commerce, to identify and address the complications arising out of the taxation of E-commerce transactions. The TAG issued its report on February 2001 ("TAG Report"). The TAG Report stated that where a product is purchased or service is availed for commercial exploitation, then, such charges should be treated as royalty and should be taxed in the source state[1].

In the past there was significant controversy on the issue as to whether online advertisement (internet) payments made by Indian companies to overseas entities should be treated as royalty.

1. Refer analysis and conclusions in para 4 on page 21 under Category 3 of the TAG report

Various judicial precedents[2] have held that payments for online advertisements should be treated as business income and not royalty considering that the customer merely made use of the facility; the customer was neither in possession of the equipment nor had access/ control to the portal.

In this regard, recently, the Government has put to rest this controversy by introducing equalisation levy on such payments, which is in line with one of the options as contained in BEPS Action Plan 1.

Currently equalization levy is only applied to certain specified payments, however, Committee has been set to expand the scope of equalization levy. Hence, one may expect that its applicability would be expanded to cover several other E- commerce transactions enumerated in TAG Report. Levy of equalization levy is not under Income-tax Act 1961. Accordingly, claiming credit of the same in foreign country may be challenge. However assessee may explore to get credit under DTAA on lines of DDT in the countries where credit for DDT is allowed.

Taxability of transponder/satellite charges

Over the past years, there has been considerable controversy around taxability of transponder/ satellite charges as royalty (especially as process royalty and equipment royalty) under the Income-tax Act, 1961 ('Act') and the relevant Double Taxation Avoidance Agreements ('DTAAs').

In simple terms, a transponder is a device, placed on satellites, for receiving and rebroadcasting a television signal. Broadcasting companies avail services from Satellite companies (owning satellites and transponders) for broadcasting its content over the desired footprint.

'Royalty' is exhaustively defined under Explanation 2 to Section 9(1)(vi) of the Act and generally under Article 12 of the relevant DTAA entered into by India.

The Delhi HC in the case of Asia Satellite Telecommunications[3] provided the much needed clarity on taxability of transponder charges wherein it held as under:

- The transponder is an integral and inseparable part of the satellite. Thus, even though the agreement refers to a lease of transponder capacity, since the satellite equipment was not leased out to the broadcaster and the satellite company operated and controlled the satellites, it should not amount to equipment royalty.
- The use of process is distinguishable from access to the process. Here, the broadcasters were merely given access to the process and the transponder capacity to be utilised for transmitting the signals, but there was no right to use the process of the transponder capacity, for which the control and operation was with the satellite company (and not the broadcaster).
- Since it did not grant the broadcaster a right to use the process of transponder capacity nor was the satellite equipment leased, the payments were held not to constitute 'royalty' under the Act[4].

With a view to neutralise the above favourable judicial precedents on taxation of transponder/ satellite charges and expand the scope of royalty, the definition of 'royalty' under the Act has been amended by inserting a clarification *vide* Finance Act, 2012 with retrospective effect from 1st June, 1976[5].

The amended royalty definition clarifies (in explanation 6 to Section 9(1)(vi) of the Act) the meaning of the expression 'process' to include

2. *Yahoo India (P) Ltd. vs. DCIT [2011] 140 TTJ 195 (Mum.); ITO vs. Right Florist Pvt. Ltd. (ITA No 1336/Kol/2011); Pinstorm Technologies Pvt. Ltd. vs. ITO (ITA No 4332/Mum/2009)*
3. *Asia Satellite Telecommunications Co Ltd. vs. DIT (2011) 332 ITR 340 (Delhi)*
4. See also ISRO Satellite Centre, In re (2008) 307 ITR 59 (AAR)
5. Memorandum explaining the provisions of the Finance Bill, 2012

transmission by satellite (including up linking, amplification, conversion for downlinking of any signal), cable, optic fibre or by any other similar technology, whether or not it is secret. Further, under Explanation 5, it has been clarified that royalty always included consideration in respect of any right, property or information, whether or not:

- The possession or control of such right, property or information is with the payer; or
- Such right, property or information is used directly by the payer; or
- The location of such right, property or information is in India.

Since an express amendment in the form of clarification with retrospective effect was brought into the Act, Revenue started applying amended 'royalty' definition to matters pending adjudication on taxability of transponder/satellite charges and that resulted in disallowances of expenditure on account of non-withholding of taxes. In this regard, it could be argued that where taxes were not withheld on payments made based on the legal position existing at the time of payment, there was no default in withholding taxes and consequently no disallowance is warranted on the basis of the aforesaid retrospective amendment[6].

On the other hand, even though royalty definition provided under the Act has been amended to expand its scope, the corresponding royalty definition provided under the relevant DTAAs entered into by India has not been amended. Accordingly, one may adopt a position that the definition of royalty as provided under the relevant DTAA should be interpreted narrowly and the judicial precedents existing prior to enactment of Finance Act, 2012 should continue to apply based on the following arguments:

- Royalty definition should be interpreted taking into account the intention of the Sovereign States at the time of entering into the DTAA;
- Definition of royalty under the Act cannot be imported into the DTAA;
- Where the amended definition of royalty is imported into the DTAA, it would amount to unilateral amendment to the DTAA;
- Under the Act the meaning of the term royalty is only for the purposes of that particular clause and hence, cannot be extended to other provisions of the Act or the DTAA [typically under Article 3(2)] as this is not a definition for the purposes of the Act.
- Where the intention of the contracting countries is to tax the aforesaid payments, the same have been specifically included in the definition of 'Royalties' under the DTAA. For instance, definition of the term 'Royalties' as per Article 12 (Royalties and Fees for Technical Services) of the India–Hungary DTAA specifically includes consideration for transmission by satellite, cable, optic fibre or similar technology.

The above view is supported by several judicial precedents[7].

In this regard, there are certain judicial precedents[8] which have taken a contrary position

6. *Channel Guide India Limited (2012) (ITA 1221/Mum/2006 and ITA 549/Mum/2006) (Mum); New Bombay Park Hotel Pvt. Ltd. vs. ITO (ITA No. 7641/ Mum/ 2011) (Mum)*
7. *DIT v Shin Satellite Public Co. Ltd. (ITA 500/2012), DIT vs New Skies Satellite BV (ITA 473/2012) (Del HC); DDIT vs. Taj TV Ltd (2016) (72 taxmann.com 143) (Mum); B4U International Holdings Ltd v DCIT [2012] 52 SOT 545 (Mum), Channel Guide India Ltd vs. ACIT [2012]153 TTJ 432 (Mum), DIT vs. Nokia Networks OY [2012] 253 CTR 417(Del)*
8. *Verizon Communications Singapore Pte Ltd. vs. ITO (IT) (2014) (361 ITR 575); Poompuhar Shipping (360 ITR 257) (Mad); Vodafone South Ltd. vs. DDIT (2015) 53 taxmann.com 441 (Bang ITAT); Viacom 18 Media (P) Ltd. vs. ADIT (2014) (44 taxmann. com 1) (Mum. ITAT)*

wherein it is held that the meaning of the term 'process' as provided under the Act should be considered for interpreting the definition of 'royalty' under relevant DTAA primarily on the basis that the definition of royalty under the Act and under the DTAA is *pari materia*.

However, considering the arguments mentioned above, a better view of the matter could be that the payment for transponder/satellite charges should not be taxed as royalty under the provisions of the relevant DTAA (subject to any specific provisions that could be contained in the relevant DTAA for taxability of such payments).

Taxability of telecommunication charges (call termination, interconnection, roaming and band-with charges)

Call termination service enables completion of a call on a telecom network. Interconnection service refers to transmission of calls between the networks of two operators at different locations. Roaming means a facility whereby a subscriber of a cellular phone uses the cellular services outside the home network. Data services include payments for transmission of data from a terminal at one location to a terminal at another location e.g. VPN, international private leased circuit (IPLC), internet services, etc. All types of data services involve payment of band-width charges for transmission of data using optic fibre cables, undersea cables or satellite.

Prior to Finance Act, 2012, various judicial precedents[9] had held that call termination, interconnect and roaming charges should not be covered within the ambit of royalty due to the following reasons:

- The service recipient merely enjoys the facility in the equipment. In other words, the service recipient merely takes an advantage from the equipment;
- The service recipient neither has possession of the equipment nor has any control over such equipment through which the services are provided;
- The 'process' used by the service provider is not a 'secret process';
- The services provided by telecom operators are standard services and are available to anyone agreeing to make payment for the same[10].

However, after the amendments made by Finance Act, 2012, the above payment could be considered as payment towards royalty under the Act. However, as regards taxability of the said payments under the relevant DTAA, the arguments as mentioned earlier regarding applicability of amended royalty definition to DTAA, should equally apply under this category of payments and hence, basis the above legal arguments, the payments should not be treated as royalty under the relevant DTAA. The said view is also supported by a recent decision[11].

Taxability of payments made for use of ships on time charter and bare-boat charter basis

Time charter – Shipping companies typically provide vessels on time charter on a routine basis. Time charter means hiring of a fully equipped (i.e., manned) vessel along with its crew for a specific period of time. There is considerable uncertainty under the Act regarding taxation of income of foreign shipping companies ('FSC') from time charter.

As per the Act, 'royalty' means consideration for the use or right to use any industrial, commercial

9. *Illustratively Cable & Wireless Networks India (P). Ltd., In re [2009] 315 ITR 72 (AAR); Dell International Services (India) P Ltd, In re [2008] 305 ITR 37 (AAR)*
10. *Wipro Ltd. vs. ITO [2003] 80 TTJ 191 (Bang)*
11. *Bharti Airtel Ltd. vs ITO (TDS) (2016) (67 taxmann.com 223) (Del. ITAT)*

or scientific equipment ('ICS equipment'). Thus, in order to qualify within the meaning of royalty, two conditions need to be satisfied:

(a) There should be an equipment; and

(b) Such equipment should be used or there should be a right to use such equipment.

The word 'equipment' has not been defined in the Act. The Madras High Court[12] has held that ship is an equipment and the hire charges partakes the character of royalty for use of the equipment under the provisions of section 9(1)(vi) of the Act. In view of the above judicial precedent, it is possible to take a view that under the Act, a vessel can be regarded as equipment and payment for time charter can be regarded as royalty.

Further, it could also be argued that a time charter contract is akin to a contract for carriage of cargo and therefore under a time charter contract, the vessel owner renders the services to the charterers. The Supreme Court of India[13] observed that if the terms of the charter-party and the general tenor of the document show that the payment is for 'use and hire of the vessel' as against for carriage of goods, then it cannot be said that under the time charter contract, the vessel was not given on hire to the charterer.

Thus, whether time charter of a vessel is income from royalty or income for carriage of goods or income from provision of services, depends on the facts of each case and the wordings of the agreement.

Payment for time charter is generally regarded as 'royalty' under the DTAAs, if the definition of royalties under the relevant DTAA includes consideration for use of or right to use ICS equipment. The position may be different in the following cases, where, the definition of royalties with respect to consideration for use of ICS equipment in DTAAs, provides for the certain exclusions e.g.:

- In the DTAA of India with USA, Canada and Singapore, rentals of ships incidental to any activity directly connected with operation of ships in international traffic, and rentals of containers used in connection with operation of ships in international traffic is excluded from Royalty article.
- In the DTAA of India entered into with UK and Finland, income derived from operation of ships in international traffic is excluded from Royalty article.

The UN and OECD Model of DTAA on Article 8 suggests that profits obtained by leasing a ship on charter, fully equipped, manned and supplied (i.e. time charter) is income from operation of ships in international traffic.

Bareboat charter ('BBC') – Under this arrangement, the owner merely lets-out the vessel to the charterer without crew.

Where BBC arrangement is an ancillary activity of an enterprise engaged in the international operation of ships, based on judicial precedents[14], it may be contended that income from BBC is eligible for benefit of shipping article of DTAA.

As mentioned above, in cases of DTAAs *inter-alia* with US, Canada, Singapore, rental income from lease of ships incidental to any activity directly connected with operation of ships in international traffic is specifically excluded from the definition of royalty and therefore the said income should be taxable as per the shipping article of the said DTAAs.

Further, in a recent decision of the Madras High Court[15], payments for hire of dredgers on BBC basis was held to be not taxable as royalty as the definition of royalty under the India-Netherlands DTAA does not include consideration for the use or right to use any ICS equipment.

However, where the definition of royalty under the DTAA includes consideration for use or right to use

12. Poompuhar Shipping Corporation Ltd. (PSCL) (360 ITR 257)
13. *Union of India vs. Gosalia Shipping (P) Ltd. 113 ITR 307 (SC)*
14. Balaji Shipping UK Ltd. (253 CTR 460) (Bom HC)
15. Van Oord ACZ Equipment BV (373 ITR 133) (Mad HC)

any ICS equipment and does not provide for any exclusion, payments under the BBC arrangement may also partake the character of royalty.

Taxability of software payments

In general terms, a computer software, or just software, is a collection of computer programmes and related data that provide the instructions telling a computer what to do and how to do it.

The surge in transactions in the IT domain, undoubtedly, picked the interest of the tax authorities over the past few years. In order to determine the taxability of payments for such transactions, appropriate revenue characterisation is critical. The income characterisation issue of software payments poses challenges given the unique nature of rights associated with software. This issue is further compounded by other factors such as the multiplicity of delivery models, constantly evolving practices in the Information Technology domain, etc. This has led to extensive litigation with the Revenue authorities.

The issue principally is on characterising software transactions as generating either "royalty" income or "business profits".

Some of the typical software transactions *inter-alia* include:

- Supply of "shrink wrapped/ off-the shelf" software licence;
- Supply of bundled/embedded software;
- Supplies to distributor of software;
- Multiple-user software license

Under Section 9(1)(vi) of the Act, in Explanation 2, royalty has been defined to *inter alia* include consideration (including lump sum consideration) for the transfer of all or any rights (including the granting of licence) in respect of patent, invention, model, design, secret formula, process, trademark, copyright, literary, artistic or scientific work. It further includes consideration for the use of any patent, invention, model, design, secret formula, process, trademark or similar property.

Computer Software/programme has been included in the term 'literary work' under the Indian Copyright Act, 1957 ('ICA'). Section 2(o) of the ICA defines 'literary work' to include computer programme, tables and compilations includes computer literary databases.

The definition of Royalty under many of India's DTAAs as well as under the OECD and UN MCs is generally narrower in scope as compared to that under the Act. The term is generally restricted to the qualification of any payment as "royalty" only if it is **for the use of, or right to use** *inter alia* any copyright of a literary, artistic, scientific work or a secret formula or process.

Accordingly, the main controversy regarding taxation of software payments is whether the sale/licensing of software amounts to use or right to use or transfer of a copyright or copyrighted article.

If the payment made is towards copyright then it would be classified as "royalty" under the Act and relevant DTAA and would be taxable in India in the hands of foreign supplier. On the other hand, if the payment is towards copyrighted article, then it only represents purchase price of the article and cannot be regarded as "royalty" income in the hands of foreign supplier.

<u>Transfer of a copyright right in the computer programme</u>

Section 14 of the ICA, the copyright rights in a computer programme would generally include the following:

- Rights to make copies of a computer programme for distribution to public by sale or other transfer of ownership, or by rental, lease or lending;
- Right to make derivative of the computer programme;
- Right to make public performance of the computer programme; or
- Right to publicly display the computer programme.

In this situation, a person acquires almost all the rights in relation to the computer programme rather than just acquiring a right to use the same for personal/internal use.

Transfer of a copy of the computer programme (a copyrighted article)

In these arrangement the licensee receives a limited right to use the software. The licensee is not granted the right to the source code in the software and is thus not entitled to modify / replicate the source code of the software in any manner whatsoever. In such a situation, a person acquires merely a copy of the computer programme, giving him only the right to use the same for personal/internal use and does not grant him any other rights in relation thereto.

Copyright right v. Copyrighted article

One view on the taxability of such software licensing transactions is that it is similar to the case of selling copyrighted article, say a book, where on the purchase of the book, what the buyer buys is only the copyrighted book, with the publisher/author still owning the copyright of reprinting the books. By a mere purchase of a copyrighted book, the copyright does not get automatically transferred to the buyer. The copyright always remains with the publisher/author.

In the case of shrink-wrapped or standard software for example, the buyer/end-user buys the product and is not granted any rights in respect of the software contained therein.

Therefore, the distinction that is worth noting is that the buyer is paying consideration for a "copyrighted article" and not a "copyright right".

There have been and continues to be plethora of rulings on this aspect wherein the Courts have adopted contrary views. While some have disregarded the above distinction and held that payments for licence of computer software tantamount to payment of royalty and hence such payments should be chargeable to tax in India[16]. While some other Courts have appreciated the said distinction and held the payments for computer software would be in the nature of Royalty only where there is a transfer of a copyright right in the software to the licensee[17].

The OECD Commentary also recognizes the difference between a copyright right and copyrighted article and has clarified that whether payments received in connection with computer software would be considered as royalties would depend upon the nature of rights regarding use and exploitation of the programme. The OECD Commentary recognizes that in case of a computer software, only the transfer of partial rights in the copyright (without the transferor fully alienating the copyright rights) would constitute royalty. The Commentary also provides that the right acquired which is limited to enable the user to operate the programme should not be construed as royalty.

Retrospective amendment in the definition of "Royalty" *vide* Finance Act, 2012 under the Act

As discussed earlier, *vide* Explanation 4, the definition of "royalty" has been clarified to include, all or any right "for use" or right "to use" computer software, including the granting of a licence. Similar to the arguments discussed earlier, a better view of the matter is that the payment for computer software should not

16. *Illustratively, CIT vs. M/s. Samsung Electronics Co. Ltd. and others (345 ITR 494) (Kar), CIT vs. Synopsis International (212 Taxman 454) (Kar), DDIT vs. Reliance Infocom (39 taxmann.com 140) (Mum ITAT), Millenium IT Software (14 Taxmann.com 17), SkillSoft Ireland (AAR No. 985 of 2010), Citrix Systems Asia Pacific PTY Ltd (18 taxmann.com 172)*

17. *Illustratively, DIT vs. Infrasoft Ltd. (39 Taxmann.com 88) (Del), Nokia Networks OY (358 ITR 259) (Del), DIT vs. Ericsson A.B. (343 ITR 470) (Del), Halliburton Exports Inc (ITA N0. 363 of 2016) (Del) DDIT vs. Solid Works Corporation (152 TTJ 570) (Mum ITAT), Novell Inc (2011- TII-200- ITAT) (Mum ITAT), Allianz SE vs. ADIT (51 SOT 399) (Pune ITAT), Kansai Nerolac Paints Limited vs. ADIT (ITA No. 568/Mum/2009), Reliance Industries Ltd & Ors (47 CCH94) (Mum ITAT) Capegimini Business Services (India) Ltd vs. ACIT (46 CCH 253) (Mum ITAT), Baan Global BV (ITA No 7048/m/2010) (Mum ITAT), Galatea Limited vs. CIT (157 ITD 938) (Mum ITAT), Datamine International Ltd vs. ADIT (46 CCH 296) (Del ITAT), Aspect Software Inc vs. ADIT (44 CCH134) (Del ITAT)*

be taxed as royalty under the provisions of the relevant DTAA (subject to any specific provisions that could be contained in the relevant DTAA for taxability of such payments).

The above view is supported by decision of several judicial precedents[18].

Further, recently the Hon'ble Mumbai ITAT[19] have observed that:

- Computer software has been recognised as a separate item in the 2nd proviso to clause (vi) of Section 9 and in Explanation 4 under Explanation 2 to Section 9(1)(vi) of the Act.
- The Act (even post-2012 amendment) does not specifically include 'computer software' in the term 'literary work' under royalty definition in Explanation 2(v) of the Act and by the same analogy, it would be out of scope of restrictive beneficial definition of royalty under the Treaty.
- Even though computer software will be included under 'literary work' under ICA, as the consideration is paid for the 'literary work' and not for 'copyright in the literary work', the subject payment would not constitute royalty under the Treaty.

Indian exchange control implications

Generally, over the years, the provisions of the Indian exchange control regulations [as contained in the Foreign Exchange Management Act, 1999 ('FEMA')], have been liberalised.

All the transactions discussed in this article apart from transponder services, are treated as Current Account Transactions and permitted under automatic route. However, for making payments towards transponder services, prior approval of the Ministry of Information and Broadcasting would be required[20].

Further, it should be noted that payments for computer software would be permitted under automatic route only in case of pure licensing arrangement and should not involve transfer of intellectual properties.

Also, Indian payers should maintain appropriate documentation to the satisfaction of their respective authorised dealers to ensure compliance with Indian exchange control regulations.

Conclusion

To conclude, taxability of various payments mentioned above continues to be a complicated affair. The retrospective amendment to the definition of royalty have added to the complication. It is worthwhile to note that the matter is pending for adjudication before the Supreme Court in case of various taxpayers. Further, the Government of India realizing the growing discomfort and concerns among various stakeholders have formed a Tax Simplification Committee *inter alia* to study and identify the provisions/phrases in the Act which are leading to litigation due to different interpretations and make recommendations to bring predictable and non-adversarial tax regime. Appropriate resolution/ recommendation by the Tax Simplification Committee on the taxability of above various payments would certainly go a long way in ensuring a predictable and non-adversarial tax regime in India.

18. *DIT vs. Infrasoft Ltd (39 Taxmann.com 88) (Del); Reliance Industries Ltd & Ors (47 CCH94) (Mum ITAT); Baan Global BV (ITA No 7048/m/2010) (Mum ITAT), Galatea Limited vs. CIT (157 ITD 938) (Mum ITAT)*
19. Capegemini Business Services (India) Limited (46 CCH 253) (Mum ITAT)
20. Master Direction No 8/2015-16 on Other Remittance facilities dated 1 January 2016 (updated up to 11 February 2016)

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Fees for Technical Services – Act vs. DTAA (including Make Available, MFN clause)

Taxability of services rendered by non-residents as fees for technical services ('FTS') has always been a litigative issue. In fact, with a plethora of recent decisions, it has become a burning issue these days. There is a constant litigation as to whether the services rendered would qualify as FTS or not and accordingly liable to tax in India. The reason for this litigation is that if the payment is not qualified as FTS, then it would not be taxed in India in the absence of a permanent establishment ('PE') (as in majority of the cases it would be considered as business income).

Meaning of FTS under the Income-tax Act, 1961 ('the Act'): The term FTS has been defined under Explanation 2 to Section 9(1)(vii) of the Act. As per the said explanation FTS *means any consideration (including any lump sum consideration) for the rendering of any managerial, technical or consultancy services (including the provision of services of technical or other personnel) but does not include consideration for any construction, assembly, mining or like project undertaken by the recipient or consideration which would be income of the recipient chargeable under the head "Salaries".*

As per the Act, the services could be either managerial / technical / consultancy in nature to qualify as FTS. However, the following receipts are explicitly out of the scope of FTS:

- Consideration for assembly, mining, construction projects
- Income taxable under the head 'Salaries'.

Although these services can be technical in nature but these are specifically out of the scope of FTS and liable to tax as business income. In case the services are rendered by an employee, then even though the services may be technical or managerial in nature, they will be offered to tax under the head 'Salaries' and not as FTS.

Meaning of FTS under the Double Tax Avoidance Agreements ('DTAA' or 'tax treaty'): Majority of the tax treaties entered by India cover the taxability of FTS. However, there are DTAAs which do not cover the taxability of FTS, for e.g., tax treaty with UAE, Thailand, etc., do not cover taxability of FTS. The expression FTS as generally used in the tax treaty means payment of any kind to any person, other than to an employee of the person making payments, in consideration for any service of **technical, managerial or consultancy** nature, including provision of services of technical or other personnel. However, majority of the tax treaties exclude from the scope of FTS the payments made for

- Services rendered by an employee;
- Services for personal use of the individual or individuals making payments;
- Services that are ancillary and subsidiary, as well as inextricably and essentially linked, to the sale of property.

Technical, Consultancy and Managerial in nature: As seen above, both under the Act as well as DTAAs, FTS includes fees for services which are managerial, technical or consultancy in nature. Let us examine each of these elements in detail i.e., what do we mean by technical, managerial or consultancy in nature.

i. Technical in nature: It is pertinent to note that the term technical has not been defined under the Act or tax treaty. Therefore, we have to resort to the general meaning of the term technical. The general/ popular meaning of the term technical is involving applied and industrial science. As per the Memorandum of Understanding ('MOU') to India-USA tax treaty technical services means service requiring expertise in a technology.

   The services can be classified as technical when special skills or knowledge or education related to a technical field are required for provision of such services. Some examples of technical services are as follow:

   - Architectural services;
   - Feasibility and project report;
   - Inspection and testing services;
   - Geological surveys.

ii. Consultancy in nature: It is pertinent to note that the term consultancy also has not been defined under the Act or tax treaty. Consultancy services involve providing an advice or opinion. Further, as per the MOU to India-USA tax treaty term consultancy services is used in the context for advisory services. Some examples of services being consultancy in nature are as follows:

   - Developing a marketing and sales strategy;
   - Advising of best course of action among various viable options.

iii. Managerial in nature: The term managerial also has not been defined under the Act or tax treaty. Managerial services are generally related to controlling, guiding and administering the affairs of a business. Certain examples of managerial services are as follows:

   - Hiring and training commercial agents;
   - Human resource development;
   - Managing financial operations.

Concept of 'Make Available': The scope of FTS article of various tax treaties is restricted by the expression 'Make Available'. Few Indian tax treaties which contain the expression 'Make Available' technical knowledge, skill, knowhow, etc. are India-USA, India-UK, India-Canada, India-Australia, India-Netherlands, India-Singapore. The expression 'Make Available' has far reaching consequences as it limits the services which can be taxed as FTS.

Let us understand the meaning of expression 'Make Available'. A service is considered as 'Make Available' technical knowledge, skill, know-how, etc., when the person receiving the service is able to utilise the technology or skills on his own without having recourse to the service provider. In the terms of a layman, the following services would be considered as making available the technical skill or knowledge to the recipient:

- Air-conditioner repairs: When a technician is called for repairing of an air-conditioner ('AC') and the technician comes and repairs the AC. In this case, no technical skill or knowledge is made available by the technician.

  However, if the technician explains to the owner / user of the AC how an AC is to be repaired (what components are to be checked / precautions to be taken while removing the wires, etc.) then he is providing owner the knowledge of repairing an AC. Therefore, next time the owner would be able to repair the AC on his own without calling the technician. In this case, the technician has made available the knowledge and skill.

- Installation of Machinery: Another example of making available technical skill or knowledge would be installation of a new equipment on the factory floor and also providing the basis for selection of area of installation, method of installation, tools and machinery used (crane, rollers, screws, etc.). Thus, in this case knowledge for installation of similar equipment is made available.
- Replacement by Indian Engineers: A foreign engineer is called for repairs and maintenance of machineries installed in business premises and also to teach Indian engineers about repairs and maintenance so that in future the foreign engineer can be replaced by Indian engineers. This would amount to making available the technical knowledge related to repairs and maintenance to Indian engineers.

  The concept of 'Make Available' as provided in India-USA tax treaty is reproduced below for the purpose of reference:

  "… "fees for included services" means payments of any kind to any person in consideration for the rendering of any technical or consultancy services (including through the provision of services of technical or other personnel) if such services:

  a) …

  b) make available technical knowledge, experience, skill know-how or processes, or consist of the development and transfer of a technical plan or technical design…"

  Here it is important to note that as per India-USA tax treaty development and transfer of a technical plan or technical design would be considered as fees for included services even though in this case no technical knowledge, skill or know-how is made available to the service recipient.

Apart from the explanations provided in the tax treaties, various Indian Judicial precedents have analysed the meaning of the term 'make available' in details. Some of the relevant decisions wherein the concept of make available is defined are as follows:

- *Raymond Limited vs. DCIT [(2003) 86 ITD 791] (ITAT-Mum)*: *"…Thus, the normal, plain and grammatical meaning of the language employed, in our understanding, is that a mere rendering of services is not roped in unless the person utilising the services is able to make use of the technical knowledge etc. by himself in his business or for his own benefit and without recourse to the performer of the services in future. The technical knowledge, experience, skill etc., must remain with the person utilising the services even after the rendering of the services has come to an end…Some sort of durability or permanency of the result of the "rendering of services" is envisaged which will remain at the disposal of the person utilising the services."*
- *CIT vs. De Beers India Minerals Pvt Ltd [(2012) 346 ITR 467] (HC-Kar)*: *"22. What is the meaning of "Make Available". The technical or consultancy service rendered should be of such a nature that it "makes available" to the recipient technical knowledge, know-how and the like. The service should be aimed at and result in transmitting technical knowledge, etc., so that the payer of the service could derive an enduring benefit and utilise the knowledge or know-how on his own in future without the aid of the service provider. In other words, to fit into the terminology "making available", the technical knowledge, skill, etc., must remain with the person receiving the services even after the particular contract comes to an end."*
- *DCIT vs. Pan AmSat International Systems Inc. [(2006) 9 SOT 100] (ITAT-Del)*: *"…the act of "making available" should emanate from the person who renders the technical services and does not take in the capacity or ability of the person to whom the services are rendered to gather, by his own efforts or inquisitiveness, any technical knowledge, experience, skill etc. There should be an agreement or formal understanding or arrangement under which the technical knowledge, experience etc. are transmitted to*

> *the person utilising the technical services, with both parties at that time clearly acknowledging or being aware of the right of the person utilising the technical services to apply the technical knowledge, experience etc. in future for his own benefit without recourse to the person rendering the technical services."*

MOU to India-USA tax treaty: The paragraph 4 of Article 12 of the India-USA tax treaty defines FTS. The MOU describes in detail the category of services mentioned in paragraph 4 of Article 12. As per the MOU, category of services provided in clause 4(b) is narrower than the category of services provided in paragraph 4(a). The reason being that clause 4(b) excludes any service that does not 'make technology available' to the person acquiring the service. The MOU also provides instances where the technology would not be made available:

- The provision of the service may require technical input by the person providing the service does not *per se* mean that technical knowledge, skills, etc. is made available.
- The use of a product which embodies technology shall not *per se* be considered to make the technology available.

Further, the MOU provides that the technical and consultancy services could make technology available in a variety of settings, activities and industries. Such services may, for example, relate to any of the areas such as engineering services, bio-technical services, food processing, environmental and ecological services, communication through satellite or otherwise, energy conservation, exploration or exploitation of mineral oil or natural gas, geological surveys, scientific services, technical training.

It is also important to note that the MOU also provides various examples to understand that concept fees of included services and impact of make available expression to restrict the scope of fees of included services. These examples are discussed below:

Example 3

Facts: A U.S. manufacturer has experience in the use of a process for manufacturing wallboard for interior walls of houses which is more durable than the standard products of its type. An Indian builder wishes to produce this product for its own use. It rents a plant and contracts with the U.S. company to send experts to India to show engineers in the Indian company how to produce the extra-strong wallboard. The U.S. contractors work with the technicians in the Indian firm for a few months. Are the payments to the U.S. firm considered to be payments for "included services"?

Analysis: The payments would be fees for included services. The services are of a technical or consultancy nature; in the example, they have elements of both types of services. The services make available to the Indian company technical knowledge, skill and processes.

Example 4

Facts: A U.S. manufacturer operates a wallboard fabrication plant outside India. An Indian builder hires the U.S. company to produce wallboard at that plant for a fee. The Indian company provides the raw materials, and the U.S. manufacturer fabricates the wallboard in its plant, using advanced technology. Are the fees in this example payments for included services?

Analysis: The fees would not be for included services. Although the U.S. company is clearly performing a technical service, no technical knowledge, skill, etc., is made available to the Indian company, nor is there any development and transfer of a technical plant or design. The U.S. company is merely performing a contract manufacturing service.

Example 6

Facts: An Indian vegetable oil manufacturing company wants to produce a cholesterol-free oil from a plant which produces oil normally containing cholesterol. An American company has developed a process for refining the cholesterol out of the oil. The Indian company contracts with the U.S. company to modify the formulas which it uses so as to eliminate the cholesterol, and to train the employees of the Indian company in applying the new formulas. Are the fees paid by the Indian company for included services?

Analysis: The fees are for included services. The services are technical, and the technical knowledge is made available to the Indian company.

Example 7

Facts: The Indian vegetable oil manufacturing firm has mastered the science of producing cholesterol-free oil and wishes to market the product worldwide. It hires an American marketing consulting firm to do a computer simulation of the world market for such oil and to advise it on marketing strategies. Are the fees paid to the U.S. company for included services?

Analysis: The fees would not be for included services. The American company is providing a consultancy service which involves the use of substantial technical skill and expertise. It is not, however, making available to the Indian company any technical experience, knowledge or skill, etc., nor is it transferring a technical plan or design. What is transferred to the Indian company through the service contract is commercial information. The fact that technical skills were required by the performer of the service in order to perform the commercial information service does not make the service a technical service within the meaning of paragraph 4(b).

As can been seen in example 4 and example 7, even though the US company is providing either technical or consultancy service but the technical knowhow and knowledge is not transferred to the service recipient and hence, the services cannot be qualified as fees for included services.

Whereas the examples 3 and example 6 inform us about the scenarios in which it would be considered that the technical knowledge or knowhow is made available and therefore, these services are fees for included services.

Therefore, drawing reference from the judicial precedents and MOU to India-USA DTAA various tests are decided to determine whether a service is making available the technical skill, knowledge or knowhow, etc. The relevant tests are:

- The service recipient is at the liberty to use the technical knowledge, skill, knowhow and process at his own right;
- The technical knowledge, skill, knowhow, etc. must remain with the service recipient even after the rendering of services has come to an end;
- The service recipient is able to make use of the technical knowledge, skill, etc. by himself in his business or for his own benefit and without having recourse to the service provider in future.

However, the following tests, even if satisfied, are irrelevant to decide whether a service is making available:

- Provision of service may require technical inputs by the service provider;
- Service recipient acquires some familiarity or insights into the manner of provision of services;
- The service recipient gets a product and not the technology itself;
- Merely allowing somebody to make use of services, whether actually used or not.

Most Favoured Nation ('MFN') Clause and 'Make Available': There are certain tax treaties signed by India which contain protocol to the tax treaty. The protocols form an integral part of the tax treaty and includes an MFN clause for certain Articles to the tax treaty.

The objective of the MFN clause is to ensure that the country with whom the tax treaty is signed has most beneficial provisions *qua* that Article in comparison with other tax treaty signed by that nation. The implications of the MFN clause is that after signing of the tax treaty (say India-France tax treaty) a new tax treaty is signed with an OECD member country, as the case may be, (e.g., India-UK tax treaty which is signed post India-France tax treaty) and the India-UK tax treaty provides for a beneficial tax rate or has reduced scope for FTS (i.e., Article 13 of India-France tax treaty), then in that case the beneficial provisions for FTS provided under India-UK tax treaty will be applicable for India-France tax treaty also.

The relevant extract of MFN clause of India-France tax treaty is as follows

"10. It is understood that in case India applies a levy, not being a levy covered by Article 2, such as the Research and Development Cess on payments meant in Article 13, and if after the signature of this Convention under any Convention or Agreement or Protocol between India and third State which is a member of the OECD, India should give relief from such levy, directly by reducing the rate or the scope of the levy, either in full or in part, or, indirectly by reducing the rate or the scope of the Indian tax allowed under the Convention, Agreement or Protocol in question on payments as meant in Article 13 of this Convention with the levy, either in full or in part, then, as from the date on which the relevant Indian Convention, Agreement or Protocol enters into force, such relief as provided for in that Convention, Agreement or Protocol shall also apply under this Convention."

To illustrate the impact to MFN clause the following situation can be considered:

- As per the Article 13 of India-France tax treaty, the term FTS means payments of any kind to any person, other than payments to an employee of the person making the payments and to any individual for independent personal services mentioned in Article 15, in consideration for services of a managerial, technical or consultancy nature. However, India has signed a protocol to the India-France tax treaty.
- The paragraph 10 of protocol to the India-France tax treaty provides that if a new tax treaty with an OECD member country, entered after the India-France tax treaty is signed, provides for a reduced rate of tax or reduces the scope on payments covered under Article 13 then in that case relief provided under the new tax treaty will be provided under the India-France tax treaty as well.
- The tax treaty with France was signed on 1st September, 1989. Thereafter, India has signed tax treaty with USA which has a narrower scope of FTS. As per India-US tax treaty only those services which make available the technical skill or know-how are considered as FTS. Hence, the FTS in the India-France tax treaty will automatically carry such narrower scope and only those services which make available the technical knowledge or knowhow will be considered as FTS under India-France tax treaty. The reliance can be placed on the recent decision of Delhi High Court in case of Steria (India) Ltd. which is discussed later on.

Various other tax treaties entered by India which contain the MFN clause for FTS are as follows:

- India-Belgium
- India-Spain
- India-Sweden
- India-Kazakhstan

Therefore, all these tax treaties would have a restrictive meaning of FTS if new tax treaties entered after them have such restrictive meaning.

Interplay between FTS and PE

The FTS article of majority of the DTAAs signed has a para worded in the following manner:

"The provisions of paragraphs 1 and 2 shall not apply if the beneficial owner of the royalties, fees for technical services or the payments for the use of equipment being a resident of a Contracting State, carries on business in the other Contracting State in which the Royalties, fees for the technical services or the payments for the use of equipment arises, through a permanent establishment situated therein, or performs in that other Contracting State independent personal services from a fixed base situated therein, and the Royalties, fees for technical services or the payments for the use of equipment are effectively connected with such permanent establishment or fixed base. In such case the provisions of Article 7 or Article 14, as the case may be, shall apply."

The provision essentially says that if FTS are effectively connected to a PE of the beneficial owner of the source state, then such income will not be taxed as FTS. If it effectively connected to a PE then it will be subject to tax as per the Article 7 dealing with taxation of business profits in case of

existence of a PE. In simple words if the services are effectively connected to a PE in the source State then FTS will be taxed as business profits. The Supreme Court in the case of *Ishikawajma-Harima Heavy Industries Ltd. vs. DIT [(2007) 158 Taxman 259*] held that since the appellant carries on business in India through a PE, the services clearly fall out of the applicability of Article 12(5) of the tax treaty and into the ambit of Article 7.

However, even after coming into the ambit of Article 7 of the tax treaty (i.e.. when the services are being through a PE), in order to be taxed as business profits the services have to be effectively connected to the PE. If services are not effectively connected to the PE and then FTS will be taxed under Article 12 only. Reference, is drawn to the recent ruling of Delhi ITAT in the case of *International Management Group (UK) Ltd. vs. ACIT (Intl. Taxation)* which is discussed later on.

It is important to note that the interplay will work in a different manner in case a Service PE is there. In majority of the tax treaties, the definition of Service PE itself provides that it will be formed on furnishing of services other than included services as defined in Article 12 (Royalties and Fees for Technical Services). Therefore, in case of a Service PE, provisions of Article 12 will override the Service PE clause.

Recent Judicial Precedents

- *Steria (India) Ltd. vs. CIT [(2016) 72 taxmann. com 1] (HC-Del.)*

  The Delhi High Court in the case of Steria (India) Ltd. has held that protocol forms an integral part of a DTAA. Accordingly, the MFN clause in the protocol to the India-France DTAA is self-operational and does not require a separate notification from Central Government to be effective. Overruling the AAR's decision, the High Court held that the amount paid to offshore service provider for provision of managerial services does not constitute 'Fees for technical services' ('FTS') by virtue of restricted scope/definition of FTS under the India-UK DTAA which must be read as forming part of India-France DTAA.

- *International Management Group (UK) Ltd. vs. ACIT (Intl. Taxation) [TS-545-ITAT-2016] (ITAT-DEL.)*

  The ITAT with respect to held that taxability under Article 13 shifts to taxability under Article 7 only in respect of FTS which is 'attributable' to the PE in question. Thus, Article 13 (6) of DTAA shall apply only to the extent of the activities carried on by the taxpayer through its PE. In this case, the activities which are not at all connected with or arising through IMG's Indian PE are not covered by Article 7 of DTAA and same shall be taxable as FTS under Article 13. Thus, the balance receipts not effectively connected to, or arising through, Indian PE, can be taxed in India under Article 13 as FTS.

- *Outotec OYJ vs. DDIT (ITA Nos 558/Kol/2014 & 462/Kol/2015) (ITAT-Kol)*

  The ITAT held that providing management support and other services were not liable to tax as per India-Finland tax treaty. In order to be covered by the provisions of Article 13(4) of the India-Finland tax treaty, not only the services should be technical in nature but such as to result in making the technology available to the person receiving the technical services. The other services such as IT support services and repairs and supervision services also do not satisfy the Make Available test as no technology, know-how, etc. were transferred to the recipient. Thus, the services were not to be taxed as FTS.

Conclusion: As you would observe, taxability of FTS has been a litigative issue. It depends on the facts of each case and the relevant tax treaties involved to conclude whether income received for services should be offered to tax as FTS or not.

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FTS – Installation, Building Site, Construction or Assembly Project

I) Taxability under Sections 44DA & 44BB (including in case of mining projects) and interplay between 44DA & 44BB

Infrastructure sector is a key driver for the Indian economy. The sector is highly responsible for propelling India's overall development and enjoys intense focus from Government for initiating policies that would ensure time-bound creation of world class infrastructure in the country.

Projects like roads, airports, bridges, water systems, telecommunications, exploration or extraction of resources etc., are the foundations of modern economies. They have a huge multiplier effect.

Installation project means putting together or re-grouping of prefabricated elements such as the erection of steel scaffolding or units of production. Building site or construction project includes the construction of buildings, bridges or canals, excavating and dredging and the laying of pipelines etc. Delivery of materials to a construction or assembly project is not by itself a construction or assembly project.

The objective of this article is to examine taxability of income in the nature of fees for technical service (**FTS**) arising from installation, building site, construction or assembly project from the perspective of section 44DA and 44BB of Income-tax Act, 1961, (**The Act**) and exclusion clause in FTS article in various treaties, when there is income connected to PE.

➢ **Applicability of Section 44DA of the Act.**

Section 44DA is a special provision for computing income by way of Royalties, or FTS, in case of non-residents and has been introduced in Finance Act 2003. Section 44DA provides that income by way of Royalty or FTS received by any non-resident (whether a company or not) from the Government or an Indian concern under an agreement made after 31-3-2003 will be computed on net income basis, and shall be taxed under the head "Profits and Gains of Business or Profession" at applicable tax rates as mentioned at Part I of The First Schedule, if:—

- Such non-resident carries on business in India through a permanent establishment or performs professional services from a fixed place of profession in India; and
- The right, property or contract in respect of which the royalties or FTS are paid is effectively connected with such permanent establishment or fixed place of profession, as the case may be.

While computing the income u/s. 44DA following deductions are not allowable:—

- Any expenditure or allowance which is not wholly or exclusively incurred for the business of such permanent establishment or fixed place of profession in India; or
- Amounts paid by the permanent establishment to the head office or to any of its other offices except reimbursement of actual expenses.

Further, the non-resident will have to:

- Maintain prescribed books of account in accordance with Section 44AA of the Act;
- Audit the books of account; and
- Furnishes an audit report in the prescribed form.

Explanation (a) to Section 44DA specifies that FTS would have the same meaning as provided in Explanation (2) to Section 9(1)(vii) which defines the term "fees for technical services".

As per Explanation 2 to Section 9(1)(vii) "*fees for technical services*" *means any consideration received from the rendering of any managerial, technical or consultancy services but it* ***does not include consideration for any construction, assembly, mining or like project*** *undertaken by the recipient or consideration which would be income of the recipient chargeable under the head "Salaries".*]

Explanation (c) to Section 44DA specifies that the word 'Permanent Enterprise' shall have the same meaning as in Section 92F (iiia) of the Act which states that Permanent Establishment *'… includes a fixed place of business through which the business of the enterprise is wholly or partly carried on'.*

Income by way of FTS not connected to PE in case of non-residents will be taxable u/s. 115A of the Act.

➢ **Applicability of Section 44BB of the Act.**

Taxation of oil sector has been complex given inherent nature of business. In order to provide clarity the Indian Government inserted Section 44BB by Finance Act, 1987 w.r.e.f 1st April, 1983. This section is a special provision for computing profits and gains in connection with the business of exploration, etc., of mineral oils and applies to an assessee engaged in the business of providing services and facilities in connection with, or supply of plant and machinery on hire used or to be used in the prospecting for, or extraction or production of mineral oils. For such assessees, a sum equal to 10% of aggregate of the amounts shall be deemed to be income of assessee which shall be chargeable to tax under the head "Profits and Gains of Business or Profession".

This section shall not apply where the provisions of following sections as described below are applicable for the purposes of computing profits or gains or any such other income as referred to in:-

- Section 42 – Special provision for deductions in the case of business for prospecting, etc., for mineral oil.
- Section 44D – Special provisions for computing income by way of royalties, etc., in the case of foreign companies.
- Section 44DA – Special provision for computing income by way of Royalties, etc., in case of non-residents.
- Section 115A – Tax on dividends, Royalty and technical service fees in case of foreign companies.
- Section 293A – Power to make exemption, etc., in relation to participation in the business of prospecting for, extraction, etc., of mineral oils.

Further, the non-resident can claim profits lower than the deemed rate of 10% under the head "Profits and Gains of Business or Profession" if:

- It maintains prescribed books of account in accordance with Section 44AA of the Act; and
- Get's its books of account audited and furnishes an audit report u/s. 44AB of the Act;

Explanation (i) to Section 44BB specifies that the word "plant" includes ***ships, aircraft, vehicles, drilling units, scientific apparatus and equipment, used for the purposes of the said business***; Explanation (ii) to Section 44BB defines that the word "mineral oil" includes petroleum and natural gas.

Section 44BB would apply to situations wherein the non-resident forms a PE under the DTC with the respective country of which the non-resident is a taxpayer. If no PE is established even the income arising from business of providing services and facilities in connection with, or supply of plant and machinery on hire used or to be used in the prospecting for, or extraction or production of mineral oils would not be taxable u/s. 44BB.

This aspect has been elucidated by the High Court of ***Uttarakhand in the case of CIT vs. Enron*** *Oil & Gas Expat Services Inc. Dehradun [2013] 213 Taxman 44 (Uttarakhand)*. It was held that Article 7 of DTAA requires a non-resident US enterprise to have a permanent establishment in India for being taxed in India, otherwise it is not taxable in view of the said treaty, even if it receives any remuneration in connection with any matter provided in Section 44BB of the Act.

- **Interplay between Sections 44DA and 44BB of the Act**

As a measure of simplification, Finance Bill 1987 inserted a new Section 44BB w.r.e.f AY 1983-84, providing for determination of income earned by non-resident oilfield service providers engaged in specific business on a deemed basis of 10% of gross receipts. Section 44DA has been introduced w.e.f. AY 2004-05 for determination of income earned of a non-resident by way of royalty or FTS.

It may be noted that both Sections 44DA and 44BB are special provisions under the Act but both have different applicability under the law.

Based on prevailing tax rates, a base tax rate of 40% is applicable on income earned by a non-resident deemed to be at 10% u/s. 44BB. The effective rate of tax u/s. 44BB is 4% (plus applicable surcharge & education cess) of the gross revenues, whereas u/s. 44DA the effective rate of tax could be much higher if the profits from such PE are in excess of 10% of gross receipts. Hence there could be substantial difference in the effective rate of tax u/s. 44DA and u/s. 44BB of the Act.

In past, there has been considerable litigation which have predominantly hinged on whether income from services rendered by non-resident oilfield service providers are taxable u/s. 44DA or u/s. 44BB of the Act. There have been disputes between taxpayers and revenue, mainly on the issue of chargeability of FTS relating to oilfield service providers u/s. 44DA or u/s. 44BB of the Act.

Another area where disputes have arisen is that, proviso to Section 44BB(1) excludes income taxable as FTS u/s. 115A and 44D. Although Section 44DA was inserted w.e.f. AY 2004-05 and which applies to agreement by non-residents with Government or Indian concern after 31st March 2003, no corresponding amendment was made in Section 44BB of the Act to exclude income taxable as FTS u/s. 44DA of the Act.

The legislature in its wisdom, therefore ***vide*** Finance Act 2010 amended the proviso to section 44BB and also to Section 44DA. The relevant extract of the Memorandum to Finance Bill 2010 explaining the intention of amendment is reproduced below:

*"…….. **Combined effect of the provisions of Sections** 44BB, 44DA and 115A is that if the income of a **non-resident is in the nature of fee for technical** services, it shall be taxable under the provisions of either Section 44DA or Section 115A irrespective of the business to which it relates. Section 44BB applies **only in a case where consideration is for services and** other facilities relating to exploration activity which **are not in the nature of technical services. However, owing to judicial pronouncements, doubts have been** raised regarding the scope of Section 44BB vis-a-vis*

Section 44DA as to whether fee for technical services relating to the exploration sector would also be covered under the presumptive taxation provisions of Section 44BB.

In order to remove doubts and clarify the distinct *scheme of taxation of income by way of fee for technical services, the proviso to Section 44BB has been amended with effect from assessment year 2011-12 so as to exclude the applicability of Section 44BB to income which is covered u/s. 44DA. Similarly, Section 44DA is also proposed to be amended with effect from assessment year 2011-12 to provide that provisions of Section 44BB shall not apply to the income covered u/s. 44DA."*

As a result of the amendment

(a) FTS will be taxed u/s. 44DA

(b) Income for other consideration will be taxed u/s. 44BB.

Based on the above amendment there is enough clarity to state that if any income in the nature of FTS connected to PE, has been earned by non-residents in India, it will be taxable u/s. 44DA of the Act.

While in case of non-residents providing technical services while engaged in the business of providing services or facilities in connection with, or supplying plant and machinery on hire used, or to be used, in the prospecting for, or extraction or production of, mineral oils of oilfield service providers, would be chargeable to tax on deemed basis u/s. 44BB of the Act.

➢ **Relevant Judicial Precedents**

- Delhi High Court in case of *DIT vs. OHM Ltd. [2013] 352 ITR 406 (Delhi)* held that profits of the non-resident assessee will be computed as per Section 44BB and not under Section 44DA as it was engaged in providing geophysical survey services to oil and gas exploration industry by way of electromagnetic survey, processing and interpretation of data being specified services.
- In a landmark case of ***Oil & Natural Gas*** *Corporation Ltd. v. CIT [2015] 376 ITR 306 (SC)*, the question before the Honourable Supreme Court, was "Whether the amounts paid by ONGC to the non-resident assessees/foreign companies for providing various services in connection with prospecting, extraction or production of mineral oil is chargeable to tax as "fees for technical services" u/s. 44D read with Explanation 2 to Section 9(1)(vii) of the Income-tax Act or would such payments be taxable on deemed basis u/s. 44BB of the Act".

The Supreme Court analysed Instruction No. 1862 issued by CBDT and listed a table of 44 contracts and held that income of oilfield service providers are taxable u/s. 44BB of ITA. It is pertinent to note that while the Instruction dealt with only specific kind of services, the Supreme Court has held that a wider gamut of services should be taxed u/s. 44BB. On analysis of Section 44D and 44BB it held that, the Act does not define the expressions "mines" or "minerals". The said expressions are found defined and explained in the Mines Act, 1952 and the Oil Fields (Development and Regulation) Act 1948. Supreme Court has viewed that it is the proximity of the works contemplated under an agreement, executed with a non-resident assessee or a foreign company, with mining activity or mining operations which would be crucial for determination of the question whether the payments made under such an agreement to the non-resident assessee or the foreign company is to be assessed u/s. 44BB or Section 44D of the Act.

Based on such detailed analysis, the Supreme Court held that:

> ***"The facts indicate that the pith and substance of each of the contracts/agreements is*** *inextricably connected with prospecting, extraction or production of mineral oil. The* ***dominant purpose of each of such agreement*** *is for prospecting, extraction or production*

of mineral oils though there may be certain ancillary works contemplated thereunder. If that be so, we will have no hesitation in holding that the payments made by ONGC and received by the non-resident assessees or foreign companies under the said contracts is more appropriately assessable under the provisions of Section 44BB and not Section 44D."

It should also be noted that, in view of Supreme Court decision, which becomes the law of land as per Article 141 of Constitution of India, there is now a favourable discernible trend in decisions of Courts / Revenue authorities that is preferable and welcome by taxpayers.

Following aforesaid Supreme Court's decision various Courts / Revenue authorities have passed orders favourable to taxpayers:

1. *ONGC vs. ITO, International Taxation, Dehradun [2016] 69 taxmann.com 421 (Delhi - Trib.)*

2. *Authority For Advance Rulings (Income-tax), New Delhi vs. Corpro Systems Ltd. [2016] 68 taxmann.com 330 New Delhi)*

3. *Siem Offshore Crewing AS vs. ADIT, International Taxation, Dehradun [2016] 68 taxmann.com 135 (Delhi – Trib.)*

It appears that the tax authorities would not be pursuing further appeals to higher appellate authorities wherein the facts of the case are similar to ONGC.

In fact, after the Supreme Court decision, Uttarakhand High Court has already quashed reopening of assessment proceedings on the basis of amendment made by Finance Act, 2010 in a batch of writ petitions in case of *CGG Veritas Services SA (WPMS No 517 of 2013)*. It is also seen that the tax officers are dropping reassessment proceedings or allowing benefits of Section 44BB in reassessment proceedings.

Litigation in relation to taxability of non-residents oilfield service providers for establishing taxability under deemed profit basis of Section 44BB of ITA now appears to be settled *vis a vis* Section 44DA.

II) Exclusion clause in FTS article in various DTCs i.e., income connected with PE

The presence of **"Permanent Establishment" (PE)** in a country will generally result in an entity being exposed to tax in that country. An understanding of the term permanent establishment is therefore, crucial in the planning of any international commercial operations.

The Double Tax Convention Agreements **(DTC's)** between developed countries generally follow the Organisation for Economic Co-operation and Development **(OECD)** Model Convention. United Nations **(UN)** Model Convention is followed in the case of DTC's between developing countries.

Article 5(1) of the OECD Model Convention **(OECD MC)** and UN Model Convention **(UN MC)** provides that the term PE means a fixed place of business through which the business of an enterprise is wholly or partly carried on.

Article 5(2) of both these Conventions provide that the term PE, includes the following:

a) A place of management;

b) A branch;

c) An office;

d) A factory;

e) A workshop, and

f) A mine, an oil or gas well, a quarry or any other place of extraction of natural resources.

Article 5(3) of OECD MC states that a building site or construction or installation project constitutes a PE only if it lasts for more than 12 months.

Article 5(3) of UN MC states that the term PE also encompasses:

(a) "A building site, a construction, ***assembly*** or installation project or *supervisory activities in connection therewith*, but only if such site, project or activities last more than *6 months*"

(b) *The* ***furnishing of services****, including consultancy services, by an enterprise through employees or other personnel engaged by the enterprise for such purpose, but only if activities of that nature continue (for the same or a connected project) within a Contracting State for a period or periods aggregating more than 183 days in any 12 month period commencing or ending in the fiscal year concerned.*

There is no separate Article in OECD MC and UN MC for technical fees. However the same is defined in US MC as furnishing of services, FTS normally forms part of business profits - Article 7.

From the above it could be noted that:

- As regards scope of PE, UN MC is wider and includes "Assembly Project" as well as "Supervisory Activities" in connection with the building site, construction, assembly or installation project.
- Even the period for determination of PE is 6 months under UN MC as compared to 12 months under OECD MC.
- There is no separate Article in OECD MC and UN MC for technical fees. Although the same is defined in US MC as furnishing of services.
- FTS normally forms part of business profits under Article 7 and would be taxable as business income on constituting a PE.

The concept of FTS as separate Article in the DTC's emerged due to developing nations like India harping upon the source rule of taxation as they did not want to give away a tax pie for technical fees arising from their countries.

India has entered into comprehensive DTC's with 95 countries. The DTC's provide for allocation of taxation rights to source State and residence State in respect of business profits including that of a permanent establishment, royalty, FTS, capital gains etc. The DTC's aim to avoid the burden of double taxation on income of residents of the two countries.

As per Section 90(2) of the Act, the provisions of the Act or DTC whichever is more beneficial would be applicable. Benefits of DTC is applicable to persons who are residents of one or both the contracting states.

DTC entered into between India and various countries generally define the term "Permanent Establishment" under Article 5, taxation of income arising from Business under Article 7 and income arising from "FTS" under Article 12 or 13.

The relevant Articles under DTC's with relevant countries are analysed as under:

➢ **Analysis of DTC between India-United States of America (USA)**

As per Article 5(2)(j) - any installation or structure used for a period of more than 120 days in any 12 month period would constitute a PE if it is used for exploration or exploitation of natural resources.

Article 5(2)(k) of India-USA DTC also includes ***other sites, projects or activities, if any*** along with building site, a construction, assembly or installation project or supervisory activities in connection therewith. This means if any building site construction is taking place at suppose "Place A" and in order to complete the project at Place A, suppose at Place B some work is carried out, period of Place B would also be considered for determination of PE in India.

In order to constitute a PE in India, the period for aforesaid activities should be more that 120 days which is in contrast to a period of more than 12 months under OECD MC and 6 months under UN MC. Further the 120 days period in any 12 months period is not similar to a calendar year or fiscal year.

However based on Article 5(2), if a PE is constituted in the Other State and Fees for Included Service is attributable to such PE or fixed base, than the provisions of Article 7, "Business Profits" or Article 15 "Independent Personal Services" as the case may be shall apply.

As per Article–12 of India-USA DTC, taxation rights of income arising from Fees for Included Services are also given to the source country i.e. State in which they arise and according to the laws of that State but the tax rate is restricted to 10% or 15% depending upon the nature of income.

Article 7 provides that income attributable to PE would be chargeable to tax in the country where PE is constituted after allowing for deductions/expenses which are incurred for the purpose of business of PE in accordance with taxation laws of that state. The relevant sections under domestic laws in India includes Section 44DA and 44BB of the Act.

Net income attributable to PE relating to FTS will be chargeable to tax u/s. 44DA of the Act on net basis at corporate tax rate of 40% (plus applicable surcharge & education cess).

As regards income relating to non-resident assessee engaged in providing services and facilities in prospecting, exploration of mineral oil, if PE is established it will be chargeable to tax u/s. 44BB of the Act under deemed tax basis i.e. 10% of aggregate receipts would be deemed to be income under the head profits and gains of business and charged to tax at corporate tax rate of 40% (plus applicable surcharge & education cess) i.e., effective rate of tax would be 4% (plus applicable surcharge & education cess) of aggregate receipts.

- **Analysis of DTC between India-United Kingdom (UK)**

As per Article 5(2)(i) – any installation or structure used for the exploration or exploitation of natural resources would constitute a PE.

As per Article 5(2)(j) in order to constitute a PE in India, the period for activities relating to business site or construction, installation or assembly project or supervisory activities in connection therewith should be carried out for a period of more than 6 months which is in contrast for a period of more than 12 months in OECD MC.

Where such project or supervisory activity are incidental to the sale or machinery or equipment, continues for a period of less than six months and the charges payable for the project or supervisory activity exceed 10% of the sale price of the machinery and equipment it will be also considered as PE.

The proviso to Article 5(2) of India-UK DTC has a deemed PE clause for service providers engaged in mineral oil business. An enterprise will be deemed to have a PE in India if it provides services or facilities which are in connection with or supplies plant and machinery on hire used or to be used in for the prospecting of or extraction or production of, mineral oils irrespective of number of days. This aspect of deemed PE is unique to India-UK DTC unlike other DTC's explained in this article.

As per Article–13 of India UK DTC, taxation rights of income arising from FTS are also given to the source country i.e. State in which they arise according to the laws of that State but the tax rate is restricted to 10% or 15% depending upon the nature of income.

Article 7 provides that income attributable to PE would be chargeable to tax in the country where PE is constituted after allowing for deductions/expenses which are incurred for the purpose of business of PE in accordance with taxation laws of that State. The relevant sections under

domestic laws in India includes Section 44DA and 44BB of the Act.

Net income attributable to PE relating to FTS will be chargeable to tax u/s. 44DA of the Act on net basis at corporate tax rate of 40% (plus applicable surcharge & education cess).

As regards income relating to non-resident assessee engaged in providing services and facilities in prospecting, exploration of mineral oil, PE would be deemed to be established and it will be chargeable to tax u/s. 44BB of the Act under deemed tax basis i.e., 10% of aggregate receipts would be deemed to be income under the head Profits and Gains of business and charged to tax at corporate tax rate of 40% (plus applicable surcharge & education cess) i.e., effective rate of tax would be 4% (plus applicable surcharge & education cess) of aggregate receipts.

- **Analysis of DTC between India – Norway**

Article 5(3)(a) of India-Norway DTC also includes ***other such sites, projects or activities,*** along with building site, a construction, assembly or installation project or supervisory activities. This means if any building site construction is taking place at suppose "Place A" and in order to complete the project at Place A, suppose at Place B some work is carried out, period of Place B would also be considered for determination of PE in India.

In order to constitute a PE in India, the period for aforesaid activities should be more than 3 months which is in contrast to a period of more than 12 months in OECD MC and 6 months in UN MC.

However based on Articles 5(2) and 5(3), if a PE is constituted in the Other State and FTS is attributable to such PE or fixed base, then the provisions of Article 7, "Business Profits" or Article 14 "Independent Personal Services" as the case may be shall apply.

As per Article–12 of India-Norway DTC, taxation rights of income arising from FTS are also given to the source country i.e., State in which they arise according to the laws of that State but the tax rate is restricted to 10%.

Article 7 provides that income attributable to PE would be chargeable to tax in the country where PE is constituted after allowing for deductions / expenses which are incurred for the purpose of business of PE in accordance with taxation laws of that State. The relevant sections under domestic laws in India include Section 44DA and 44BB of the Act.

Net income attributable to PE relating to FTS will be chargeable to tax u/s. 44DA of the Act on net basis at corporate tax rate of 40 % (plus applicable surcharge & education cess).

As regards income relating to non-resident assessee engaged in providing services and facilities in prospecting, exploration of mineral oil, if PE is established it will be chargeable to tax u/s. 44BB of the Act under deemed tax basis i.e. 10% of aggregate receipts would be deemed to be income under the head Profits and Gains of business and charged to tax at corporate tax rate of 40% (plus applicable surcharge & education cess) i.e., effective rate of tax would be 4% (plus applicable surcharge & education cess) of aggregate receipts.

> Infinite patience, infinite purity, and infinite perseverance are the secret of success in a good cause.
>
> — *Swami Vivekananda*

CA Geeta Jani & CA Jaya Hariharan

FTS Exclusions

1. Scope of the article

1.1 "Fees for technical services" ('FTS') is defined in Explanation 2 to Section 9(1)(vii) of the Income-tax Act ('ITA'). As per the said Explanation, fees for technical services means any consideration including lump sum consideration for rendering managerial, technical or consultancy service, including the rendering of services of technical or other personnel. Further, the latter part of the Explanation provides that FTS will not include consideration "for any construction, assembly, mining or like project" undertaken by the taxpayer.

1.2 This article throws light on the scope of the latter part of the Explanation viz., exclusions from the definition of FTS under ITA – namely, the exclusion in respect of construction and assembly projects. The ambit of the exclusions is discussed in light of the judicial development and associated controversies in this regard. Further, the article also captures impact of provisions contained in the Indian tax treaties in respect of the excluded projects under ITA.

2. Background

2.1 What is 'fees for technical services'?

(i) As aforementioned, Explanation 2 to Section 9(1)(vii) of ITA defines fees for technical services ('FTS') to mean any consideration whether lump sum or otherwise for the rendering of any 'managerial', 'technical' or 'consultancy' services. In addition thereto, it includes consideration for provision of services of technical or other personnel. Besides this, it excludes consideration for certain specified activities or projects which are dealt with separately hereunder.

(ii) Taxation of FTS under the tax treaties is along the lines of royalty taxation. It is generally the resident State that has the taxing rights of payments in the nature of FTS, including specific rules for taxation in the hands of the 'beneficial owner'.

2.2 When is FTS taxed under ITA?

(i) S.9(1)(vii) of ITA determines the charge on income by way of FTS. But for this provision, if any service is rendered outside India absent any nexus with India, it is outside the tax net of ITA. As per the provision, even where services are rendered outside India, income is deemed to accrue or arise in India and chargeable to tax in India if it is for the purposes of business/profession or for making or earning income from source in India.

(ii) While the scope of Section 9(1)(vii) and source rule exclusion contained therein

is a subject matter of discussion in other articles, it is pertinent to note that the analysis of exclusions under Explanation 2 as detailed in this article is relevant only where source taxation under Section 9(1)(vii) is triggered.

2.3 What is excluded from the definition of FTS under ITA?

(i) Section 9(1)(vii) was introduced by Finance Act 1976. While defining the term FTS, Explanation 2 to Section 9(1)(vii) excluded certain payments from being taxable as FTS although they may be in the nature of managerial, technical or consultancy services. As per the said Explanation, where consideration is payable for any construction, assembly, mining or like project undertaken by the recipient or such consideration is taxable as salaries in the hands of the recipient, the same is not taxable as FTS under ITA.

(ii) Once it is FTS, the person undertaking the project is required to pay tax on gross basis i.e., without any deduction or restricted deduction for any allowance or expenditure. Now, the carrying out of the aforementioned projects is almost like carrying on a business involving incurrence of substantial expenditure. It is hence that an exclusion was carved out to allow taxpayers to be taxed on net basis i.e., permitting deduction of expenditures incurred for the purposes of the projects. This rationale is explained by Central Board of Direct Taxes ('CBDT') in its Circular 202 dated 5th July 1976 as under:

"16.3 The expression "fees for technical services" has been defined to mean any consideration (including any lump sum consideration) for the rendering of managerial, technical or consultancy services, including the provision of services of technical or other personnel. ***It, however, does not include fees of the following types, namely:***

1. ***Any consideration received for any construction, assembly, mining or like project undertaken by the recipient. Such consideration has been excluded from the definition on the ground that such activities virtually amount to carrying on business in India for which considerable expenditure will have to be incurred by a non-resident and accordingly, it will not be fair to tax such consideration in the hands of a foreign company on gross basis or to restrict the expenditure incurred for earning the same to 20 per cent of the gross amount as provided in new section 44D. Consideration for any construction, assembly, mining or like project will, therefore, be chargeable to tax on net basis, i.e., after allowing deduction in respect of costs and expenditure incurred for earning the same and charged to tax at the rates applicable to the ordinary income of non-resident as specified in the relevant Finance Act.***

2. Consideration which will be chargeable to tax in the hands of the recipient under the head "Salaries".

(iii) Further, following judicial precedents have also explained the intent of the legislature in carving out this exclusion:

- In the case of *DCIT vs. Schlumberger Seaco Inc.*[1] while analysing taxation

1. [50 ITD 348] [1994]

of income derived by the taxpayer from exploration of oil in light of provisions of Section 44B *vis-à-vis* S.115A, the Calcutta Tribunal observed that the business of exploration of oil carried on by taxpayer is not FTS. In this regard, it explained the Circular explaining the basis of the latter part of the Explanation viz. exclusion of certain projects from the definition of FTS. It observed that the Legislature, while introducing Explanation 2 to section 9(1)(vii), had in mind only those non-residents who did not carry on any business as such in India but were merely in receipt of the income by way of fees for technical services and that it is for this reason that projects that are business-like are excluded from the purview of the definition.

- Further, Delhi High Court in the case of *DIT vs. Rio Tinto Technical Services*[2] while determining applicability of Article 7 *vis-à-vis* Article 12 to the facts of the case, observed that generally construction, assembly or mining projects are not regarded as services relating to FTS in common parlance. Also, the said projects are not strictly manufacturing or trading. It is therefore that Legislature expressly clarified as a part of the section itself that consideration paid for such projects are not to be regarded as FTS.

- The circumstance that a certain receipt does not constitute FTS on account of it being covered by the exclusion does not thereby suggest that the receipt cannot be charged to tax in India. It only suggests that the income of the recipient will be considered as in the nature of normal business income and the Rules relating to computation of business income will apply. To put it alternatively, the rules which are special to computation and taxation of FTS will not be applicable in such a case. Also, in view of the specific definition of FTS, the classification of income into FTS or non-FTS should be analysed with reference to the definition rather than a common parlance perception

2.4 Having understood the rationale of the Legislature in carving out the exclusion, let us now analyse the precise scope of the exclusion

(i) The ITA is silent on the terms used in the Explanation. In other words, there is no statutory definition in the ITA and hence meanings of the words may be inferred from dictionary meanings and may need to be understood in commercial parlance.

(ii) Construction may be understood as creation of something new by placing parts together; build, arrange or devise. 'Erection' is considered synonymous to construction and may include alterations and repairs[3]. Further construction may also include assembly, elevation, fabrication, establishment, etc. also, construction need not necessarily mean on surface of land but may also include excavating, dredging, etc. Further, renovation involving more than mere maintenance or redecoration of buildings, roads, bridges, or canals also can be construction[4].

2. [2012] 340 ITR 507
3. P. Ramanatha Aiyar (page 404)
4. Refer OECD MC 2010 – Commentary on Article 5(3), para 17

(iii) Dictionary meanings of 'Assembly' suggest that it means to fit/ join or put together or collect.

(iv) **Integrated contracts**

- In the case of National Mineral Development Corporation Ltd.[5], a comprehensive Contract was awarded to a non-resident (NR) for supply, assembly and erection of Conveyor belt with support maintenance. For supervision, erection and commissioning separate consideration was agreed. Tax Authority sought to classify supervision, erection and commissioning payment as technical services chargeable as FTS in terms of Section 9(1)(vii). Hyderabad Tribunal held that the services were part of the contract and hence was covered by the exclusion as whole of the responsibility of erecting the conveyor belt was that of the NR and supervision was a part of such overall contract. While concluding so, it observed that there is nothing in the section that suggests the type of construction contemplated for the purposes of the exclusion. It further held that assembly of loose parts of machinery can also be 'construction' for the purposes of this exclusion.

- Further, in the case of *Horizontal Drilling International vs. CIT*[6] the job of laying under sea pipeline was held to be a part of construction contract and was held to be covered by exclusion carved out in the definition of FTS despite the fact that the job was highly technical in nature. In view of the AAR, the consideration for execution of work cannot be equated with rendering of technical services and that the overall project cannot be disintegrated to determine what is the element of technical fees in it.

- The Hyderabad Tribunal[7] while deciding on treatment of supervisory activity observed that even though two agreements are separately entered into, if in fact they constitute one and a single agreement, they are to be understood as such irrespective of the fact that for one payment the price is paid and for the other a fee.

- AAR[8] allowed benefit of exclusion of 9(1)(vii) in respect of comprehensive EPC contract despite the fact that multiple contracts were signed.

- **Supplemental contract was part of EPC project and covered by exclusion:** In the case of *CIT (A) vs. Sundwiger EMFG and Co*[9]., a non resident company entered into contract for supply of capital equipment in connection with set up of the metal and alloy project on EPC basis and signed different/ supplemental agreements wherein one of the supplemental contracts dealt with technical services in connection with supervision of the project. It was the view of the tax authority that supplemental contract for supervision amounted to technical services and was chargeable to tax in India in terms of section 9(1)(vii) of the Act. As

5. ITO vs. national mineral development corporation ltd. (1992) (44 TTJ 8) / [42 ITD 570]
6. [237 ITR 142]
7. SMS Scholemann Siemag [57 ITD 254]
8. 228 ITR 487
9. 262 ITR 110 (AP)

against that, it was taxpayer's contention that the project was a comprehensive construction project and hence consideration pursuant supervision contract was not covered by S. 9(1)((vii). The High Court accepted taxpayer's contention and held that the impugned amount was not subject to tax as fees for technical services since supplemental contract was part of EPC project and was covered exclusion provided in terms of the definition of FTS.

(v) **Step-in aid services**

- Supreme Court in the case of Continental construction Ltd.[10] while interpreting 'foreign project' for the purposes of S.80HHB observed that the definition as provided in the section cannot be restricted to mere physical activity but should be understood as including the technical knowledge or rendering of technical services necessary to bring about the construction and / or assembly.

- In the case of Angland Investment Services Inc.[11] Delhi Tribunal held that exclusion in terms of Explanation 2 to S.9(1)(vii) would also include such services that are connected with and are provided with the ultimate aim of construction. It observed that construction was not just the physical laying of bricks and mortars but also included mental process of step-in-aid viz., engineering and bid evaluation. Thus, where services are held to be step-in-aid for construction, consideration would not be taxable as FTS in terms of Section 9(1)(vii), read with Explanation 2 thereto.

- This decision was followed by the Delhi Tribunal itself in the case of MSV International Inc.[12] wherein it observed that technical consultancy services rendered in relation to construction of highway project are to be excluded in terms of Explanation 2 to S.9(1)(vii).

(vi) One other aspect that emerges from the observations of various courts on this issue is that due regard has been given to the terms of the contract as agreed between the parties so as to determine the precise coverage of the exclusion. Thus, it would be pertinent to note the contractual terms of the contract for the project before concluding on the taxability in light of S.9(1)(vii) r.w. Explanation 2.

(vii) **What is the quantum of consideration eligible for exclusion in terms of the Explanation?**

- Once it is ascertained that the project falls within the ambit of exclusion, the next step is to determine the quantum of consideration that stands excluded from being taxable as FTS. The exclusion is for 'consideration for construction, assembly, mining or like project'. Thus, it is necessary to determine what is it that is paid as 'consideration for' the projects so as to be excluded from being taxable as FTS.

- The projects included in the Explanation providing for the

10. 195 ITR 81 (1992)
11. (1985) (22 taxman 9)
12. TS-78-ITAT-2016

exclusion would generally include and involve other services required for execution of the projects. Some consideration is paid towards provision of such services too. The question that arises is whether the recipient of consideration can take benefit of exclusion in respect of payments received for such connected services too. Now, if the aforementioned judicial rulings are any guide, it appears that Courts have allowed benefit of the exclusion not by restricting it to the consideration paid 'for' but also towards consideration paid for services in connection with the construction or assembly projects in case of integrated contracts or where services could be classified as a step-in-aid to the completion of the contract.

- However, it is also relevant to note the facts of the case before the Andhra Pradesh High court. In the case of *Elchem Technology v. DCIT*[13], taxpayer supplied equipment to the Indian Company which became part of furnace which the Indian Company was to establish. In addition to the supply of equipment, it also supplied certain engineering and other services. Taxpayer was not to be concerned with construction or assembly of the furnace. Further, the supply and technical support agreement were independent and there was no interdependence between the two. In view thereof, the High Court held that such services were covered by scope of the definition of FTS and were not covered by exclusion in respect of the consideration for construction, etc. The High Court held that merely because the taxpayer supplied equipment to the recipient of services did not mean that it was consideration for construction of the project.

(viii) **Let us now consider the following rulings wherein the Courts denied benefit of exclusion to the taxpayer for services in connection with the specified projects:**

- In the case of *Mangalore Refinery and Petrochemicals Ltd. vs. DCIT*[14] taxpayer engaged in the business of refining crude oil, engaged the services of foreign corporation for offshore designs and drawings to be used for the purposes of installation of refinery. Since the foreign corporation only rendered services in relation to designs and drawings and did not carry out construction of refinery, Tribunal denied benefit of exclusion in respect of payments received by it.
- In *Aditya Birla Nuvo ltd. vs. ADIT – IT*[15]*, Mumbai* tribunal held that mere supervisory activity in connection with a project would not qualify for the exclusion in terms of Explanation 2.

(ix) The above rulings throw light on one other pre-requisite for being covered within the scope of the exclusion viz. recipient of fees itself has to undertake the specified projects:

- As per Explanation 2, what is excluded from FTS is consideration

13. (250 ITR 164)
14. (2008) 14 TTJ 632 (Mum.)
15. (2011) 44 SOT 601 (Mum)

for the specified projects '***undertaken by the recipient***'. Thus, on plain reading of the language of the provision, if the project is not undertaken by the recipient, then the benefit of exclusion would not be available.

- Issues may arise on when can it be said that the recipient has 'undertaken' i.e. has agreed or promised to do something (here, the specified projects). Where I Co undertakes construction activity by itself by utilising its own employees and resources, it is I Co who has undertaken the project. Suppose I Co hires a contractor who supplies required manpower while the entire responsibility of mining is with I Co, it is again I Co who has undertaken the project. Now consider a case where I Co appoints a contractor such that it is the contractor who supplies the know-how, manpower, etc. and is also responsible for the project, here, the contractor and not I Co can be said to have undertaken the project.

(x) Consistent with the language of the provision, in the following cases, Tribunals/ Courts have held that benefit of exclusion is only available if the recipient of fess has itself undertaken the project:

- In the case of *Hotel Scope Vista Ltd. vs. ACIT*[16], taxpayer was engaged in the business hotel construction. It engaged the services of a foreign contractor to render managerial, technical and consultancy services in relation to the hotel constructed by the taxpayer. Basis meaning of the term "project" it contended that what is excluded is a construction project which is much wider than actual construction and hence services in relation to such construction project should also be excluded from FTS in terms of Explanation 2. The Tribunal ruled against the taxpayer and held that the said payments cannot qualify for the exclusion envisaged by Explanation 2: (a) construction project was not undertaken by the recipient, but by the taxpayer-payer; (b) the recipient was merely rendering services in connection with the project; (c) consideration for construction project would mean consideration for actual construction activities undertaken and not for any other services in connection with the same; (d) had the legislature intended to exclude consideration for connected services, it would have expressly mentioned "consideration for any services in connection with construction project".

- In the case of *Jindal Tractebal Power Co. Ltd. vs. DCIT*[17], while the Bangalore Tribunal was concerned with whether or not the consideration paid was for the construction of power plant project, it observed that the power project was not undertaken by the recipient, but by the taxpayer who was payer. Thus, it held that the amount paid towards technical services, start up services and turnkey responsibility for setting up of power plant was not covered by the scope of the exclusion.

16. (2007) 18 SOT 183 (Del)
17. (2007) 106 ITD 227

- The same has been the line of thinking of the Karnataka[18] as also Andhra Pradesh (supra)[19] High Court wherein the foreign company (recipient of fees) did not itself carry on any construction / assembly activity.
- *ITO vs. SMS Scholemann Siemag*[20], the Hyderabad Tribunal noted that to be eligible for being excluded from the definition of FTS, the receipt of consideration has to be for construction and assembly by the taxpayer itself and not for its supervision alone. Construction or assembly as such is to be undertaken by the taxpayer but not mere supervision thereof, under the agreement.

(xi) Thus, the judicial view appears to be in line with the language of the provision which requires the recipient itself to have undertaken the project so as to be covered by the exclusion. While there do not appear to be any rulings in favour of any other view, in Angland Investment Services inc. (supra), the aspect of recipient not having undertaken the project itself was not considered by the Delhi Tribunal.

2.5 Having noted the above, one may consider a situation where the recipient may not have undertaken the whole of the project by itself – may be on account of sheer size or requirement of additional resources or nature and complexity of contract etc. In such cases, it may be suggested that even if the recipient has not undertaken the whole of the project, even a part of it in itself may qualify as a 'project'. The application of exclusion to cases of joint project or where two or more entities form a consortium in order to undertake a project would depend on the contractual terms agreed and who can be said to have undertaken the construction / assembly/mining activity so as to be covered by the exclusion; while applicability of the exclusion to parties who have only provided technical services, without actually undertaking the activity in relation to which services are provided may be debatable.

2.6 Is the benefit of exclusion only available for large projects?

(i) While there is nothing in the explanation to suggest that only large scale projects are intended to be given the benefit of exclusion, the Circular uses terms like 'considerable expenditure' which raises a doubt as to whether the exclusion is only meant for large projects. Practically, non-residents may not engage in projects of smaller scale so as to trigger any doubt on their eligibility to be covered by the exclusion.

2.7 Interpretation of 'like project'

(i) Apart from construction, assembly and mining, consideration for "like project" also stands excluded from definition of FTS. Since the same is not defined, the scope of 'like project' would be a subject matter of interpretation. Following the principle of *ejusedem generis*, "like project" would mean those projects that are comparable in terms of features of the construction, assembly and mining projects – say projects that are labour intensive; requiring technical knowledge; that take long time for completion could be among the common features between the three named exclusions.

(ii) **Do "Installation" projects fall within the ambit of the exclusion?**

18. International Operating Services Ltd. vs. CIT (1997, 228 ITR 599)
19. Elchem Technology vs. DCIT (250 ITR 164)
20. [57 ITD 254] (Hyd)

- The word "installation" is not expressly cited in the Explanation. Dictionary meanings define the term "Install" to mean to set in a position ready to use. One line of distinction between construction/assembly and installation is that installation could be placing something which is already ready in a particular location while construction or assembly require creation of something new. However, this appears to be a very thin line of distinction and such a difference may not be visible in case of certain type of projects. Issue then arises whether installation projects can be covered by 'like projects' as appearing in the Explanation.

- In the case of Ericssion Telephone Corporation India[21], AAR did make certain observations which are noteworthy in the context of scope of the exclusion. In this case, the taxpayer was engaged in introducing a new system of telecommunication. Taxpayer contended that it was merely assembling hardware and software and hence it was covered by the exclusion. In this regard, the AAR observed that the work of the taxpayer involved much more than just assembly – it required high degree of technical knowledge and experience in order to install the hardware in a manner that fulfilled specifications of the customer which may more appropriately be called as 'installation' of a new system. Further, the contract also talked about rendering of related services including of training staff to be able to efficiently operate the system. AAR also indicated that the term "installation" is absent in Explanation 2 and the taxpayer was not responsible for "assembly" in the contract between taxpayer and customer – both the factors being persuasive to conclude on the nature of Services rendered. Although AAR did not decide on the issue, it appears that in absence of specific inclusion of the term 'installation' in the Explanation, benefit of exclusion may not be available to such projects. However, ambit of 'like project' has not been discussed in the ruling.

- In Kreuz Subsea Pte Ltd.[22]'s case, Mumbai Tribunal stated that installation activity includes erection/setting up of machine, equipment, testing and commissioning of such machines and equipment and also relates to construction of a project.

(iii) Whether exclusions enlisted in the Explanation are exhaustive?

- Basis discussion in the preceding paragraph, it appears that the exclusion is restricted to only construction, assembly and mining projects. Further, with limited guidance on interpretation of the term 'like project', the same seems to be highly fact driven on whether or not a particular project may fall within the ambit of the exclusion under the last limb. Further, it also appears to be unlikely that installation projects be covered by the exclusion such that consideration paid for the same does not qualify as FTS.

21. (1997) 224 ITR 203 (AAR)
22. 2015, 58 taxmann.com 371

3. The discussion above can be summarised in the form of a case study:

3.1 Consider the following:

(i) I Co enters into a contract with F Co 1 for laying down pipeline in Northern India.

(ii) F Co 1 sends its employees/ personnel to India for execution of I Co's contract.

(iii) F Co 1 in turn sub-contracts part of the project to F Co 2 such that F Co 1 is responsible to I Co for the work of F Co 2 and F Co 2 is not directly accountable to I Co for the work.

(iv) In addition to the said project, I Co also avails services from a NR for supervision and maintenance of the pipelines constructed by F Co 1.

3.2 Which of the following payments would qualify for FTS exclusion

(i) Payment made by I Co to F Co 1?
Job of laying down pipeline qualifies as 'construction' project. Accordingly, payment made by I Co to F Co 1 for such construction project would fall within the ambit of FTS exclusion. Accordingly, consideration received by F Co 1 would not be taxable in India as FTS.

(ii) Payment made by F Co 1 to F Co 2?
S.9(1)(vii)(c) deals with payment made by a non-resident in respect of business/ profession of F Co 1 in India or for the purpose of source of income in India. In the present case, F Co 1 makes payment to F Co 2 in respect of a construction project in India; accordingly, the payment may be taxable in India unless it is covered by FTS exclusion in terms of Explanation 2 to S.9(1)(vii), viz. "*consideration for any construction, assembly, mining or like* ***project undertaken by the recipient...***". The language of the provision requires the construction project to be undertaken by the recipient.

In the case under consideration, per the contractual terms, F Co 2 (i.e. the recipient) is not undertaking the construction project as a whole but is merely performing a portion of the project, for which F Co 1 continues to remain responsible to I Co. Hence, payment by F Co 1 to F Co 2 would not qualify for FTS exclusion. Had it been a case where F Co 2 was liable for the portion of work undertaken by it or consideration was determined for each one separately, there could be a possible suggestion that the project is done jointly by both F Co 1 and F Co 2 such that benefit of exclusion may extend to income earned by both parties.

(iii) Payment made by I Co to NR?
FTS exclusion covers consideration made "for" any construction, assembly, mining or like project undertaken by the recipient. While F Co 1 undertakes the construction work, a NR supervises the same and is also paid for the maintenance of the project. Payment to NR, although relates to or is in connection with the construction project, is not "for" undertaking a construction project. Accordingly, this payment may not be excluded from FTS taxation. In a situation where the payment is made to F Co 1 for the overall construction contract, integrated to include all incidental/ancillary/connected services for a lump sum consideration, such consideration payable for the project in total could enjoy benefit of FTS exclusion.

4. Concept of FTS under the treaty and scope of comparable exclusion

4.1 Indian treaties can broadly be divided into three parts in respect of special tax treatment of FTS viz.

(i) Set of treaties which do not have FTS Article and such receipts continue to get covered by business income article;

(ii) Set of treaties which have narrower concept of make available;

(iii) The treaties which have source taxation of FTS under special Article.

4.2 To our understanding, none of the treaties covered by category (iii) above has exclusion in respect of construction or assembly project comparable to domestic law. In respect of the treaties covered by category (ii), exceptionally – say, under India-Portugal or India-Singapore treaty, carve out is made in respect of project involving exploitation or exploration work.

4.3 Having regard to decision in case of Rio Tinto Technical Services (supra), the exclusion if regarded to be clarificatory in nature should not impact implications under the treaty as well. The comprehensive activity of project execution involving construction or assembly should arguably remain outside the scope of FTS Article.

4.4 Most Indian treaties trigger PE presence in respect of construction, assembly or Indian project if the project lasts for specific duration. Likewise, if supervisory activities in connection with construction or assembly project is undertaken, there is emergence of PE if the activity crosses specified threshold.

4.5 On an assumption that the construction/assembly project triggers PE, all activities which are effectively connected with such PE and attributable to such PE will trigger business taxation on net basis instead of being covered by FTS Article leading to gross basis of taxation.

4.6 If the activity of construction or assembly project does not trigger PE in India, there may not be taxation in India if the project work is comprehensive to include construction and assembly activity and not limited to services.

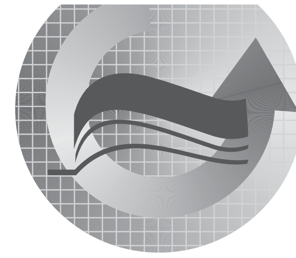
4.7 In respect of supervisory activity which does not constitute part of assembly or like project, if the presence crosses threshold of PE, taxation of likely to be under business Article on net income basis. As against that, if supervisory activities are technical in nature and do not cross the threshold of PE, the amount is likely to be assessed as FTS on gross basis.

Do not be afraid of a small beginning. great things come afterwards. Be courageous. Do not try to lead your brethren, but serve them. The brutal mania for leading has sunk many a great ships in the waters of life. Take care especially of that, i.e. be unselfish even unto death, and work

— *Swami Vivekananda*

Know that every time you feel weak, you not only hurt yourself but also the cause. Infinite faith and strength are the only conditions of success.

— *Swami Vivekananda*



CA Rajesh L. Shah

Taxation of Royalty and FTS Procedural Aspects for Tax Deduction

Having identified the nature of taxability under Royalty/FTS and its rate, there are various procedures to be followed for deduction viz., payment of TDS, filing of TDS return, issue of TDS Certificates, consequences for not complying with the Income-tax Act and rules, etc. Scope of this article will be to discuss the step-by-step process, obtaining of TRC, applicability of section 206AA, Form No: 15CA and 15CB, Grossing up u/s. 195, Disallowance u/s 40(a)(i) and 40(a)(ia), Penalty u/s. 201 & 201(1A) including some judicial precedents.

1. Step-by-Step Process

1.1 Time of deduction

Once having identified the nature of payment i.e. Royalty or FTS, payer should deduct tax u/s. 195(1) at the time of credit of income to the account of non-resident or at the time of payment thereof, whichever is earlier.

1.2 Time of deposit

Rule 30 of Income Tax Rules prescribes the time limit within which tax has to be deposited with the Government which is explained in the table below:

Deductor	Section(s)	Manner of credit	Due date
Government [Rule 30(1)]	All	Without challan	On the same day on which tax is deducted
		With challan	On or before 7 days from the end of the month in which tax is deducted
Other than Government [Rule 30(2)]	All (excluding Salaries)	Credit to the account of the payee as on March	30th April
		In any other case	Within seven days from the end of the month in which deduction is made

1.3 Issue of TDS Certificate

Rule 31 of the Income Tax Rules prescribes a certificate of deduction of tax at source to be furnished by the payer to the payee in Form No: 16A. The time limit within which Form No: 16A is to be issued is as follows:

Periodicity	Quarter	Due date of furnishing of Form 16A
Quarter	April - June	15th August
	July – September	15th November
	October – December	15th February
	January - March	15th June

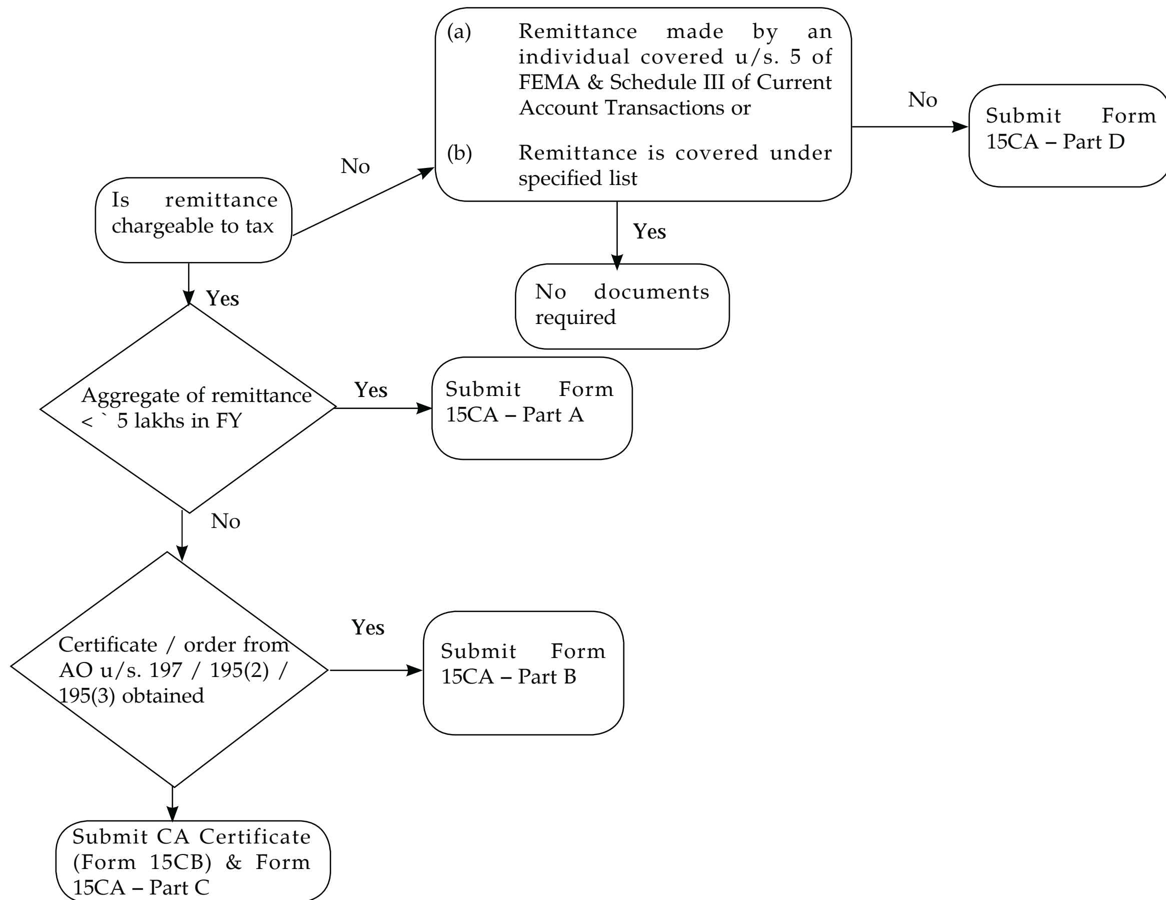
1.4 Filing of statement of deduction of tax

According to Rule 31A of Income Tax Rules, every person responsible for deduction of tax from payment to non-resident is required to file Form 27Q every quarter with Director General of Income Tax (Systems) within due date as given hereunder:

Quarter	Due Date of filing Form 27Q
April – June	31st July
July – September	31st October
October – December	31st January
January - March	31st May

2. Form No: 15CA and 15CB

Rule 37BB of Income Tax Rules prescribes the furnishing of information for payment to a non-resident, not being a company or to a foreign company popularly known as Form 15CA and 15CB. Rule 37BB has been substituted by IT (Twenty-first Amdt.) Rules, 2015 *vide* Notification No: 93/2015 dated December 16, 2015 w.e.f. April 1, 2016. Requirements of Form 15CA and 15CB can be easily understood in the form of flow chart as give hereunder:



3. Tax Residency Certificate (TRC)

3.1 Section 90(4) was inserted by the Finance Act, 2012 w.e.f. 1st April 2013 to provide that benefit of DTAA will not be available to an assessee, not being a resident, unless the assessee obtains a certificate from the Government of his country of residence.

3.2 Section 90(5) was inserted by the Finance Act, 2013 w.e.f. 1st April, 2013 to provide that assessee should submit such other documents and information as may be prescribed. Rule 21AB was amended by IT (Eleventh Amdt.) Rules, 2013, w.r.e.f 1st April, 2013 to provide that the non-resident assessee should furnish information in Form 10F, if the information required in Form 10F is not provided in the certificate issued by the Government of the country of residence.

3.3 The issue that arises is whether TRC is required if the non-resident party is not liable to tax under the Income-tax Act. Section 90(4) provides that if benefit of DTAA is to be availed, then TRC is required. Therefore in the case where non-resident is exempt from tax under the Act, then he did not obtain TRC.

3.4 The issue that is often debated is whether, if TRC is not available at the time of deduction, whether benefit of DTAA is available. Since Section 90(4) unambiguously provides that if benefit of DTAA is to be availed, then TRC is required. Therefore in a situation where the non-resident party is not able to submit TRC, benefit of DTAA will not be available.

3.5 It may be possible that TRC is available for previous year and not for the year during which the deduction is made for example remittance for FTS is to be made in November 2016, but TRC is available for 2015. Whether benefit of DTAA is available in the year 2016 on the basis of TRC of 2015. The wordings of section 90(4) unambiguously provide that if benefit of DTAA is to be availed, then TRC is required. Therefore under the situation where TRC is available for 2015, benefit of DTAA will not be available.

3.6 Some countries follow calendar year whereas India follows financial year. Now whether TRC will be required for both the financial years to which the transaction relates for e.g., US follows calendar year i.e., 1st January to 31st December and India follows financial year i.e. 1st April to 31st March. Remittance from India is to be made, say for FTS to US Resident in January 2017. Whether India will require TRC for both 2016 and 2017 to cover the financial year 1st April, 2016 to 31st March, 2017. Since TRC is required at the time of remittance, accordingly an opinion can be taken that TRC will be required for 2017 only, as at the time of remittance, payee is a resident of US. For safe side one may take TRC for 2016 although technically it is not required.

4. Section 206AA – Required to furnish Permanent Account Number (PAN)

4.1 Section 206AA was inserted w.e.f. 1st April 2010 to provide that if any person is entitled to receive any sum or income or amount on which tax is deductible under chapter XVII-B and PAN is not provided by the deductee, tax is to be deducted at the higher of following rates:

(i) At the rate specified in the relevant provision of this Act; or

(ii) At the rate or rates in force; or

(iii) At the rate of 20%

In short, if PAN is not provided by the deductee, then tax at the rate of 20% will have to be deducted, subject to other conditions.

Here it should also be noted that all types of payment made to non-resident are not covered. Only those payments on which tax is deductible under Chapter XVII-B is covered for e.g. remittance for maintenance abroad, dividend income on which dividend distribution tax is paid will not be subject to Section 206AA.

4.2 Section 206AA (7) was substituted by Finance Act, 2016 w.e.f. 1st June, 2016 to provide

that provision of section 206AA will not apply to a non-resident subject to such conditions as may be prescribed.

4.3 Rule 37BC was inserted by the Income Tax (Seventeenth Amendment) Rules, 2016 w.e.f. 24th June 2016 to specify the circumstances under which provisions of section 206AA will not apply.

4.4 Rule 37BC provides that in respect of payment in the nature of Interest, Royalties, Fees for Technical Services and payments on transfer of capital asset, provisions of section 206AA will not apply if the deductee furnishes the following information and documents:

(i) Name, E-mail ID and contact number;

(ii) Address in the country or territory where the deductee is resident;

(iii) TRC, if the country or territory provides for issuance of such certificate in its laws;

(iv) Tax Identification Number (TIN) of the deductee in the country or territory of his residence, and in case TIN is not available, then a unique identification number.

4.5 It may be noted here that Rule 37BC will apply to specific nature of income viz., Interest, Royalties, Fees for Technical Services and payments on transfer of capital asset. Other income like Business Profits are not covered and therefore normal provisions of the Section 206AA will have to be complied with.

4.6 Section 206AA(7) was inserted w.e.f. 1st June, 2016 whereas Rule 37BC prescribing various relaxations / conditions were inserted w.e.f. 24th June, 2016. The issue that arises whether Section 206AA(7) will be applicable to the payment made between 1st June 2016 to 23rd June 2016. Section 206AA(7) refers to "such conditions as may be prescribed" and since no conditions / rules were prescribed until 24th June, 2016, provisions of Section 206AA(7) is redundant for the interim period from 1st June, 2016 to 23rd June, 2016. It means that other provisions of section 206AA will have to be complied with and if PAN is not available, then TDS will have to be deducted @ 20%. However there is another equally strong view that since Rule 37BC is beneficial, benefit of the conditions prescribed should be available to the remittance affected between 1st June 2016 and 23rd June, 2016 although it is debatable.

4.7 Surcharge and Education Cess

Section 2 of the Finance Act of the relevant assessment year provides various sections for which the rate of tax needs to be increased by surcharge and education cess. Section 206AA is not covered under the list of sections and therefore there is no requirement to increase the rate of 20% as determined under Section 206AA by surcharge or education cess.

4.8 Section 206AA is ***non-obstinate*** clause as it starts with "Notwithstanding anything contained in any other provisions of this Act......." The issue that arises is that if a person is not liable to tax, then whether the person still has to obtain PAN. The issue was settled in favour of assessee by Karnataka High Court in the case of ***Smt. A. Kowsalya Bai vs. Union of India (2012) 346 ITR 156***. Karnataka High Court observed that it may not be necessary for such persons whose income is below taxable limit to obtain PAN. Imposing condition to invariably go for a PAN on such small depositors would cause hindrance and discourage such small investors to come forward to invest their money for secured returns and as security for their future.

4.9 One of the major issue that arises in interpreting Section 206AA, is whether tax is to be deducted at 20% under Section 206AA where treaty benefits are available and non-resident deductee does not have PAN.

One view is that Section 90(2) overrides all other sections although it does not start with ***non-obstante*** clause as it gives benefit to non-resident assessee through the treaty which India has entered into with other countries. The issue came up before the Pune Tribunal in

the case of ***DDIT vs. Serum Institute of India Ltd. (2015) 68 SOT 254***. Pune Tribunal held in favour of assessee and observed that "it would be quite incorrect to say that though the charging section 4 of the Act and Section 5 of the Act dealing with ascertainment of total income are subordinate to the principle enshrined in Section 90(2) of the Act but the provisions of Chapter XVII-B governing tax deduction at source are not subordinate to section 90(2) of the Act. Notably, section 206AA of the Act which is the centre of controversy before us is not a charging section but is a part of a procedural provisions dealing with collection and deduction of tax at source. The provisions of Section 195 of the Act which casts a duty on the assessee to deduct tax at source on payments to a non-resident cannot be looked upon as a charging provision."

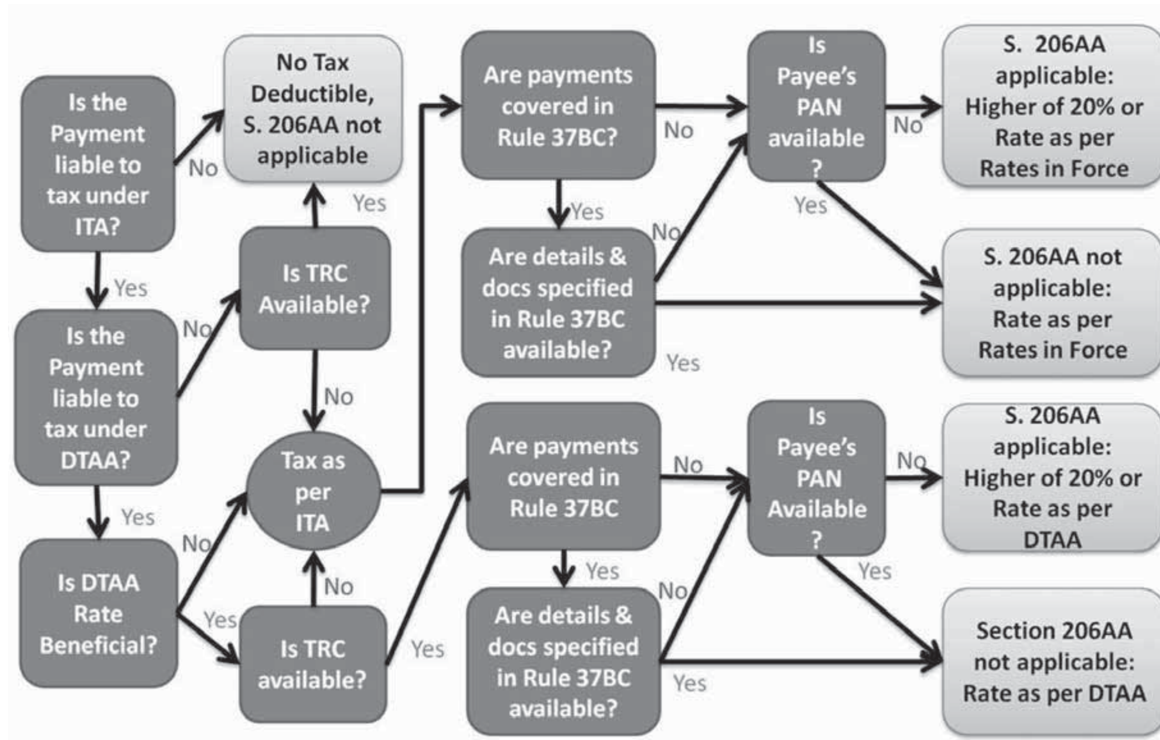
Similar view was held by Bangalore Tribunal in the case of ***DCIT vs. Infosys BPO Ltd. (2015) 154 ITD 816***.

However, Contrary view was held by Bangalore Tribunal in the case of ***Bosch Ltd. vs. ITO (2012) 141 ITD 38***.

Another view is that section 206AA is not a charging section but is only a mechanism for deduction of tax. Section 206AA does not fix the tax liability on the assessee. In that case tax has to be deducted under Chapter XVII-B read with section 206AA. Assessee can file return of income and claim refund if he is chargeable to tax at a rate lower than 20%.

5 Interplay between TRC and Section 206AA

Provisions of Section 90(4) and section 90(5) i.e., TRC and Section 206AA are applicable to payments made to non-residents. Since both the provisions apply simultaneously, there are various provisions on the process that has to be followed while making the remittances. A flow chart will help to make the process clear is given hereunder.



6. Grossing up of Tax (Section 195A) and Tax deducted is income received (Section 198)

6.1 Section 195A provides that where under any agreement or arrangement, the payer bears the tax liability of the payee, then for the purposes of deduction of tax at source, the income shall be grossed up. Further section 198 provides that tax deducted will be income of the payee. The two provisions gives the intention of the Government if the payer is bearing the tax, then income will have to be grossed up and tax will have to be deducted on the grossed up amount. The following example will clearly explain the provisions of Section 195A presuming tax rate is 10%.

Payment to non-resident	100.00
Tax on gross basis	11.11
Total taxable payment for tax purpose	111.11
Final tax on gross basis @ 10%	11.11

6.2 Provisions of Section 195A will trigger even if the payment is made where the tax is deducted @ 20% as per Section 206AA. There are various views on the provisions of applicability of grossing up for the purpose of Section 206AA.

6.3 Assuming a treaty rate of 10% and the non-resident does not have PAN and is chargeable to tax u/s. 206AA @ 20%, the following option emerges:

Particulars	Option I	Option II	Option III	Option IV
Net of tax payment to non-resident	100	100	100	100
(+) Grossing up	11.11	11.11	20	25
Total	111.11	111.11	120	125
(-) TDS	11.11	22.22	20	25
Payment made to Non-Resident	100	88.89	100	100

6.3.1 In the case *Bosch Ltd. vs. ITO (2012) 141 ITD 38 (Bang.)*, it was held that higher rate of deduction at 20% u/s. 206AA is not applicable for tax grossing-up u/s. 195A. Income is to be increased at the rates in force and not at the rate tax is withheld by the deductor as explained in option II in the above table.

6.4 Consequences of non / short deduction Sections 40(a)(i) / 40(a)(ia)

Now let us discuss the consequences of short deduction u/ss. 40(a)(i) and 40(a)(ia)

6.4.1 Section 40(a)(i) provides that any sum chargeable under this Act which is payable outside India to a non-resident is not deductible while computing income under the head "Profits and Gains of Business or Profession", if tax is not paid and remitted to the Government. It further provides that if tax is deducted and paid before the due date of filing return of income u/s. 139(1), then, deduction will be allowed in the same year. If in subsequent year, tax is deducted and paid, then expenses will be deducted in the subsequent year.

6.4.2 Section 40(a)(ia) provides that 30% of any sum payable to a resident will be disallowed if tax which was deductible under Chapter XVII-B and such tax was not deducted or after deduction has not been paid on or before the due date specified u/s. 139(i), will be disallowed. It further provides that if in subsequent year, tax is deducted and paid, then expenses will be deducted in the subsequent year. If the assessee is not deemed to be assessee in default u/s. 201 due to the fact that deductee has paid the tax and complied with the prescribed conditions of

1st proviso of Section 201, it shall be deemed that tax has been deducted and paid on such sum on the date of furnishing of return of income.

6.4.3 Disallowance u/ss. 40(a)(i) / 40(a)(ia) in case of short deduction

There may be instances where there is short deduction of tax say for e.g., tax is deducted u/s. 194C @ 2% by the assessee whereas AO is of the view that tax has to be deducted u/s. 194J @ 10% and disallows the entire expenses. The issue that arises is as to whether the disallowance u/s. 40(a)(i) should be on the whole of such expenses or on the proportionate amount of shortfall of tax deducted or no disallowance should be made.

In the following cases it was held that since tax was deducted, although at lower rate, then expenses cannot be disallowed as the said provision can be invoked only in the event of non deduction of tax but not for lesser deduction of tax. There is nothing in the said section to treat, ***inter alia***, the assessee as defaulter where there is a shortfall in deduction. This Section 40(a)(ia) of the Act refers only to the duty to deduct tax and pay to Government account. If there is any shortfall due to any difference of opinion as to the taxability of any item or the nature of payments falling under various TDS provisions, the assessee cannot be declared to be an assessee in default u/s. 201 of the Act and no disallowance can be made by invoking the provisions of section 40(a)(ia) of the Act.

(i) ***DCIT vs. Chandabhoy & Jassobhoy (2011) 49 SOT 448 (Mum)***

(ii) ***DCIT vs. S. K. Tekriwal (2011) 48 SOT 515*** *(Kol.) confirmed by Calcutta High Court, CIT* ***vs S. K. Tekriwal (2012) 361 ITR 432.***

(iii) ***Three Star Granites Pvt. Ltd. vs. ACIT (2014) 32 ITR (T) 398 (Cochin)***

(iv) ***Apollo Tyres Ltd. (2013) 60 SOT 1 (Cochin)***

One may also keep in mind the contrary decision wherein it was held that in case where tax was deductible under section 194J, but was actually deducted u/s. 194C, the same would tantamount to short deduction of tax and will attract the provisions of Section 40(a)(ia) - ***CIT vs. P. V. S.*** *Memorial Hospital Ltd. (2015) 380 ITR 284 (Kerala).*

6.4.4 Disallowance in a case where CA certificate is obtained

Tax has not been deducted while making remittance outside India on the basis of CA certificate. AO may not agree with the view of the Chartered Accountant and since no tax was deducted, AO disallows the entire expenditure u/s. 40(a)(i). The issue that arises is whether disallowance u/s. 40(a)(i) can be made where the assessee relied on the CA Certificate. It may be noted here that CA certificate is only for facilitating remittance and does not affect the taxability of the provisions of the Income-tax Act, 1961.

Karnataka High Court in the case of ***CIT vs Filtrex Technologies Pvt. Ltd. (2015) 232 Taxman 811*** held that payment to a foreign company without deduction of tax on the basis of Chartered Accountant Certificate is not a fit case to conclude that the assessee has deliberately concealed the income or furnished inaccurate particulars of the income. Assessee was not liable to penalty u/s. 271(1)(c) and also there will be no disallowance u/s. 40(a)(ia).

6.4.5 Disallowance on the depreciation amount

The issue that often arises is whether disallowance provisions are attracted in case the payment is capitalised and only depreciation amount is claimed. In the following cases it was held that no disallowance can be made of depreciation amount as Section 40(a)(i) & 40(a)(ia) does not deal with deduction of depreciation. The sum, as contemplated under section 40(a)(i) is the outgoing amount and therefore, necessarily refers to the outgoing expenditure. Depreciation is a statutory deduction and is mandatory. The deduction u/s. 32 is not in respect of the amount paid or payable which is subjected to TDS; but is a statutory deduction on an asset which is

otherwise eligible for deduction of deprecation. Depreciation is not an outgoing expenditure and therefore, the provisions of section 40(a)(i) of the Act are not attracted on such deduction.

(i) *CIT vs. Mark Auto Industries Ltd. (2012) 358 ITR 43 (P & H)*

(ii) *SKOL Breweries Ltd. vs. ACIT (2013) 142 ITD 49 (Mum)*

(iii) *Sonic Biochem Extractions Pvt. Ltd. (2013) 59 SOT 4 (Mum)*

(iv) *Muthoot Finance Ltd. vs. ACIT (2014) 49 Taxmann.com 580 (Cochin Tribunal)*

(v) *Kawasaki Microelectronics Inc. (2015) 60 Taxmann.com 256 (Bang. Tribunal)*

6.4.6 Meaning of the word payable u/s. 40(a)(ia)

Since the introduction of section, there has been a debate relating to word payable. Whether the term 'payable' refers to the amount of expenditure outstanding at the end of the year or it also refers to the expenditure paid during the previous year without deduction of tax. The divergent judicial pronouncements have added to the confusion.

Visakhapatnam Tribunal (Special Bench) in *Merilyn Shipping & Transporters vs. ACIT (2012) 136 ITD 23* which was subsequently stayed by the Andhra Pradesh High Court held that the word "Payable" means amount of expenditure which are outstanding as on 31st March and it cannot be invoked to disallow expenditure which has been actually paid during the previous year without deduction of TDS. Special Bench observed that Section 40(a)(ia) creates a legal fiction for the amounts outstanding or remains payable i.e., at the end of the every year as on 31st March and it cannot be extended for taxing the amounts already paid. In fact, Section 201 of the Act itself takes care of tax to be collected in the hands of the payee and other TDS provisions under Chapter XVIIB of the Act. No further legal fiction from elsewhere in the statute can be borrowed to extend the field of Section 40(a)(ia) of the Act. This fiction cannot be extended any farther and, therefore, cannot be invoked by Assessing Officer to disallow the genuine and reasonable expenditure on the amounts of expenditure already paid.

In the following cases, it was held that the word "Payable" means amount of expenditure outstanding as on 31st March and it cannot be invoked to disallow expenditure which has been actually paid during the previous year without deduction of TDS.

(i) *CIT vs. Vector Shipping Services Pvt. Ltd. (2013) 347 ITR 642 (Allahabad)**

(ii) *DCIT vs. Ananda Marakala (2013) 150 ITD 323 (Bang.)*

(iii) *Teja Construction (2009) 39 SOT 13 (URO) (Hyd.)*

(iv) *Underwater Services Co. vs. ITO (2012) 54 SOT 178 (Mum.)*

(v) *ITO vs. Cross Tab Marketing Services Pvt. Ltd. (2014) 149 ITD 678 (Bang.)*

(vi) *Devendra Exports Pvt. Ltd. vs. ACIT (2015) ITA Nos: 849 & 850/Mds/2013*

(vii) *Jitendra Mansukhlal Shah vs. DCIT (2015) ITA Nos. 2293 & 2294/Mum/2013*

*Hon'ble Supreme Court has dismissed the Revenue SLP against Allahabad High Court.

In the following cases, it was held that the word "payable" would mean payable at any time during the year:

(i) *DCIT vs. Ama Medical & Diagnostic Centre (2014) 63 SOT 136 (Luck.)*

(ii) *DCIT vs. Ashika Stock Broking Ltd. (2010) 44 SOT 556 (Kol.)*

(iii) *Poddar Son's Exl. Pvt. Ltd. vs. ITO (2009) ITA No: 1418 (Kol.)*

(iv) *CIT vs. Sikandarkhan N. Tunvar (2013) 357 ITR 312*

(v) *CIT vs. Crescent Export Syndicate (2013) 262 CTR 525.*

(vi) *ACIT vs. Rishti Stock & Shares Pvt. Ltd. (2013) 152 ITD 868 (Mum.)*

(vii) *Kasargod District Co-op. Bank Ltd. (2014) 55 taxmann.com 442 (Coch. Trib.)*

(viii) *Sai Builders vs. ITO (2014) 152 ITD 462 (Agra)*

(ix) *CIT vs. Sikandarkhan N. Tunvar (2013) 357 ITR 312 (Guj.)*

(x) *CIT vs. Crescent Export Syndicates (2013) ITA No. 20 of 2013 (Calcutta High Court)*

(xi) *ACIT vs. Shri Bhavook Chandraprakash Tripathi (2015) ITA No. 1372/PN/2013 (Pune Tribunal)*

CBDT *vide* its Circular No: 10/2013 dated 16th December 2013 have clarified that the Board is of the considered view that the provision of Section 40(a)(ia) of the Act would cover not only the amounts which are payable as on 31st March of a previous year but also amounts which are payable at any time during the year. The statutory provisions are amply clear and in the context of Section 40(a) (ia) of the Act the term "payable" would include "amounts which are paid during the previous year".

7. Consequences of failure to deduct or pay – Sections 201 & 201(1A)

7.1 Section 201(1) provides that where any person who is required to deduct any sum in accordance with the provisions of the Act or u/s. 192, but does not deduct or after deduction does not pay the whole or part of the tax to the Government, then such person shall be deemed to be assessee in default.

7.2 Finance Act, 2012 has inserted new proviso to section 201(1) w.e.f. 1st July, 2012 to provide that deductor will not be deemed to be assessee in default if the deductee, being a resident, has paid the tax due on the income declared by him in return of income.

Above amendment was in acceptance of the Hon'ble Supreme Court judgment in the case of *Hindustan Coca Cola Beverages (P.) Ltd. vs. CIT (2007) 293 ITR 226* wherein it was held that in case of shortfall of TDS, and tax has been paid by the payee then no further tax can be recovered from the payer. Payer would be liable to pay only interest u/s. 201(1A) and could also face penalty proceedings u/s. 271C.

It may be noted here that the amendment is with respect to deductee being a resident and is not applicable where deductee is a non-resident. However, a view can be taken that if deductee is a non-resident, benefit of Supreme Court decision in Hindustan Coca Cola Beverages (P.) Ltd (supra) can be taken.

7.3 Finance Act, 2010, w.e.f. 1-7-2010 amended Section 201(1A) to provide levy of interest in 2 situations as follows:

Simple Interest @ 1% per month is payable by the person who fails to deduct tax as required from the date on which tax was deductible to the date on which tax is deducted.

Simple Interest @ 1.5% per month is payable by the person who fails to pay the tax within time after tax is deducted. This interest is calculated on the tax deductible from the date on which tax was deducted till the date on which tax is actually paid.

For example, if A Ltd. has deducted tax in the month of January and deposited the tax so deducted in the month of April, then interest will be charged for 4 months i.e. January, February, March and April irrespective of the fact that due date for depositing tax so deducted is 7th February.

7.4 In the following case it was held that interest can be charged from the date on which tax was deductible to date on which such tax is actually paid

(i) *CIT vs. Adidas India Marketing Pvt. Ltd. (2007) 288 ITR 379*

In a case where tax is paid by the deductee, interest can be charged on assessee deductor from the date of its liability till date of actual tax payment by recipient deductee as held in the following cases:

(i) *SAA Ispahani Trust vs. ITO (TDS) [2013] 216 Taxman 1 (Madras)*

(ii) *Genins India TPA Ltd. (2015) 68 SOT 356 (Delhi)*

7.5 Section 201(3) provides that an order treating the assessee in default u/s. 201(1) should be passed within seven years from the end of the financial year in which payment is made or credit given. It may also be noted here that time limit of seven years is applicable to the person resident in India. Time limit is not applicable where deductee is non-resident. Here section 201(3) speaks about passing the order, it does not say about the period within which notice is to be issued. The issue that arises is when the notice for initiating the proceeding under section 201 can be issued. Courts have consistently held that notice u/s. 201 should be issued within a period of 4 years from the end of the previous year in which the default was initiated.

In following cases it was held that a reasonable time for initiating the proceedings u/s. 201 would be 4 years from the end of previous year

(i) *Mangalore Refinery & Petrochemicals Ltd. vs. DDIT (2007) 113 ITD 85 (Mum.)*

(ii) *Raymond Woollen Mills vs. ITO (1996) 57 ITD 536 (Mum.)*

In following cases it was held that a reasonable time for initiating the proceedings u/s. 201 would be 4 years from the end of assessment year

(i) *Sahara Airlines Ltd. vs. DCIT (2002) 83 ITD 11 (Delhi)*

(ii) *Mahindra & Mahindra Ltd. (2014) 365 ITR 560 (Bom.)*

It may be noted here that Hon'ble Supreme Court has granted SLP against Bombay High Court Judgment referred to in Mahindra & Mahindra Ltd. (Supra).

8 Disallowance u/ss. 40(a)(i)/40(a)(ia) *vis-a-vis* Penalty u/s. 201/ 201(1A)

8.1 It may be possible that AO may have recourse to both the section i.e. disallow the expenses u/s. 40(a)(i)/40(a)(ia) and also levy penalty u/s. 201. The issue that arises is whether AO has power to invoke both the sections separately i.e. whether both the sections are independent of each other or if provisions of one section is invoked, department cannot have recourse to another section.

8.2 In following decisions it was held that department cannot have recourse to both the section i.e. disallowance u/s. 40(a)(i) and also penalty u/s. 201.

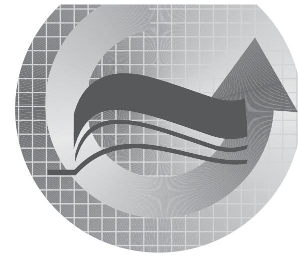
(i) *Pfizer Ltd. vs. ITO (2012) 55 SOT 277 (Mum)*

(ii) *Bosch Ltd. vs. ITO (2014) / ITA No: 1583 (BNG)*

8.3 It is not clear what would be the position in a case where the assessee pays the TDS amount in the next year and claims the expenditure. Whether provisions of Section 201 can be initiated?

CONCLUSION

Since the consequences of not complying with Chapter XVII-B are severe viz., disallowance, interest, penalties, etc. one may be advised to comply with all the provisions of TDS including the rules and also comply with the procedural part meticulously. To add to the onerous requirements, there are conflicting judgments of various courts. Government on its part should scale down the rigours of TDS provisions including disallowance, interest, penalties, etc., as the deductor has to comply with too many requirements. Further procedural part of filing TDS, rectification of TDS return filed, etc. should also be simplified.



CA T. Bhanumurthy

Transfer Pricing — Royalties & FTS

India has focused on the science and technology realising that it is the key element for the economic growth. With the Government's encouragement, the investment and development has incurred in many sectors like healthcare, agriculture and space research etc., thus India became technology savvy country. In these times, it is critical for the Indian tax policy to ensure that the taxpayers don't misuse relief provided from taxation for inflow of the technology. India entered into DTAA's with many countries based on the UN Model Tax Convention and in some cases on combination of OECD and UN Models to encourage the MNEs to set up their business. When a Multi-National Enterprise (MNE) operates in two tax jurisdictions, the tax department tends to suspect the intra group transactions of MNE's for technology transfers, as over charged the Indian operations. The Transfer Pricing is a mechanism to counter the MNEs enticement to do so. Under the Transfer Pricing Regulations (TPR), one of the contentious issue is the computation of Arm's Length Price (ALP) for Royalties and Fee for Technical Services (R&FTS) paid by the taxpayer to their Associate Enterprises.

Section 92F (ii) of the act, defines ALP to mean a 'price' which is applied or proposed to be applied in a transaction between persons other than Associate Enterprises in uncontrolled conditions. To compute the ALP it is necessary to identify the international transaction and such transaction with associate enterprise. Section 92B of the Act, defines the term 'international transaction'. This section covers the following:—

A transaction between two or more AEs either or both of whom are non-resident in the nature of

i. Purchase, sale or lease of tangible or intangible property or

ii. Provision of services or lending or borrowing money or

iii. Any other transaction having a bearing on the profits, income, losses or assets of such enterprise and shall include

iv. A mutual agreement or arrangement for the allocation or apportionment of, any contribution to any cost or expenses incurred or to be incurred in connection with a benefit, service or facility provided or to be provided.

In addition to the above, the legislator has inserted an explanation to the above *vide* Finance Act, 2012 with retrospective effect from 1-4-2002. As per the explanation (i), the international transaction shall include,

a. ……………………

b. The purchase, sale, transfer, lease or use of intangible property including the transfer of ownership or the provision of use of rights regarding land use, copyright, etc, etc……

c. …………………..

d. Provision of services, including provision of market research, market development, marketing management, administration, technical services, repairs, design, consultation, agency, scientific research, legal or accounting service.

Further, the term 'intangible property' as used in the above has been defined elaborately at Explanation (ii). It may be noted that the term royalties and FTS are not specifically defined but it is left to the taxpayer to define the terms. Under TPR, the definition of the intangibles is very wide to include all the transactions of intangibles with the AE's are international transaction so as to compute the ALP.

The definition of international transaction has been amended to overcome some of the decisions wherein the term 'international transaction' is given a restrictive meaning. The object of amendment as per the explanatory memorandum explaining the provisions of Finance Act, 2012 is that to 'enlarge' the scope of international transaction and also the term intangible property.

Under the TPR, the taxpayer needs to demonstrate that the international transactions with its AEs are at Arm's Length. The ALP is computed applying the Most Appropriate Method being one of the methods prescribed below:

Traditional transaction Methods are

1. Comparable Uncontrolled Price Method
2. Resale Price Method
3. Cost Plus Method

Traditional profit Method

4. Profit Split Method
5. Transactional Net Margin Method
6. Any other method as prescribed by the Tax Authorities

The term Royalty and Fee for Technical Services has been defined in sections 9(1)(vi) and 9(1)(vii) of the act respectively. These definitions have been espoused for all purposes throughout the Income-tax Act except for TP regulations. Thus, for the purpose of TP regulations, the characterisation of the expenditure or payment is necessary so as to adopt a Most Appropriate Method. Unlike expenditure transactions, which culminates into rendering of services the intangibles which consists of several items may not have profit element in each item independently, therefore, all the methods prescribed cannot be applied due to their inherent characteristics. The term intangibles include Royalty and FTS but not vice versa.

The intangibles include right to use industrial assets such as

a. Patents, trade mark, trade names, design or model

b. Artistic and literary rights

c. Intellectual property such as knowhow and trade secrets

OECD draft TP guidelines on intangibles, defines the term 'intangible' means which is not a physical asset or a financial asset which is owned or controlled for use in commercial activities. The commercial intangibles or trade intangibles include patents, knowhow, design and model and this can also be called marketing intangibles. Whereas, typical marketing intangibles include tradename, trademark that aid in the commercial exploitation of the product or service, customer list, distribution channel, unique names, symbols or pictures that have

important promotional value for the product concerned. The factors influencing the market intangibles are

a. Reputation or credibility of the trade name or trademark fostered by the quality of goods or services
b. Degree of quality control or
c. On-going R & D
d. Distribution and availability of the goods and services
e. The extent and success of the promotional expenditure incurred to familiarise the potential customers
f. The advertising and marketing expenses to develop a network of supporting relationship with distributors, agents or other facilitating agencies.

Sometimes, all the R & D expenditure may not produce any intangible or not all marketing activities will create an intangible or enhance an intangible. Certain activity which generates intangible assets may not follow the rule of cause and effect. The dividends out of R & D activity may be generated over a long period of time. It is not necessary that any kind of R & D activity will generate its intellectual property. Similarly the expenditure on marketing may not create a brand or market out of all campaign for sales. Hence, it is difficult to evaluate the degree to which particular expenditure has successfully resulted in a business asset. The marketing activities may encompass a wide range of business activities viz. market research, designing, sales strategy, planning product suitable to market needs, public relations, sales services, quality control. Sometimes, the intangible property will be bundled in a package like right to patent, trademarks, trade secrets and knowhow. In such cases, the parts of the package need to be considered separately to verify the ALP.

The characterisation of payment is important to determine the value of the intangible. The value varies depending upon the industry sector and facts of the specific case. In cases of intra group, the AEs enter into an arrangement that may not be found in transactions between the unrelated enterprises. In such situations, it is necessary to find the underlying reality in entering into such arrangements by applying the ALP. Care should be taken in determining whether any intangible exists or has been used in all such arrangements.

MNEs normally enters into legal agreements with its AEs in relation to intangibles specifying all the terms and conditions between them, especially, allocation of rights in intangibles before further expenditure on such intangibles leads to development or enhancement of the value of intangibles. Typically, the clauses of the agreement consist of

a. Legal owner of the intangibles
b. Licence details
c. Duration of the agreement
d. Scope and restrictions of use of intangibles
e. The products on which the intangibles can be used
f. Exclusive or non-exclusive
g. Restriction on further development of intangibles

The compensation for intangibles will depend on many factors that need to be considered. The factors are

1. The terms and conditions of the legal arrangements including the relevant registration, licence agreements and other relevant contracts.
2. FAR analysis and the cost incurred by the members of the MNE group in developing, enhancing, maintaining and protecting intangibles are in alignment

with the allocation of entitlement to intangible related returns.

3. The nature of services rendered and the cost incurred for rendering of such services.

It is important to recognise that incurring cost towards intangibles does not by itself create an entitlement to enhanced compensation. While evaluating whether AE has been compensated at ALP or not, it is important to consider the compensation paid and level of activity. Such factors need to be compared with comparable uncontrolled entities performing similar functions. Here it is important to note that the transactions involving the generation of substantial intangible rights differ from AE to AE depending on the region of operation of AE.

The Most Appropriate Method is selected considering the nature of intangible and the materiality of technology, knowhow, or rights and the availability of the uncontrolled comparable transactions. For any transfer pricing, the computation of the ALP depends on the Functions performed, Assets employed and Risks assumed (FAR) analysis.

In cases of intangibles, the qualitative assessment of the technology/right involved at the time of transaction is required. The assessment would include the following:

1. Nature of market
2. Value addition
3. Business strategy
4. Locational advantage
5. Activity of the taxpayer
6. Risk borne by each entity
7. Terms of the agreement
8. Industry research

FUNCTIONAL ANALYSIS

Functional Analysis is an important part in the TP study as in dealings between the two independent enterprises. Compensation usually will reflect the functions that each enterprise performs. Therefore in determining the controlled or uncontrolled transactions or entities are comparable, comparison of the functions undertaken by each of the related party is necessary. This comparison is to identify and to compare the economically significant activities and responsibilities undertaken by the independent and associated enterprises. Further the criticality of the functions is important rather than the number of the functions. Therefore it is necessary to create a sound platform to find the comparable and to make the appropriate adjustments if necessary. Functions are defined as the activities that each of the entities participating in a particular transaction performs as a normal part of its operations. In this analysis, initially the taxpayer has to define its activity and identify itself as a trader, manufacturer, agent, distributor etc. Thereafter the different functions performed to achieve its objectives needs to be analysed. In the process, the value added activities are identified and also the specific risks associated with the transactions.

The conduct of the parties is most important and varies depending on the facts of each case. The conduct of the parties should be in alignment with the terms of legal registrations and other contractual terms. The parties conduct generally is the best evidence to understand the legal agreements.

The functional analysis is conducted considering the following factors to know whether the intangible is developed, enhanced or maintained or protected:

a. Research and development
b. Marketing and advertisement
c. Legal protection

d. Decision regarding defence and protection against the infringement of intangibles
e. Design
f. Control over intangibles
g. Strategic decisions
h. Quality control
i. Budget allocation
j. Management of the affairs
k. Production equipment
l. Inbound and out bound logistics
m. Production scheduling and day-to-day to production activities
n. Training and personal management
o. Management information systems/IT services
p. Sales support and pricing

The compensation depends on the functions that each party perform in a contractual agreement.

RISKS

Risk analysis is generally critical in any functional analysis. Functional analysis is incomplete unless the material risks assumed by each party have been considered since the assumptions or allocations of risks would influence the conditions of transactions between the AEs.

Exchange Risk – Typically, a manufacturer bears the exchange risk. In case the distributor claims the same, then it is a matter to be challenged by the tax admin

Inventory risk – It relates to the losses associated with carrying finished products inventory. Losses include obsolescent shrinkage or market collapse such that products are only saleable at prices that produce a loss.

Credit risk – It is borne by the enterprise which supplies the product or services to a customer. The customer payment to the enterprise for the goods or service is differed to a mutual confirmed date. Normally, if any bad debt is borne by the enterprise who books the sales revenue. However, if the enterprise is compensated by the supplier for irrevocable claim and/or if its purchase price is determined on a resale price or a commission basis, that is proportionate to the cash revenue, then the examination of the actual conditions of the transactions between the parties including the pricing can provide an evidence whether in actual fact whether the enterprise or supplier who bears the bad debt risk.

Market risk – This risk arises when an enterprise is subject to adverse sales conditions due to either increased competition in the market place, adverse demand conditions within the market or the inability to develop markets or position products to service targeted customers.

Product liability risk – This risk arises when an enterprise product fails to perform at accepted or advertised standards.

Finance and treasury risk – These activities include cash and risk management, investor relations, financing current operations, forecasting cash flows and insurance and the cash requirements for the day-to-day operations.

R & D risk - It represents that the R & D activities performed by the enterprise which may not be successful. It is to be seen which enterprise R & D activities are carried and the associated cost.

ASSETS EMPLOYED

It is relevant and useful in identifying and comparing the functions performed to consider the assets that are employed. The OECD Guidelines provides that this analysis should consider tangible and valuable assets such as intangibles. Intangibles owned by any

particular organizations can be broadly divided into two. They are technical and marketing intangibles.

Contractual terms

In a functional analysis the contractual terms between the AEs if any, plays crucial role in determining the functions to be performed by each enterprise. It is necessary to examine the conduct of the parties, whether conforms to the terms of the contract or indicates a sham. In such cases, a further analysis is required to determine the true terms of the transaction.

TRANSFER PRICING METHODS FOR R & FTS

The selection of the most appropriate method depends on the nature of the intangible, a thorough functional analysis, availability of the uncontrolled comparables, availability of the reliable information about the comparables, degree of comparability between the controlled and uncontrolled transactions, reliability of the comparable adjustments and the combination of the above factors. Based on the above, one or more of the methods prescribed may be employed.

There are two general types of transactions which are relevant for transfer pricing purposes.

a. Transactions involving use of intangibles in connection with sale of goods or services: In this type of transaction, intangibles may be used in connection with controlled transactions in situations where there is no transfer of the intangibles. The nature of the transactions and use of the intangibles by the parties should be identified and taken into consideration while selecting the appropriate transfer pricing method

b. Transfer of intangible or rights in intangibles: In this type of transactions, it needs to be seen whether all the rights in intangibles or limited rights have been transferred. Further, it is important to verify the agreements to understand the restrictions imposed in further development or use of the intangibles. The nature and limitations of transferred intangibles for further development may impact the value of the right transferred and the comparability with identical transactions.

Comparable Uncontrolled Method (CUP): Generally the CUP method is preferred for computing the Arm's Length Price of intangibles. The standard of comparability under CUP method is very high. In this method the transaction is considered as comparable only if the provision of right to use intangible, services provided and the circumstances surrounding the controlled transactions are substantially same as those of the uncontrolled transactions. The internal comparable would give more reliable results in computing the ALP. If no internal comparable are available then resort has to be made for the external comparable. The ALP has to be determined in the following manner for external comparables:

a. The benchmarking analysis has to be made using the appropriate publically available database. In India there are no databases available exclusively for the intangibles. There are many foreign databases that are available exclusively for R & FTS namely Royalty source etc.

b. Identifying the third party comparable agreements by conducing the search process.

c. Analysing such agreements for factors such as rate of royalty, duration of the agreement, payment terms and geographical territory, nature of industry etc.

d. Understand the unique features of the R & FTS and if necessary adjustments need to be made for differences.

e. Based on the above search process identify the royalty rates.

In case of unique contribution in a transaction or highly integrated activities then the Profit Split Method may be more appropriate.

Profit Split Method (PSM): This method attempts to estimate on Arm's length compensation for each party in a controlled transaction by comparing the relative economic contribution of each party to the business as whole. The combined profit from such business activity is allocated between the AEs in two stages

a. Each AE is allocated on Arm's Length basis remuneration for routine contribution in relation to controlled transaction in the business activity.

b. The residual profit remaining after the first stage would be allocated among the AEs based on the facts and circumstances

The residual profit as arrived is divided among the parties based on the functions, risks and asset, by assigning the factors to each element. Based on the total weight of the factors to each of the AE the residual profit is divided accordingly.

The prevalent drawback of PSM is that obtaining the information from foreign affiliates and measuring the combined revenue and cost of the participating AEs in the controlled transactions. To make the comparability it may be required to restate the books and records on a basis by making the adjustment, in accounting policies and currencies. Due to lack of the data on the price charged in uncontrolled transactions, and also difficulties in computing the ALP using the PSM, the taxpayers are aggregating the royalty & FTS payments with other expense transactions.

Any other method: The CBDT has not prescribed any particular methodology under this head. But this being a residual method the taxpayer can choose to apply a method depending on the availability of the documentary evidence and the method should not fall under any of the other methods prescribed.

The computation of ALP for intangibles is hustled with many problems. The first problem will be identifying the uncontrolled comparable companies similar to the payments made to the AEs. In the Indian Transfer Pricing, there is no readily available data to compare the price charged in controlled transaction with that of the uncontrolled transactions. Due to these shortcomings, the taxpayers generally aggregating the price paid to the AEs under R & FTS with all other international transactions. Thus, the taxpayer's are resorting to applying the TNMM method as most appropriate method by comparing the net margins of the enterprises.

As per the OECD guidelines on intangibles, the factors that may be essential for the purpose of comparability analysis are exclusivity, extent and duration of legal protection, geographical scope, useful life, stage of development, rights to enhancement, revisions & updates and expectation of future benefits. In addition to the above, the factors that may also be considered are development of customers list and customer relationship, development of extensive dealership, software and other tools for the maintenance of dealership and logistical knowhow.

DOCUMENTATION

The next step would be preparation of the contemporaneous documentation for the international transactions. Rule 10D of the IT rules prescribes the documents to be maintained by a taxpayer. Typically, the documentation includes the taxpayer's business and group's business description & overview, FAR analysis, description of the international transactions, selection of

the most appropriate method, selection of the uncontrolled comparables, transaction specific documents and other supporting documentation to demonstrate the Arm's Length nature of the transactions.

JUDICIAL TREND

The tax department many a times have segregated the R & FTS payments so as to apply the CUP method. The judiciary has accepted that where royalty payments were based on RBI approval, then such royalty payments are at Arm's Length Price. (*DCIT vs. Owens Corning Industries India Pvt. Ltd. 51 Taxmann.com 276(2014) Hyd Tribunal, Rockwell Automation India Pvt. Ltd. vs. DCIT 54 Taxmann.com 218 (2015) Delhi Tribunal*). *DCIT vs. AVT MC Carmicle Ingredients Ltd. 67 Taxmann.com 322 (2016)(Chennai Tribunal)* and in case of *SI Group India Ltd. vs. DCIT 68 Taxmann.com 158(2016)(Mum-Tribunal).*

Over the period, the Transfer Pricing Officers have started computing the ALP at NIL for all the R & FTS payments due to lack of commercial expediency or the taxpayer's have not justified the payments by adducing the evidence. Even in this regard also, the judiciary is in favour of assessees in many cases. Some of them are

1. *TNS India Pvt. Ltd. vs. ACIT 32 ITR (Hyd Tribunal) 44 (2014)*
2. *Crane Software International Ltd vs. DCIT (2015) 52 Taxmann.com 19 (Bangaluru Tribunal)*
3. *Thyssunkrupp Industries India Pvt. Ltd. vs. Addl. CIT (2013) 33 Taxmann.com 107 (Mum-Trib) and in case of Showa India Pvt. Ltd. vs. DCIT 73 Taxmann.06 (2016) (delhi-Tribunal).*
4. *DCIT vs. Bata India Ltd 69 Taxmann.com 120 (2016) (Kolkatta Tribunal)*

In recent times, the notable decisions on the intangibles are the *L. G Electronics India (P) Ltd. vs. ACIT 140 ITD 41 (Delhi Trib -SB)/ 29 Taxmann.com 300 (2013)(Delhi Trib-SB) and also the Maruti Suzuki India Ltd. vs. Addl. CIT 328 ITR 210 (2010) (Delhi HC) / 192 Taxmann 317/233 CTR 105* (decision on writ petition by the taxpayer)

The facts in the Maruti Suzuki (M) case (supra) are that, M is in the business of the manufacture and sale of automobile. M entered into a licence agreement on 4-12-1992 with Suzuki (S) for use of Logo 'S' on the front of the new models of the cars manufactured by the M. The agreement is effective from 1993. During the AY 2005-06, M paid royalty of ` 198.60 cr to S and also incurred ` 107.22 cr towards non-routine advertisement expenditure. The TPO has made the addition of ` 206.52 cr for the following reasons.

a. M has not given the details of payment of Royalty. The trademark Suzuki which was owned by the S had piggy backed on the Maruti trademark without payment of any compensation by S to M.

b. The trademark Maruti had acquired value of super brand whereas the trademark Suzuki was a relatively big brand in the Indian market.

c. M did not give any bifurcation of royalty paid to S towards licence for manufacture and use of trademark. The TPO apportioned 50% of the royalty paid to the use of the trademark.

The High court held that the TPO had not tried to find out what royalty if any a comparable independent entity would have paid for the benefit derived by M from S *vide* agreement dated 12th December, 1992. The apportionment of royalty payment and considering 50% towards use of brand name and logo was absolutely arbitrary and wholly without any basis or rationale. The order of the TPO was based on no evidence which amounted to an error of law by him, the procedure followed

by him was faulty, the approach adopted by him was erroneous and the order passed by him was arbitrary and irrational. Therefore, the order passed by the TPO was set aside and laying down some general principles with a direction to consider the same.

In regular appeal of Maruti Suzuki India Ltd., 381 ITR 117 (Del.) (2016) it was held that AMP expenses are not international transaction u/s 92B of the Act. Further, the High Court observed that even applying the TNMM method, the profit margin of the MSIL is much higher than the comparables. Therefore, no transfer pricing adjustment could be made on account of *AMP expenses. In the case of CIT (LTU) vs. Whirlpool of India Ltd. 381 ITR 154 (Del) 2016* following the Maruti Suzuki India Ltd. case, it was held as under:

a. Bright Line Test not valid method for determining existence of international transaction or for determination of ALP.

b. There could not be presumption that the assessee was a subsidiary of the foreign company and that all the activities of the assessee were in fact dictated by the foreign company. The onus was on the Revenue to demonstrate through some tangible material that the two parties acted in consort and that there was an agreement to enter into an international transaction concerning the AMP expenses.

c. That there is no machinery provision in the Act to bring an internal transaction involving AMP expenses under the tax rider. In the absence of statutory provisions giving guidance about computation of the Arm's Length Price, the TPO cannot make adjustments on surmises and conjectures.

d. Chapter X can be invoked only when there is an existence of international transaction involving AMP expenses with an ascertainable price. If the Revenue is unable to demonstrate by tangible material that there was an international transaction involving AMP expenses, the question of determining the ALP of such transaction does not arise.

In the case of *Bausch & Lomb Eyecare India Pvt. Ltd. vs. Addl. CIT 381 ITR 227 (Delhi) (2016)*, it was held that there was no international transaction between assesse and its foreign associate enterprise regarding the AMP expenses. Therefore, the question of determination of ALP does not arise and incidental benefit to foreign AE not to be concluded as brand building exercise.

In case of *YUM Restaurants (I) Pvt. Ltd. vs. ITO 380 ITR 637 (Del)(2016)* it was held that the adoption of the Bright Line Test for determining the existence of an international transaction involving the advertising, marketing and promotion expenses was no longer legally permissible. Therefore, there would be need for a detailed examination of the operating agreement between the assessee, associate enterprise and the franchisees to ascertain if any part of the AMP expenses was for the purpose of creating marketing intangibles for the associate enterprise of the assessee. It was only after an international transaction involving the assessee and its associate enterprise in relation to the AMP expenses was shown to exist than the question of determining the Arm's Length Price of such international transaction would arise.

In *Hyundai Motor (I) Ltd. vs. DCIT (LTU) 69 Taxmann.com 295 (2016) (Chennai. Trib.)* – in this case, following the past decisions in the assessee's own case, the Bright Line Test is approved for determination of the ALP of brand development expenses receivable by assessee company from holding company. In this case the Delhi High Court cases have not referred.

In case of LG Electronics India (Pvt) Ltd., 140 ITD 41 (Delhi-Trib.-SB) it was held as under:

LGK was a Korea based company engaged in the business of manufacture, sale and distribution of electronic products. LGK entered into an agreement with LGI, a wholly owned Indian subsidiary for technical assistance and right to use the designs, drawings and industrial property rights for the manufacture, marketing, sale and service of the agreed products. As per the agreement, LGI agreed to pay royalty @ 1% of the sales to LGK for the use of above- mentioned intangible items for indefinite period. However, during the financial year 2006-07, LGI has not paid any royalty fees to LGK. The TPO observed that LGI has incurred expenses on advertisement, marketing and promotion including trade discount and volume rebate (collectively referred as AMP expenses) were 3.85% of the sales. He computed the uncontrolled comparables at arithmetic mean of 1.39% of expenses on the so called AMP expenses. The TPO was of the opinion that LGI was promoting LG brand owned by its foreign AE, hence, should have been adequately compensated by the foreign AE. Applying the Bright Line Test, the TPO held that expenses upto 1.39% of the sales should be considered as having been incurred for the taxpayer's own business and the remaining part which was in excess of such % at 2.46% on brand promotion of the foreign AE. Such excess works out to ` 161.21 crores and was proposed as a TP adjustment on account of AMP expenses for brand building.

Before the DRP, LGI was not successful and upholding the order of the TPO. The DRP directed to make 13% of the AMP expenses as further adjustment. LGI was before the ITAT and the matter was posted before the special bench. Before the Delhi ITAT (SB) special bench, LGI has contended many legal issues but the ITAT in a majority decision has upheld the order of the TPO on many legal issues but on the issue of computation of the ALP, the matter was set aside to the file of the TPO to recompute the ALP applying the single method out of the 5 methods prescribed in section 92C(1). In this regard, the ITAT has laid down the guidelines to determine the cost or value of the international transaction of brand/logo promotion through AMP expenses incurred by LGI for its LGK.

In above cases, from the facets of the decisions it is not known that whether any FAR analysis has been presented by the taxpayer or not at the time of assessment. However, the judiciary has not referred anywhere nor considered in their decisions. I believe, otherwise the decisions would have been different. In Maruti's case the TPO has objected to the payment of Royalty, whereas in the LG India case, though no royalty has been paid, the TPO has objected on the commercial expediency on not charging for enhancement of brand value. Further the courts have held that the Bright Line Test cannot be applied and AMP expenses do not fall under the definition of international transaction itself. Mostly all the decisions are in favour of the tax payers. In transfer pricing the 'intangible' is the most difficult subject and requires enormous study and analysis over a period. I believe, it is not a subject which can be decided on a year to year basis. Take the example of NOKIA. Once a 'pioneer' in cell phone manufacturing has vanished from the market in no time. The reason may be that it could not travel with the change or trend of the competitors. Therefore restraint is the need of the hour in assigning the intangible value. It is obligatory on the part of the taxpayers to support their contentions with FAR analysis so as to avoid the huge transfer pricing adjustments. The intangible is entangled with many rights which need to be unwinding before uncontrolled comparables are selected and prescribed method is chosen. The Delhi High Court has laid down guidelines about the AMP expenses. Though the decisions are welcome but certainly the transfer pricing

assessment trend is a matter of concern and it is necessary for taxpayers to present the FAR analysis in detailed manner to support their contentions.

Some of the issues in intangibles which need deliberation for transfer pricing purposes are under.

1. The expenditure on account of intangibles viz R & FTS are subject to TDS u/s. 115A, whether the adjustment under transfer pricing still possible. If there is a reduction in R & FTS in transfer pricing, whether TDS already deducted can be refunded or not.

2. What if the R & FTS is paid for is used for the business at abroad. Whether this transaction can still be international transaction. Whether R & FTS being international transaction, is it compulsory to determine the ALP by using any of the method as most appropriate method.

3. The method to be used for R & FTS

4. How the transfer pricing is applicables when the payee of R & FTS has a PE in India.

Conclusion: In the transfer pricing the most difficult and tedious process would be demonstrating that the intangible payment are at ALP. However, it is essential to validate that the intangible payments are at ALP, by adopting thorough functional and risk analysis. A proper FAR analysis will absolve the enterprises from the clutches of the transfer pricing. Often the enterprises fail to do so due to lack of information. The enterprises may explore the option of Advanced Price Agreement mechanism with the tax department to pre-empt validation of the transaction and to avoid the protracted litigation.

The past decade of the transfer pricing assessments in India created huge litigation and unpleasant atmosphere among the MNEs. India opened its economy to attract the investment & development so that its economy is accelerated. Such opening of up of economy has both advantages and disadvantages. MNEs sets up the business considering the economic advantage to them in each region. It is a fact, if no economic advantage is attached to their business there is no need for them to come to India. In my view the transfer pricing is an economic subject which needs to be evaluated by the experts in the respective subjects considering the economic activity of the each MNE. Such expert study should be guiding factor both for the MNEs and the tax department. The tax policy should concentrate on the collection of the taxes with minimum interference in the business of the MNEs. The transfer pricing cannot be a tool to neutralise the economic advantage of MNEs especially in a growing economy. The transfer pricing should be used sparingly instead of resorting to the routine additions with the comparisons. The recent amendments to the Income Tax rules about the computation of ALP may reduce the litigation a little but the basic structure of the assessment of transfer pricing remains the same. The transfer pricing assessment should be for a block period (may be for 3 years) instead of yearly affair with proper help from the experts study so that the transfer pricing remains as regressive mechanism.

> Truth can be stated in a thousand different ways, yet each one can be true.
>
> — *Swami Vivekananda*

CA Nilesh M. Kapadia

Analysis of FTS and Royalties under UN / OECD / US Model of Tax Treaties

1. Background

The scope and coverage of taxation of Royalties is not the same under the UN/ OECD and US models of tax treaties. These models are developed by these authorities to serve as a starting/reference point while negotiating a tax treaty. The OECD Model is prepared by the Organization for Economic Cooperation and Development whose membership is restricted to 35 countries, which include most of the EU countries, and also USA, Australia, Japan and other developed countries. As such, the model of OECD seeks to protect the interests of the developed countries. On the other hand, the UN Model is prepared by the United Nations, which has membership of over 190 countries, most of which are developing/ under developed countries. As such, the UN Model seeks to protect the interests[1] of such countries. The US Model is the model used by USA, which is materially different from both the other models in several respects. This obviously is a base used by USA while negotiating treaties with other countries.

2. Royalties

2.1. Taxability in source country

Article 12(1) of the OECD Model provides that Royalties are taxable only in the State of residence of the payee. i.e. the source State does not have any right to tax royalties arising in that State.

Article 12(1) of the UN Model provides that the same may be taxed both in the state of source and the State of residence. Article 12(2) provides that the State of source may also tax the royalties if the recipient of the royalties is the beneficial owner of the same at a rate to be agreed upon between the States at the time of entering the treaty. This tax is applicable to the gross amount of the royalty, i.e. without any deduction for expenses incurred to earn the same. Usually, such gross taxation is agreed upon by the States at a rate lower than the rate used for taxation on net basis, to indirectly compensate for the inherent deduction for expenses which could be claimed.

The US Model is identical to the OECD Model in as much as both exclude the source State's right to tax.

1. The said protection is done by way of varying the scope, coverage and rate of tax of the respective type of income.

2.2. Coverage

Each of the models has a different definition of the term royalties. The same are summarized below for ease of comparison.

OECD Model Convention	UN Model Convention	US Model Convention
The term 'royalties' as used in this Article means payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic, or scientific work including cinematograph films, any patent, trademark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience	The term 'royalties' as used in this Article means payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic, or scientific work, including cinematograph films, or films or tapes used for radio or television broadcasting, any patent, trade mark, design or model, plan, secret formula or process, or for the use of, or the right to use, industrial, commercial or scientific equipment, or for information concerning industrial, commercial or scientific	The term 'royalties' as used in this Article means • Any consideration for the use of, or the right to use, any copyright of literary, artistic, or scientific or other work (including computer software, cinematograph films, audio or video tapes or disks, and other means of image or sound reproduction), any patent, trademark, design or model, plan, secret formula or process, or other like right or property, or for information concerning industrial, commercial or experience scientific experience; and gain derived from the alienation of any property described in subparagraph (a), provided that such gain is contingent on the productivity, use or disposition of the property.

The definition of "royalty" under the OECD Model Convention omits equipment royalty (the term "use of, or right to use, industrial, commercial or scientific equipment" is missing). The OCED Model also excludes rentals for films or tapes used for radio or television broadcasting.

As regards the US Model Convention, while it broadly follows the OECD Model, the definition of royalties in the US Model Convention also includes capital gains arising from alienation of the property the right to use or use of which gives rise to royalties to the extent that such gain is contingent on the productivity, use, or disposition of the property.

The UN is currently debating amendment and enlargement of the scope of equipment royalties.

Certain terms used in the definition of royalties are not defined in the models, and these may be defined under the domestic laws.[2]

2.3. Royalty payment coexisting with PE

Article 12(4) of the UN Model provides that in the following circumstances, royalties will be taxed under Article 7/14 (dealing with Business Profits/Independent Personal Services), and not under Article 12. The difference will be that in such situations, the taxation in the source country will be on net basis, albeit at normal rates of tax. The

2. US Model Commentary (2006)

situation under which such changed method of taxation would apply are:

- Royalties arise in the Source State;
- The beneficial owner of the royalties is resident of the other contracting State;
- Such beneficial owner carries on business in the State of source through a permanent establishment (PE) situated therein, or performs independent personal services from a fixed base (FB) situated therein; and
- The right or property in respect of which the royalties are paid are effectively connected to such PE or FB.

The US Model is similar to the UN Model in this respect.

The OECD Model has similar provision in Article 12(3) which is *pari materia* with the UN provision, except that it does not refer to FB as the OECD Model does not have Article 14 (Independent Personal Services). The OECD Model also does not have reference to Article 7(1)(b) or (c) which provide for Force of Attraction, as such provision is present in the UN Model alone. The OECD Commentary permits counter of abuse of treaties through transfer of rights or equipment to a PE set up in a jurisdiction which provides concessional tax treatment to royalty income by making suitable domestic anti avoidance rules.

2.4. Source Rule

Article 12(5) of the UN Model provides that royalties shall be considered as arising in the State in which the payer of the royalty resides, or in which the payer (whether or not resident of the contracting state) has a PE/FB, if (i) the liability to pay the royalties was incurred in connection with the PE/FB; and (ii) the royalties are borne by the PE/FB. It is not material whether the property or equipment in relation to which the royalty is paid is situated in the State of source.

Since the OECD and US Models does not have any taxing rights allocated to the state of source, there is no source rule present in both these models.

2.5. Special relationship

Article 12(6) of the UN Model is an anti-abuse provision in the Model, to prevent misuse of the Article to attract no/lower tax rate by taking unintended benefit. The Article provides for a ceiling of application of the Article to an amount which, in cases where there is a special relationship between the parties involved, would have been agreed upon/paid by the parties in the absence of such a relationship. In other words, if there is a special relationship between the parties, and a higher amount is claimed to have been paid as royalties (which would attract a lower rate of tax if the Article has applied), the Article would apply only to the amount which would have been paid in the absence of such a relationship. The excess amount paid would be taxable as per the domestic laws of the respective contracting state, having regard to other provisions of the treaty.

The US Model also has a similar provision, which effectively provides that the Article will apply only to the arm's length amount of royalties. The US Model Commentary clarifies that if the excess payment is to be treated as dividends under the domestic law, the same will be taxed as such, subject to the rate limitation contained in Article 10(2).

The OECD Model also has the identical anti-abuse provision contained in Article 12(4). As such, under the OECD Model, the rule of no source taxation of royalties will be capped to the arm's length amount of royalties. Any excess payment will be dealt with under the domestic laws of the states, subject to other provisions of the treaty.

3. Fees for Technical Services (FTS) / Fees for Included Services (FIS)

3.1. Most of the treaties signed by India have an Article dealing with taxation of FTS/FIS. However, as of date none of the three model conventions have any Article dealing with the same. As such, neither the terms FTS/FIS have not been defined in any of the models, nor have the taxing rights of the source country been allocated

under any of the models. This is primarily on account of the OECD and US not considering such payments as demanding special rules or allocating taxing rights to the source States.

3.2. Most of the treaties signed by India, including those with the OECD countries have an Article on FTS. The treaty with USA has an Article on FIS, which has been extrapolated into few other treaties. The concept of FTS was introduced by India in its domestic legislation in 1976, and today many OECD countries also have this Article in their treaties, though the Article is conspicuous by its absence in the OECD Model.

3.3. Till date, even the UN Model does not have any Article dealing with taxation of FTS. However, for the last eight years the UN has been debating the inclusion of an Article[3] to the UN Model, with a view to protecting the tax base of the developing countries. The new Article is likely to be included in the 2017 update to the UN Model.

3.4. With the rapid changes in modern economies, particularly with respect to cross-border services, it is now possible for an enterprise resident in one State to be substantially involved in another State's economy without a permanent establishment or fixed base in that State and without any substantial physical presence in that State. In particular, with the advancements in means of communication and information technology, an enterprise of one contracting State can provide substantial services to customers in the other contracting State and therefore maintain a significant economic presence in that State without having any fixed place of business in that State and without being present in that State for any substantial period. The OECD/G20 Base Erosion and Profit Shifting Project, Action 1: Final Report "Addressing the Tax Challenges of the Digital Economy" (2015) illustrates the difficulties faced by tax policy makers and tax administrations in dealing with the new digital business models made available through the digital economy. The Report did not recommend, for the time being, a withholding tax on digital transactions (which include digital cross border services); nor did it recommend a new nexus for taxation in the form of a significant economic presence test. However, it was recognized that countries were free to include such provisions in their tax treaties, among other additional safeguards against BEPS.

3.5. The draft commentary recognizes that Fees for Technical Services may also result in the erosion of the tax base of countries that are prevented from taxing such fees by the provisions of the United Nations Model Convention. Fees for Technical Services are usually deductible against a country's tax base if the payer is a resident of the country or a non-resident with a permanent establishment or fixed base in the country. The reduction or erosion of a country's tax base by deductible fees for technical services is not generally objectionable. If the payer is an enterprise, the payments are legitimate expenses incurred by the payer for the purpose of earning income and should be deductible (assuming, of course, that the amount of the payments is reasonable). If the country is entitled to tax the non-resident service provider on the fees earned for the technical services, the reduction of the country's tax base by the deductible payments is offset by the country's tax on those fees. Where technical services are provided by an enterprise of one contracting State to an associated enterprise in the other contracting State, there is the possibility that the payments may be more

3. The current draft Article is available at http://www.un.org/esa/ffd/wp-content/uploads/2016/10/12STM_CRP1_Services.pdf

or less than the arm's length price of the services. Within a multinational group, fees for technical services may sometimes be used to shift profits from a profitable group company resident and operating in one country to another group company resident in a low-tax country. Assume, for example, that Company B, an enterprise resident in Country B, a low-tax country, provides managerial, technical or consultancy services to Company A, an associated enterprise resident in Country A, a high-tax country. Assuming that the tax treaty between Country A and Country B contains provisions following those of the United Nations Model Convention, Company B can avoid having a permanent establishment in Country A by not establishing a fixed place of business in Country A and by not furnishing services in Country A for more than 183 days in any 12-month period. Thus, before the adoption of the new Article, even if Company B was subject to tax on its income from services provided to Company A under the domestic tax law of Country A, the income would not have been taxable by Country A as a result of the tax treaty between Country A and Country B. If, for whatever reason, Company B is not taxable by Country B on that income, or is subject to a low rate of tax on such income, the multinational enterprise will have effectively shifted profits from a relatively high-tax country (Country A) to a relatively low-tax country (Country B).

3.6. In keeping with the principles underlying the development of the UN Model, the draft Article provides for source taxation of FTS, at a rate to be negotiated between the countries. The draft Article lays down nothing about the mode of taxation in the State in which fees for technical services arise. Therefore, it leaves that State free to apply its own laws and, in particular, to levy the tax either by deduction at source or individual assessment. As with other provisions of the United Nations Model Convention, procedural questions are not dealt with in the Article. Each State is able to apply the procedure provided in domestic law.

3.7. The term FTS has been defined in draft sub Article (3) as—

> 3. The term "Fees for technical services" as used in this Article means any payment in consideration for any service of a managerial, technical or consultancy nature, unless the payment is made: (a) to an employee of the person making the payment; (b) for teaching in an educational institution or for teaching by an educational institution; or (c) by an individual for services for the personal use of an individual.

As such, the broad definition is on the lines of definition contained in Explanation below section 9(1)(viib) of India' Income-tax Act, 1961, which also refers to managerial, technical or consultancy services. The draft commentary discusses the pros and cons of whether reimbursement of expenses should form part of FTS. After detailed reasoning, the draft refrains from making any reference to such reimbursements, and leaves it to the domestic laws of both the States.

The Commentary also has few examples on what would or would not constitute FTS, which will be useful while interpreting the Model, or even treaties which have identical wordings. From the Indian perspective, the jurisprudence while interpreting the domestic meaning of the said term, as also in most Indian treaties will also be useful.

3.8. Like royalties, the draft Article on FTS also has a provision that in case the payee of the FTS has a PE/FB in the source country to which the FTS are effectively connected, the same shall be taxable on net basis in the country of source.

3.9. The source rule is also similar to that of royalties, i.e. the FTS will be deemed to arise in the State where the payer resides, or has his PE/FB if the FTS are incurred by such PE/FB and borne by the same.

3.10. The draft also has a provision similar to Article 12(6) as a limitation to the scope to the arm's length amount of fees, in the event of payments between having special relationship.

3.11. In spite of the UN Committee having a majority view that for several reasons mentioned a new Article on FTS is needed to be introduced in the UN Model, a significant minority of the members of the Committee did not agree with the policy justifications set forth above for the Article. Fundamentally, these members did not agree with the justifications set forth in paragraphs 2 and 5 above that rapid changes in modern economies, particularly with respect to cross-border services, enable non-resident service providers to be substantially involved in another State's economy without a physical presence. Rather, these members were of the view that in cases of payments for technical services that are not performed in the payer's State, there is no nexus to that State that warrants taxation by that State on the payment. In the view of these members of the Committee, as a policy matter, taxation of fees for technical services is warranted only when the service provider has a sufficient nexus to the payer's State, which typically is in the form of a fixed base or a permanent establishment. In other words, to justify taxation of technical services in a State, the services should be performed in that State with the degree of nexus required by Articles 5, 7 or 14.

3.12. These members were also concerned that the inclusion of the new Article would lead to trade distortions as the taxation of goods and services would operate on a different basis. The reason for this is that the profits of an exporter of goods are taxable only in its State of residence, whereas, under the new Article, what is in effect an import tariff would be applied to technical services.

3.13. Conceding to the minority view, the UN Model commentary has an **alternative** draft of the new Article, which reflects **the minority view**.

3.14. The alternative draft provides that instead of "Fees for Technical Services", the same will apply to "Fees for Services". Only Paragraphs 5 and 6 of the draft Article will be replaced by the following, with the other paragraphs remaining unaltered. The alternative draft thus has the following two Paragraphs, instead of the ones discussed earlier.

5. For the purposes of this Article, fees for services shall be deemed to arise in a contracting State if: (a) the services are performed in that State; or (b) the payer is a resident of that State and the fees are paid to a closely related person unless the payer carries on business in the other contracting State or a third State through a permanent establishment situated in that State, or performs independent personal services through a fixed base situated in the other contracting State or a third State and such fees are borne by that permanent establishment or fixed base; or (c) the payer has in that State a permanent establishment or a fixed base in connection with which the obligation to pay the fees for services was incurred and such fees are borne by that permanent establishment or fixed base.

6. For the purposes of this Article, a person is closely related to an enterprise if, based on all the relevant facts and circumstances, one has control of the other or both are under the control of the same persons or enterprises. In any case, a person shall be considered to be closely related to

an enterprise if one possesses directly or indirectly more than 50 per cent of the beneficial interest in the other (or, in the case of a company, more than 50 per cent of the aggregate vote and value of the company's shares or of the beneficial equity interest in the company) or if another person possesses directly or indirectly more than 50 per cent of the beneficial interest (or, in the case of a company, more than 50 per cent of the aggregate vote and value of the company's shares or of the beneficial equity interest in the company) in the person and the enterprise. [For the purposes of this Article, an individual shall be connected to another individual if the individual is related to that other individual by blood relationship, marriage or adoption.]

3.15. As such, the scope and coverage of the new Article is sought to be diluted by the Alternative Draft, primarily as it seeks to restrict the scope to services which are performed in the source state, which is not the case in the draft Article.

3.16. There was also a minority view for including an FIS concept with royalties instead of introducing the FTS Article. This view wanted inclusion of FIS in the definition of Royalties in Article 12(3), and insertion of following two paragraphs in Article 12.

4. For the purposes of this Article, "Fees for included services" means payments of any kind to any person in consideration for the rendering of any technical or consultancy services (including through the provision of technical or other personnel) if such services: (a) are ancillary and subsidiary to the application or enjoyment of the right, property or information for which a payment described in paragraph 3 is received; or (b) make available technical knowledge, experience, skill, knowhow, or processes, or consist of the development and transfer of a technical plan or technical design.

5. Notwithstanding paragraph 4, "Fees for included services" does not include payments: (a) for services that are ancillary and subsidiary, as well as inextricably and essentially linked, to the sale of property; (b)for services that are ancillary and subsidiary to the rental of ships, aircraft, containers or other equipment used in connection with the operation of ships or aircraft in international traffic; (c) for teaching in or by an educational institution; (d) by an individual for services for the personal use of an individual; (e) to an employee of the person making the payments or to any individual or individuals for professional services as defined in Article 14 (Independent Personal Services).

The scope of this term is also sought to be explained by including examples explaining the same.

3.17. In the end, it is also proposed to amend Article 23 for providing credit of taxes paid in the source country by the residence country.

3.18. As stated earlier, the US Model does not have any Article dealing with FTS. The US-India DTAA has the concept of FIS, in its Article dealing with royalties. The Memorandum of Understanding on FIS included in the US India DTAA issued by the US IRS gives several examples which explain the concept of "make available", and the same will be useful not only while interpreting the India-US DTAA, but also the third option under the UN Model, if and when the same is introduced.

CA Jayesh Kariya, CA Manjusha Todankar,
CA Prerana Shet

Export Commission – Whether Fees for Technical Services?

1. Backdrop

With the globalisation, the Indian entrepreneurs have been going overseas to explore global business opportunities not only in the form of exports but also for execution of large EPC projects, buying out manufacturing and technical capabilities. The entrepreneurs have been extensively tapping of international markets for local and export sales. In order to incentivise, they have been offering commission or referral fees to its non-resident agents. Since it entails payment to a non-resident agents, the rigors of Section 195, dealing with withholding tax from payments to non-residents are attracted. The Authors have discussed nuances of such arrangement in detail.

2. Taxability of exports commission

2.1 Concept and taxation rules

Taxability of export commission has always been a matter of litigation since long. Before arriving at a conclusion on taxability of export commission, one need to characterise the services rendered by the overseas agent, which could be either be commercial services or a technical services. If the services are characterised as merely commercial services, the payment made to the foreign agents/service provider (say F Co) would be taxable in India only if:

— Income is received or deemed to be received by F Co in India [Section 5(2)(a)]

— Income accrues or deemed to accrue to F Co in India [Section 5(2)(b)]

— F Co (Agent) has a business connection in India [Section 9(1)(i)]

On the other hand, if the services are characterised as technical services, the same would be covered by the provisions of Section 9(1)(vii) of the Act. As covered in the article published elsewhere in this publication, in order to term the payment to agents as 'FTS', the nature of services should be either managerial, technical or consultancy services.

In the event the commission is for finder's fee simpliciter, where the agent's only job is referencing clients and the commission is paid for any order that has materialised, in that case the taxpayer should be able to adopt a stand that such payment is not taxable as FTS.

The CBDT Circular No. 23 of 1969 (which is now withdrawn) provided guidance on this issue. As per Example 4 of the said Circular *"Foreign Agents of Indian Exporters – Where a foreign agent of Indian exporter operates in his own country and his commission is usually remitted directly to him and is, therefore not received by him and is, therefore, not received by him or on his behalf in India. Such*

an agent is not liable to income-tax in India on the commission"

The aforesaid stand was further clarified in detail in Circular 786 of 2000 (which is also now withdrawn).

However, since the withdrawal of these Circulars, this issue has led to further litigation. In *CIT v. Toshoku Ltd. (125 ITR 525)*, the SC held that a non-resident acting as an agent outside India did not carry on any business operations in India. In the said case, the Supreme Court had held that sales commission, which were earned by the non-resident for services rendered outside India could not be deemed to be income which had either accrued or arisen in India.

In essence the said Circular interpreted provisions of Section 9 of the Act whereby the underlying principles propounded were that the commission income of a foreign agent cannot be taxed in India if there exists no business connection in India and the income is not received in India. The subsequent amendments to Section 9 of the Act, which relates to business connection in case of dependent/independent agent and taxability of FTS, do not alter the legal position.

2.2 Exception provided in clause (b) under Section 9(1)(vii) of the Act

Section 9(1)(vii)(b) provides that income by way of FTS payable by a resident to non-resident shall be deemed to accrue or arise in India except where it is payable in respect of services utilised in a business or profession carried on by such person outside India or for the purpose of making or earning income from any source outside India.

Accordingly, Section 9(1)(vii)(b) deals with two situations, i.e. payment made for services to be utilised for the purpose of business or profession carried out outside India and making or earning income from any source outside India.

In context of international transaction, the term source can be interpreted[1] as one of the following:

— The 'payer' of the income; or

— The 'Contract' by virtue of which the income is received; or

— The actual activity carried out

Source can be said to be in India where the contract is executed in India or all the activities are carried out in India. In some cases, it can also be a case wherein only part of the contract is performed in India and the essential activity of contract is to be performed outside India. Accordingly one can argue that the payments to agents are covered within the exception under Section 9(1)(vii)(b) of the Act.

Recently the Mumbai Tribunal had the occasion to consider this issue in case of Pahilajrai Jaikishin (66 TM 30). Here, the taxpayer had paid export commission to foreign agents for rendering services abroad in relation to sourcing of export orders and for collecting payments on behalf of the assessee-firm. The export commission was paid only on receipt of export proceeds. The Agent got samples of products sent by the taxpayer approved by the overseas buyers. Once approval is granted, the agent gave a feedback by informing a taxpayer what is in demand and ultimately it is the suppliers choice to develop the particular product or not and the agent has no say in the same.

The Tribunal observed that these foreign agents have rendered services for sourcing export orders and for collecting payments for and on behalf of the taxpayer which is their business income not liable to tax in India. The other services such as sample approvals, etc. are

1. Reliance in this regard can be placed on:

- *Lufthansa Cargo India (P.) Ltd. vs. DCIT (2004) (91 ITD 133)*
- *Asia Satellite Telecommunications Co. Ltd. vs. DCIT (2003)(85 ITD 478)*

incidental to the main activity of sourcing of export orders by these foreign agent for the assessee-firm. These services cannot be described as managerial, consultancy or technical services as contemplated under Explanation 2 to Section 9(1)(vii) of the Act to come within deeming provisions of Section 9(1)(vii) of the Act.

Whereas, Delhi High Court in the case of *CIT vs. Havells India Ltd. (21 TM 476)* took a contrary view. The assessee paid certain amounts to US Company for purpose of obtaining witness testing of AC contractor. It was contended that the services were utilised for export of goods outside India and thus the source of income is outside India. The HC held that the export contracts are concluded in India and the assessee's products are sent outside India after manufacturing in India. Thus the source of income is the contract and manufacturing activity, both of which are in India.

A question also arises whether the source is a customer or not? If the customer is located outside India and the services or goods are provided outside India, then whether the income accrues to foreign agent outside India. In this regard, it is interesting to note the observations of AAR in case of Dell International Services India Pvt. Ltd. (172 TM 418).

"The source of such income is very much within India and the entire business activities and operations triggering the exports take place within India. The source, which generates income must necessarily be traced in India. Having regard to the fact that the ***entire operation*** *are carried on by the applicant in India and income is earned from such operation taking place in India, it would be futile to contend that the source of earning income is outside India i.e. the country of the customer. Source is referable to* ***starting point or the origin or the spot where something spring into existence. The fact that the customer and the payer is non-resident and the end product is made available to that foreign customer does not mean that the income is earned from a source outside India."***

In many rulings, the focus is given on the activities carried out in India by the payer. In fact, in the context of taxability of income, the focus should be on the activities carried out by the agent or service provider as the latter is the source of income for the recipient because the taxability is to be examined is of the non-resident. If the source is traced back to origin of income of the payer, then the source will always be in India and the income will always be taxed in the hands of the non-resident agent in India.

2.3 Business transactions and FTS

In case where the arrangement does not involve an agency arrangement simpliciter, key facts need to be analysed in detail to determine whether the said services can be classified as FTS. Some illustrations along with judicial precedents have been discussed below:

2.3.1 Commission in respect of trade exhibition to be held in India

In the case of Rajiv Malhotra (284 ITR 564), the Authority of Advance Rulings ('AAR') held that commission payable to a non-resident agents for soliciting foreign participants abroad for a trade exhibition to be held in India, would be taxable under the Act in view of specific provisions of Section 5(2)(b) r/w s. 9(1)(i) as the right to receive the commission arose in India.

In this instance, the commission would arise in India only when the exhibitors participate in the show and make full and final payment to the organiser. As the source of income of the agent is participation by the exhibitors in the exhibition in India operations for holding the show are to be carried on in India.

2.3.2 Commission for procurement of export orders

Payments made to foreign agents to procure export orders outside India on commission basis has been examined by Madras High Court in *CIT vs. Faizan Shoes (P.) Ltd. (367 ITR 155)*. For procuring orders for leather business

from overseas buyers, wholesalers or retailers, as the case may be, the non-resident agent is paid 2.5 per cent commission on FOB basis. The non-resident agent does not provide technical services for the purposes of running of the business of the assessee in India. After exhaustive analysis of the different provisions of the Act, it was concluded that the services rendered by the non-resident agent can at best be called as a service for completion of the export commitment and would not fall within the definition of 'fees for technical services'.

The aforesaid decision has also been followed in *CIT vs. Orient Express (56 TM 331).*

2.3.3 Fees paid in connection with getting patent registered outside India

Bangalore Tribunal in the case of Titan Industries (11 SOT 206) has held that fee paid to non-resident for getting patent registered outside India, for earning income from a source outside India not being taxable in India, assessee was not obliged to deduct tax at source. Source of income is located outside India as payment made was for sales to be made outside India.

2.3.4 Referral Fees

In certain businesses like services business, F Co bags a consolidated global contract from another multinational company. Both these groups have their group companies in India and such Indian entities enter into local contracts, as per the terms agreed between their overseas parents for provision of services. Since the F Co refers this work to its Indian entity I Co, I Co pays certain referral fee to F Co. As regards taxability of referral fees, the taxpayer could contend that while the source of revenue is in India, the referral fees are paid for referring the contracts to I Co and as such no technical services have been provided. However, as the eventual source is in India, the tax authorities could contend that F Co has business connection in India and accordingly, it I Co is not entitled to claim benefit of exclusion provided under Section 9(1)(vii).

2.3.5 Logistics support services

Mumbai Tribunal in case of Yash Raj Films Pvt. Ltd. (28 TM 247) had the opportunity to opine on taxability of logistics support services. The Tribunal held that merely if some managerial skills are required to render services, it would not make the services as managerial service. The requirement of knowledge of local law on part of the service provider to render services would not change the basic nature of services which otherwise are commercial in nature. The services rendered outside by overseas service provider in connection with making logistics arrangement outside India are in the nature of commercial services and not FTS.

3. Summing up

Taxability of payments to overseas service provider including overseas agencies is a contentious issue and have passed the test of various Courts with conflicting views leaving the issue open to the Courts to decide. Important aspects to be examined are – whether the services commercial in nature or technical in nature; whether the services are covered by exclusion provided in section 9(1)(vii) of the Act; whether the source of income is in India or outside India. This aspects require detailed analysis of the contract, activities carried out, location of activities, nexus of income with the source of income, etc. In case the analysis and conclusions are not accepted by the Tax Authorities, then the tax would need to be deducted and paid to the Government. Any non-compliance would also result in penal consequences e.g. payment of tax, interest, penalty and more importantly disallowance of expenses. In the larger interest of taxpayers and minimising tax disputes, the CBDT should issue a circular with guiding principles on taxability of export commission or remuneration to overseas service provider.

Fees for Technical Services – Its interpretation under different business transactions and tax ramifications

1 Backdrop

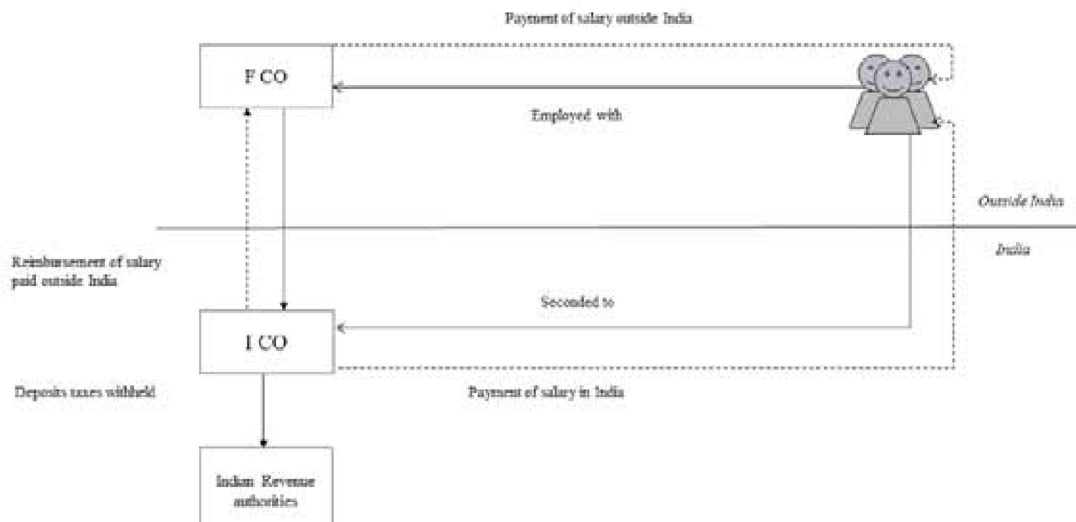
With the globalisation, the business models have undergone a sea change. Despite digitisation and automation, the need for skilled human capital has been on the rise for most countries especially developing countries as the requirement is grave there. This has resulted in movement of professional and skilled people across the globe and thereby necessitated the evolvement of various models of secondment of people to effectively and efficiently utilise the workforce and also to manage other commercials and softer aspects associated with it. The secondment arrangement between third parties or group entities poses many challenges beginning from commercial aspects, people related issues, country risks, tax costs, social security aspects and many more. Over the period of time, taxation risk has been gaining more importance given the aggressive approach of the Revenue Authorities across the globe. We have discussed many of such challenges and mitigation aspects in this article.

We have also briefly touched upon two more aspects – (i) taxability of exports commission as Fees for Technical Services ('FTS') and (ii) in order to characterize any income as FTS does some sort of human intervention is a MUST?

2 Secondment of personnel

2.1 Typical secondment arrangement

Foreign company ('F Co.) seconds its employee to an Indian entity ('I Co'). During the period of secondment, the employee generally works exclusively under the control and supervision of I Co. F Co is generally not be responsible for any work or activities of employee during the period of secondment. In most cases, the deputed employee is on dual employment whereby part of the salary is paid to the employee in his home country (more often than not for the continuity of the social security benefits) and part is paid in India. I Co. withholds tax on whole of the salary earned by the expatriate employee and deposits it with the Indian Government. Further the F Co. may cross charge the salary paid to the expatriate employee outside India to I Co.



Such arrangement is largely seen in case of long-term secondment as compared to the short-term deputation (say below six months). Under the short-term arrangement, generally, the employee remains on the payroll of the F Co and the I Co pays fees to the F Co for deputation of people.

2.2 Issues arising out of secondment arrangement

At the outset, the arrangement appears to be simple, but there are various complex issues that get associated with such arrangement and the companies have to manage tax challenges both in the home country and the source country. The tax issues that emerge are highlighted below:

— Whether the cross charged would be regarded as 'FTS'

— Whether the amount cross charged by F Co is taxable in India?

— Whether the I Co would be required to withhold tax from such payments or reimbursements?

— Whether the secondment of expatriate employees to India would lead to Permanent Establishment ('PE') of F Co in India (Fixed PE or Service PE)

— Whether remuneration earned by expatriates from such deputation is taxable in source country or not?

— Whether such arrangement leads to double taxation – non-deduction in the hands of the I Co and taxation of remuneration in the hands of employees?

Let's analyse some of the issues in more detail.

2.3 Concept of FTS under the Income-tax Act and Double Taxation Avoidance Agreements (Tax Treaty)

Under the Income-tax Act, 1961 (the Act), income of F Co from such deputation arrangement could be taxes as a business income, if the arrangement results into a PE or FTS, depending on the terms arrangement and the factual aspects. As per Section 9(1)(vii) of the Act FTS is defined as -

"any consideration (including any lump sum consideration) for the rendering of any managerial, technical or consultancy services (including the provision of services of technical or other personnel) but does not include consideration for any construction, assembly, mining or like project undertaken by the recipient or consideration which would be income of the recipient chargeable under the head "Salaries"

Further, under the Tax Treaty, Article 12 or Article 13 deals with FTS taxation. The term FTS is defined differently under different treaties. In many treaties, the definition is the same as given in the Act. Whereas in some treaties like India-USA, the word "managerial services" is missing and at the same time many treaties like India-USA, India-Singapore, etc. provide for the concept of "Make Available". As per the "Make Available" concept, the payment for services would be regarded as FTS if the services make available technical knowledge, experience, skill, know-how or process or consist of the development and transfer of a technical plan or technical design. The concept of "make available" has been explained in details in the MoU to India-USA tax Treaty and various judicial rulings. Further, the Treaty provides that if the F Co has a PE in the source country (say India) and the FTS is effectively connected/ attributed to such PE, then such FTS is taxable as business income under Article 7. Invariably, provision of training as part of rendition of services would satisfy the criteria of "make available" and would qualify as FTS.

Therefore, the two fundamental questions that needs to be addressed are:

— Whether the deputation arrangement tantamount to rendering of services by F Co to I Co? and

— Whether the payments could be characterised as FTS OR whether

the payments are in the nature of reimbursement of costs incurred by the F Co?

In order to address the first question, one need to analyse whether the F Co is acting as **the employer** and is providing services through its personnel. Thereafter, one need to assess whether the services are in the nature of FTS or not.

2.4 Concept of Employer – Legal employer vs. economic employer

2.4.1 In the context of secondment arrangement, the concept of economic employer and legal employer is very relevant to ascertain whether the arrangement triggers taxation or not. The Supreme Court in the case of Morgan Stanley Inc., had analysed the concept of legal employer and economic employer while examining the issues of existence of Service PE in India of Morgan Stanley USA. The Supreme Court had discussed various aspects such as – supervision of the work, control over the employee, responsibilities for the work done by the employee, employee is on whose payroll, whether the employee has a lien on the F Co, etc.

2.4.2 OCED Guidance

As the issue is very contemporary one, the OECD Commentary on Model Tax Convention has laid down following key factors for determining who should be the economic employer of an expatriate.

— Who has the authority to instruct the individual regarding the manner in which the work has to be performed;

— Who controls and has responsibility for the place at which the work is performed;

— Who puts the tools and materials necessary for the work at the individual's disposal;

— Who determines the number and qualifications of the individuals performing the work;

— Who has the right to select the individual who will perform the work and to terminate the contractual arrangements entered into with that individual for that purpose;

— Who has the right to impose disciplinary sanctions related to the work of that individual;

— Who determines work schedule and the holidays of that individual;

— For whose interest is the individual working; and

— Who has the right to appraise the individual and determine promotions / increments.

The OECD has illustratively explained the above factors with the help of certain examples to determine the economic employer.

Example	Particulars	Conclusion as per OECD
1	A Co, which specialises in providing training services, enters into an agreement with B Co, a resident of State B, to train its employees on the usage of new software. Mr X an employee of A Co is sent to B Co's office to provide the training.	X is under formal employment of A Co and his services are an integral part of A Co's business and are rendered on behalf of A Co, A Co is the employer

Example	Particulars	Conclusion as per OECD
2	C Co, a resident of State C, has developed a marketing strategy for the group. In order to ensure that the strategy is well understood and followed by D Co, its group subsidiary, C Co sends one of its employees 'X' to work in D Co's headquarters.	Since in this case C Co's business includes the management of worldwide marketing activities and X's own activities are an integral part of that activity. X will be an employee of C Co.
3	E Co, a resident of State E, is part of a group that owns and operates hotels worldwide. F Co another group company and resident of state F, has shortage of employees to run the hotel. Thus, Mr X an employee of E Co is sent to work at the reception desk of F Co for a period of five months. Mr X remains formally employed and paid by E Co. F Co pays the travel expenses of Mr X and pays a management fee to E Co based on X's remuneration.	In this case OECD suggests that the activities of F Co may first need to be checked before looking at the activities of the formal employer. The activities of Mr X can be regarded as integral part of F Co's business and if even under the domestic law of state F the services of X are considered to have been rendered to F Co in an employment relationship, state F could then logically consider that F Co as the employer.
4	G Co, a resident of state G, carries on business of filling temporary business needs for specialised personnel. H Co, a resident of state H, engaged in providing engineering services on building sites, requires an engineer for 5 months to work on its project in state H. G Co recruits Mr X, a resident of state X, under a five month employment contract. Under a separate contract between G Co and H Co, G Co agrees to provide the services of X to H Co during that period and G Co will pay X's remuneration, social contributions, travel expenses and other employment benefits and charges.	In this case, the activities of X are integral by nature to the business of H Co. Thus, Mr X will be treated as an employee of H Co.

[Contd... on page 139]

Ms. Anjali Agrawal & Ms. Bhakti Vaidya

HOT SPOT
Can a Limited Liability Partnership be appointed as a Tax Auditor??

The Income-tax Act, 1961 has provided persons engaged in the profession of chartered accountancy with various avenues and opportunities, including income tax representation, tax audit assignments, issuance of certificates and reports under the Act, etc.

Section 44AB of the Income-tax Act, 1961 ("the Act") which deals with tax audit, provides that the accounts of the specified persons are required to be audited by an accountant, as defined in the Explanation below section 288(2) of the Act.

Prior to June 1, 2015, the term *"accountant"* was defined under section 288 of the Act to mean a chartered accountant within the meaning of the Chartered Accountants Act, 1949 ("the CA Act"). Under the CA Act, until the year 1959, "chartered accountant" was defined to mean a person who is a member of the Institute and who is in practice. Thereafter, the definition was amended and the words "and who is in practice" were omitted. Thus presently, the term "chartered accountant" under the CA Act means a member of the Institute, and there is no condition as to his being in practise to be a chartered accountant.

Last year, an amendment was brought in the definition of the term *"accountant"* under section 288 of the Act, (***vide***, the Finance Act, 2015). The amended definition of the term "accountant" is as follows:

> *"In this section, "accountant" means a chartered accountant as defined in clause (b) of sub-section (1) of section 2 of the Chartered Accountants Act, 1949 who holds a valid* ***certificate of practice*** *under sub-section (1) of section 6 of that Act, but does not include* ***except for the purposes of representing the*** *assessee under sub-section (1)—*
>
> *(a) In case of an assessee, being a company, the person who is not eligible for appointment as an auditor of the said company in accordance with the provisions of sub-section (3) of section 141 of the Companies Act, 2013 (18 of 2013);* ***or***
>
> *(b) In any other case,—*
>
> *(i) The assessee himself or in case of the assessee, being a firm or association of persons or Hindu undivided family, any partner of the firm, or member of the association or the family;*

(ii) In case of the assessee, being a trust or institution, any person referred to in clauses (a), (b), (c) and (cc) of sub-section (3) of section 13;

(iii) In case of any person other than persons referred to in sub-clauses (i) and (ii), the person who is competent to verify the return under section 139 in accordance with the provisions of section 140;

(iv) Any relative of any of the persons referred to in sub-clauses (i), (ii) and (iii);

(v) An officer or employee of the assessee;

(vi) An individual who is a partner, or who is in the employment, of an officer or employee of the assessee;

(vii) An individual who, or his relative or partner—

(i) Is holding any security of, or interest in, the ***assessee:***

Provided *that the relative may hold security or interest in the assessee of the face value not exceeding one hundred thousand rupees;*

(ii) Is indebted to the assessee:

Provided *that the relative may be indebted to* ***the assessee for an amount not exceeding one*** *hundred thousand rupees;*

(iii) Has given a guarantee or provided any security in connection with the indebtedness of any third person to the assessee:

Provided *that the relative may give guarantee or provide any security in connection with the indebtedness of any third person to the assessee* ***for an amount not exceeding one hundred*** *thousand rupees;*

(viii) A person who, whether directly or indirectly, has business relationship with the assessee of such nature as may be prescribed;

(ix) a person who has been convicted by a court of an offence involving fraud and a period of ten years has not elapsed from the date of such ***conviction"***

(underlined for emphasis)

While the amended definition generated much stir in our Chartered Accountants' fraternity on the effect of various exclusionary clauses provided therein, during the said commotion, one important effect of the said amendment, which has not got the required attention, is the amendment in the main body of the definition, where an additional condition has been inserted that the 'accountant' must hold a valid Certificate of Practice (COP) under section 6(1) of the CA Act.

Section 6 of the CA Act reads as under:

> *"(1) No member of the Institute shall be entitled to practise whether in India or elsewhere unless he has obtained from the Council a certificate of practice"*
>
> *(underlined for emphasis)*

Now, under the Scheme of the CA Act, only individuals can become a member of the Institute. A Limited Liability Partnership (LLP), or for that matter, even a partnership firm cannot hold a COP.

As per section 2(2) of the CA Act, a member of the Institute shall be deemed to be practice, when individually, or in partnership with Chartered Accountant's in practice, he engages himself in the practice of accountancy, auditing, or services that in the opinion of the Council, are or may be rendered by a Chartered Accountant in practice.

It is pertinent to note that the term "partnership" under the CA Act, has been specified to include partnership in limited liability partnership.[1]

1 MCA General Circular No. 10/2011.

Thus, after the introduction of the concept of LLP in 2009, Chartered Accountants do conduct their practice even under an LLP structure. In the context of the appointment as a statutory auditor, section 141[2] of the Companies Act, 2013 provides that a firm or an LLP can be appointed as auditor of a company, if a majority of its partners are practising in India. However, a provision similar to Companies Act, 2013 is not present in the Act.

Hence, a crucial issue that needs to be addressed is as to whether the insertion of a specific condition in the definition of the term 'accountant' under the Act, that the person must hold a valid COP, would forbid LLPs/firm of Chartered Accountants to be appointed as Tax Auditor under section 44AB of the Act.

In any case, as far as partnership firms are concerned, it may be possible to argue that since such firms do not enjoy separate legal entity, as long as valid COPs are held by all its partners, it would be eligible to be appointed as a Tax Auditor under the Act. Indeed, section 13(2) of the General Clauses Act, 1897[3], provides that words in the singular includes plural. Therefore, it is arguable that when all partners of the firm are holding certificate of practice, they would be regarded as 'accountants' within the meaning of section 288 of the Act.

In fact, the legal position that a partnership firm is only a 'group of individuals' has been approved even by the Supreme Court in *Mahabir Cold Storage vs. CIT (1991)(188 ITR 91)(SC)*, wherein it is held that:

> *"Under the Indian Partnership Act, 1932, the partnership firm registered thereunder is neither a person nor a legal entity. <u>It is merely a collective name for the individual members of the partnership...</u> Either under the 1922 Act or the 1961 Act, firm is liable to be separately assessed to tax as well as all its partners in their capacity as individuals if they have taxable income."*
>
> *(underlined for emphasis)*

Similarly, it was held by the Supreme Court in the case of Malabar Fisheries Co. v. CIT (120 ITR 49) as under:

> *"A partnership firm under the Indian Partnership Act, 1932, is not a distinct legal entity apart from the partners constituting it and equally, in law, the firm as such has no separate rights of its own in the partnership assets and when one talks of the firm's property or firm's assets all that is meant is property or assets in which all partners have a joint or common interest."*

Furthermore, the Supreme Court while upholding the validity of levy of wealth tax on HUF held that an "individual" would include a group of individuals.[4]

Accordingly, based on the foregoing legal position of a partnership firm, it is arguable that the foregoing amendment in the definition of 'accountant' under the Act would not have any impact on the partnership firms of Chartered Accountants.

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2 141. (1) A person shall be eligible for appointment as an auditor of a company only if he is a chartered accountant:
Provided that a <u>firm whereof majority of partners practising in India</u> are qualified for appointment as aforesaid may be appointed by its firm name to be auditor of a company.
(2) Where a <u>firm including a limited liability partnership</u> is appointed as an auditor of a company, only the partners who are chartered accountants shall be authorised to act and sign on behalf of the firm.

3 Section 13. Gender and number - In all (Central Acts) and Regulations, unless there is anything repugnant in the subject or context, words importing the masculine gender shall be taken to include females, and words in the singular shall include the plural, and vice versa.

4 Banarsi Dass v. WTO (56 ITR 224)(SC)

Besides, the past practice under the Act too indicates the acceptance of a partnership firm as 'accountants' for the purposes of the Act. Accordingly, where earlier[5], it was mandated that the power of attorney of an assessee to be represented before the Hon'ble Tribunal can be provided to only individuals or group of individuals and not a firm or any legal body, the said condition was subsequently relaxed in respect of partnership firms ***vide*** Notification No. F. 161-Ad(AT)/70, dated May 8, 1973, wherein it was provided as under:

> *"In partial modification of the instructions in this office previous note of even number, dated 30-12-1971, the President, Income-tax Appellate Tribunal, has decided that it will also be sufficient if, while filing the power of attorney in favour of a firm in a case, the constitution of the firm is also intimated to the Tribunal when its power of attorney is filed."*

Also, even under the Guidance Note on Tax Audit under section 44AB of the Act issued by the Institute of Chartered Accountants of India, it is provided that though the section refers to the accounts being audited by an 'accountant' which means a Chartered Accountant, the audit can also be done by a firm of Chartered Accountants, in which case, it would be necessary to state the name of the partner who has signed the audit report on behalf of the firm. The member signing the report as a partner of a firm should give his membership number while registering himself in the e-filing portal[6].

Therefore, on the foregoing basis, the firms of Chartered Accountants might continue their practice of undertaking tax audits despite the new definition of 'accountant' under the Act. However, regrettably, the same may not be true for an LLP of Chartered Accountants, since as is well known, an LLP is a different structure as compared to a partnership firm, having a separate legal existence, limiting the personal liability of its partners and is considered as a body corporate.

It is also relevant to note that there is a ceiling of maximum 20 partners in a partnership firm, while there is no such restriction in a limited liability partnership. Further, the maximum number of tax audit assignments that can be taken up by a chartered accountant is 60. Therefore, a firm having 20 partners can take up tax audit assignments of 1,200 companies. In the absence of a cap to the total number of partners in an LLP, an LLP can have larger number of partners and can take up larger number of tax audit assignments. Thus, if LLPs are permitted to undertake Tax Audit assignments there would effectively be no limit on the number of Tax Audit assignments undertaken under a single name.

Considering that presently, the demography of chartered accountants in practice is still primarily focused in sole proprietary firms and smaller partnership firms, the fact that there is effectively no limit to the number of tax audit assignments that can be taken up in the LLP structure, it shall virtually wipe out the small scale practice.

In any case, considering the increasing preference of Chartered Accountants to practice through an LLP structure, it would be vital to bring a suitable amendment/ clarification under the Act to permit even LLPs to undertake Tax Audit assignments. However, any clarification in this respect should, ideally, limit the total number of assignments that can be taken up by both the partner, and the LLP, to the same extent as could be carried out by a partnership firm.

5 vide Notification: No. F. 161-Ad(AT)/70, dated December 30, 1971.

6 Para 9.3 of the Guidance Note

FAQs on Withdrawal of Legal Tender Character of the existing Bank Notes in the denominations of ` 500/- and ` 1,000/-

1. **Why is this scheme introduced?**
   The incidence of fake Indian currency notes in higher denomination has increased. For ordinary persons, the fake notes look similar to genuine notes, even though no security feature has been copied. The fake notes are used for antinational and illegal activities. High denomination notes have been misused by terrorists and for hoarding black money. India remains a cash based economy hence the circulation of Fake Indian Currency Notes continues to be a menace. In order to contain the rising incidence of fake notes and black money, the scheme to withdraw has been introduced.

2. **What is this scheme?**
   The legal tender character of the existing bank notes in denominations of ` 500 and ` 1,000 issued by the Reserve bank of India till November 8, 2016 (hereinafter referred to as Specified Bank Notes) stands withdrawn. In consequence thereof these Bank Notes cannot be used for transacting business and/or store of value for future usage. These Bank Notes can be exchanged for value at any of the 19 offices of the Reserve Bank of India or at any of the bank branches or at any Head Post Office or Sub-Post Office.

3. **How much value will I get?**
   You will get value for the entire volume of notes tendered at the bank branches/RBI offices.

4. **Can I get all in cash?**
   No. You will get up to ` 4,000 per person in cash irrespective of the size of tender and anything over and above that will be receivable by way of credit to bank account.

5. **Why I cannot get the entire amount in cash when I have surrendered everything in cash?**
   The Scheme does not provide for it, given its objectives.

6. **` 4,000 cash is insufficient for my need. What to do?**
   You can use balances in bank accounts to pay for other requirements by cheque or through electronic means of payments such as Internet banking, mobile wallets, IMPS, credit/debit cards etc.

7. **What if I don't have any bank account?**
   You can always open a bank account by approaching a bank branch with necessary documents required for fulfilling the KYC requirements.

8. What if, if I have only JDY account?

A JDY account holder can avail the exchange facility subject to the caps and other laid down limits in accord with norms and procedures.

9. Where can I go to exchange the notes?

The exchange facility is available at all Issue Offices of RBI and branches of commercial banks/ RRBS/UCBs/State Co-op. banks or at any Head Post Office or Sub-Post Office.

10. Need I go to my bank branch only?

For exchange up to ` 4,000 in cash you may go to any bank branch with valid identity proof.

For exchange over ` 4,000, which will be accorded through credit to bank account only, you may go to the branch where you have an account or to any other branch of the same bank.

In case you want to go to a branch of any other bank where you are not maintaining an account, you will have to furnish valid identity proof and bank account details required for electronic fund transfer to your account.

11. Can I go to any branch of my bank?

Yes you can go to any branch of your bank.

12. Can I go to any branch of any other bank?

Yes, you can go to any branch of any other bank. In that case you have to furnish valid identity proof for exchange in cash; both valid identity proof and bank account details will be required for electronic fund transfer in case the amount to be exchanged exceeds ` 4,000.

13. I have no account but my relative/friend has an account, can I get my notes exchanged into that account?

Yes, you can do that if the account holder relative/friend etc. gives you permission in writing. While exchanging, you should provide to the bank, evidence of permission given by the account holder and your valid identity proof.

14. Should I go to bank personally or can I send the notes through my representative?

Personal visit to the branch is preferable. In case it is not possible for you to visit the branch you may send your representative with an express mandate i.e. a written authorisation. The representative should produce authority letter and his/her valid identity proof while tendering the notes.

15. Can I withdraw from ATM?

It may take a while for the banks to recalibrate their ATMs. Once the ATMs are functional, you can withdraw from ATMs up to a maximum of ` 2,000/- per card per day up to 18th November, 2016. The limit will be raised to ` 4,000/- per day per card from 19th November, 2016 onwards.

16. Can I withdraw cash against cheque?

Yes, you can withdraw cash against withdrawal slip or cheque subject to ceiling of ` 10,000/- in a day within an overall limit of ` 20,000/- in a week (including withdrawals from ATMs) up to 24th November, 2016, after which these limits shall be reviewed.

17. Can I deposit Specified Bank Notes through ATMs, Cash Deposit Machine or Cash Recycler?

Yes, Specified Bank Notes can be deposited in Cash Deposits Machines/Cash Recyclers.

18. Can I make use of electronic (NEFT/RTGS/IMPS/Internet Banking/Mobile banking etc.) mode?

You can use NEFT/RTGS/IMPS/Internet Banking/Mobile Banking or any other electronic/non-cash mode of payment.

19. How much time do I have to exchange the notes?

The scheme closes on 30th December, 2016. The Specified banknotes can be exchanged at branches of commercial banks, Regional Rural Banks, Urban Co-operative banks, State Co-operative Banks and RBI till 30th December, 2016.

For those who are unable to exchange their Specified bank notes on or before December 30, 2016, an opportunity will be given to them to do so at specified offices of the RBI, along with necessary documentation as may be specified by the Reserve Bank of India.

20. I am right now not in India, what should I do?

If you have Specified bank notes in India, you may authorise in writing enabling another person in India to deposit the notes into your bank account. The person so authorised has to come to the bank branch with the Specified bank notes, the authority letter given by you and a valid identity proof (Valid Identity proof is any of the following: Aadhaar Card, Driving Licence, Voter ID Card, Passport, NREGA Card, PAN Card, Identity Card issued by Government Department, Public Sector Unit to its Staff)

21. I am an NRI and hold NRO account, can the exchange value be deposited in my account?

Yes, you can deposit the Specified bank notes to your NRO account.

22. I am a foreign tourist, I have these notes. What should I do?

You can purchase foreign exchange equivalent to ` 5,000 using these Specified Bank Notes at airport exchange counters within 72 hours after the notification, provided you present proof of purchasing the Specified Bank Notes.

23. I have emergency needs of cash (hospitalisation, travel, life saving medicines) then what I should do?

You can use the Specified Bank Notes for paying for your hospitalisation charges at Government hospitals, for purchasing bus tickets at Government bus stands for travel by State Government or State PSU buses, train tickets at railway stations, and air tickets at airports, within 72 hours after the notification.

24. What is proof of identity?

Valid Identity proof is any of the following: Aadhaar Card, Driving Licence, Voter ID Card, Passport, NREGA Card, PAN Card, Identity Card issued by Government Department, Public Sector Unit to its Staff.

25. Where can I get more information on this scheme?

Further information is available on our website (www.rbi.org.in) and the website of the Government of India (www.finmin.nic.in)

26. If I have a problem, whom should I approach?

You may approach the control room of RBI by e-mail: publicquery@rbi.org.in or on Telephone Nos. 022 22602201/022 22602944

Press Information Bureau
Government of India
Ministry of Finance
10-November-2016 10:28 IST

Replies given by Revenue Secretary Dr. Hasmukh Adhia on the questions relating to action by Income Tax Department in respect of old currency deposited in banks

Q.1 A lot of small businessmen, housewives, artisans, workers may have some cash lying as their savings at home, will the income tax department ask questions if the same is deposited in banks?

A.1: Such group of people as mentioned in the question need not worry about such small amount of deposits up to ` 1.5 or ` 2 lakhs, since it would be below the taxable income. There will be no harassment by Income Tax Department for such small deposits made.

Q.2: Will the Income Tax Department be getting reports of cash deposits made during this period? If so, will the current threshold of reporting requirement of reporting cash deposits of more than ` 10 lakhs will only continue?

A.2: We would be getting reports of all cash deposited during the period of 10th November to 30th December, 2016 above a threshold of ` 2.5 lakhs in every account. The department would do matching of this with income returns filled by the depositors. And suitable action may follow.

Q.3: Suppose the department finds that huge amount of cash above ` 10 lakhs is deposited in a bank account, which is not matching with the income declared, what would be the tax and penalty to be paid on the same?

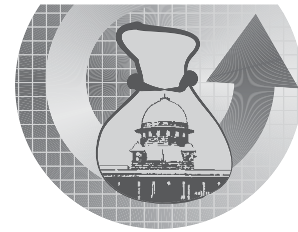
A.3: This would be treated as the case of tax evasion and the tax amount plus a penalty of 200% of the tax payable would be levied as per the section 270(A) of the Income-tax Act

Q.4: It is believed that a lot of people are buying jewelry now, how does department plan to tackle this?

A.4: The person who buys jewelry has to give his PAN number. We are issuing instructions to the field authorities to check with all the jewelers to ensure that this requirement is not compromised. Action will be taken against those jewelers who fail to take PAN numbers from such buyers. When the cash deposits of the jewelers would be scrutinized against the sales made, whether they have taken the PAN number of the buyer or not will also be checked.

ERRATA

In the October, 2016 issue of The Chamber's Journal (Page 141), the subject of the Essay of the 3rd Price winner of The Dastur Essay Competition was wrongly printed as "Religion and Terrorism" instead of "Reshaping India through Priceless Heritage". The error is regretted.



B.V. Jhaveri, *Advocate*

DIRECT TAXES
Supreme Court

S. 50B: Important law explained on what constitutes a "slump sale" and whether capital gains on liquidation of a firm are chargeable to tax

Vatsala Shenoy vs. Joint Commissioner of Income-tax – [Civil Appeal No. 1234 of 2012 dated 18th October, 2016]

1. In 1995-96, M/s. Mangalore Ganesh Beedi Works, a partnership firm was dissolved and thereafter it was sold by the partners to the other three partners as a going concern. The case of the assessee was that it was a capital receipt in their hands not exigible to income-tax. The AO treated it as a capital gain chargeable to tax. The assessee's successive appeal to the Commissioner (Appeals), the Appellate Tribunal and the High Court had failed, thereby sustaining the order of the AO.

2. As per the Partnership Deed of M/s. Mangalore Ganesh Beedi Works, the firm got dissolved on 6th December, 1987 by efflux of time. However, because of the difference of opinion among the erstwhile partners, the affairs of the firm could not be wound up and two of the partners filed in 1988 a petition in the High Court under Part X of the Companies Act, 1956. The business of the partnership firm continued because of the interim order passed by the High Court in view of clauses 3 and 16 of the Partnership Deed. Finally on 14th June, 1991, the order was passed in the said Company Petition for winding up the affairs of the firm by selling its assets as an ongoing concern. This order of the High Court had become final in the year 1994 after the withdrawal of the Special Leave Petition. Accordingly, the firm was to be sold as an ongoing concern to such of its partner/s, who makes an offer of a highest price.

3. Three partners individually and in group made the bid which was the highest and therefore, the same was accepted by the High Court on 21st September, 1994. The business and the assets of the firm were handed over to these partners by the Official Liquidator on 7th January, 1995.

4. On these facts, the AO computed income from 1st April, 1994 to 20th November, 1994 as the business of the firm including the entire capital gains on sale as a going concern. The income for the second period from 21st November, 1994 till 31st March,

1995 was assessed in the hands of the AOP. In order to protect the interest of the Revenue, the AO had added the amount taxable in the hands of the firm in the assessment of the AOP.

5. The total proceeds of ` 92 crore was first apportioned among the assessees in the ratio in which they had received the said amount. Thereafter, this amount is divided into LTCG and STCG. Two components of LTCG are taken into consideration, namely, 'goodwill' and 'sale of land'. Likewise, STCG is arrived at in respect of transfer of movables which were depreciable assets. The approach adopted by the AO was to take into consideration the market value of the assets of the firm, namely land, building and plant & machinery which had already been evaluated by the Registered Valuer. The market value of these three assets was ` 21,52,90,000/-. Thereafter, the balance amount of ` 70,47,10,000/- was treated as representing goodwill of the firm which was taxed as LTCG.

6. The counsel for the assessees submitted that the aforesaid approach of the AO is incorrect, invalid and impermissible in law.

7. It was submitted that the firm was sold as a going concern and there could not have been any capital gain on the sale of ongoing concern. He argued that the undertaking that was transferred as a going concern was a capital asset. However, at that time, there was no provision as to how the asset of the firm when sold is to be computed as a capital gain. Such a provision was introduced for the first time by the Finance Act, 1999 by inserting section 50B of the Act with effect from 1st April, 2000, laying down the mechanism for computation of capital gains in case of Slump Sale.

8. It was, therefore, argued that prior to 1st April, 2000, the slump sales were not taxable. Relying on the decision of the Supreme Court in the case of *PNB Finance Ltd. vs. CIT (307 ITR 75),* it was contended that the sale of ongoing concern to the AOP had to be treated as a slump sale within the meaning of section 2(42C) of the Act and therefore, it was not permissible for the AO to assign the amount of ` 92 crore into different heads of Land, Building and Plant & Machinery and treating the balance amount as goodwill. It was a capital asset as an ongoing concern which was sold at ` 92 crore and in the absence of provisions relating to mode of computation and deduction at the relevant time, consideration was to be treated as capital receipt and no capital gain tax was payable thereon.

Their Lordships of the Supreme Court rejected the contention of the assessee and held as under:

(i) What follows from the aforesaid facts is that the firm stood dissolved with effect from December 6, 1987; the company petition had to be filed by two partners in view of eruption of disputes among the partners; the business was carried on by the partners with controlling interest as an interim arrangement; the income was assessed in their hands as AOP and not in the hands of the firm which had already been dissolved; assets of the company were put to sale in accordance with Clause 16 of the Partnership Deed of a dissolved firm, though as a going concern; and outgoing partners (assessees herein) received their net share of the value of the assets of the firm out of the

amount received by way of sale of the assets of the firm as per Clause 16 of the Partnership Deed. On the aforesaid facts, it becomes clear that asset of the firm that was sold was the capital asset within the meaning of Section 2(14) of the Act. It is not even disputed. Once it is held to be the "capital asset", gain herefrom is to be treated as capital gain within the meaning of Section 45 of the Act.

(ii) The assessees, however, are attempting the wriggle out from payment of capital gains tax on the ground that it was a "slump sale" within the meaning of Section 2(42C) of the Act and there was no mechanism at that time as to how the capital gains is to be computed in such circumstances, which was provided for the first time by Section 50B of the Act with effect from April 01, 2000. However, this argument fails in view of the fact that the assets were put to sale after their valuation. There was a specific and separate valuation for land as well as building and also machinery. Such valuation has to be treated as that of a partnership firm which had already stood dissolved.

(iii) As per the aforesaid definition, sale in question could be treated as slump sale only if there was no value assigned to the individual assets and liabilities in such sale. This has obviously not happened. It is stated at the cost of repetition that not only value was assigned to individual assets, even the liabilities were taken care of when the amount of sale was apportioned among the outgoing partners, i.e., the assessees herein.

(iv) Once we hold that the sale in question was not slump sale, obviously Section 50B also does not get attracted as this section contains special provision for computation of capital gains in case of slump sale. As a fortiori, the judgment in the case of *PNB Finance Limited (2008) 13 SCC 94 : 307 ITR 75* also would not apply.

(v) When we apply the said legal principle to the facts of the instant case, we find that the partnership firm had dissolved and thereafter winding up proceedings were taken up in the High Court. The result of those proceedings was to sell the assets of the firm and distribute the share thereof to the erstwhile partners. Thus, the 'transfer' of the assets triggered the provisions of Section 45 of the Act and making the capital gain subject to the payment of tax under the Act.

(vi) In so far as argument of the assessees that tax, if at all, should have been demanded from the partnership firm is concerned, we may only state that on the facts of this case that may not be the situation where the firm had dissolved much before the transfer of the assets of the firm and this transfer took place few years after the dissolution, that too under the orders of the High Court with clear stipulation that proceeds thereof shall be distributed among the partners. In so far as the firm is concerned, after the dissolution on December 6, 1987, it had not filed any return as the same had ceased to exist. Even in the interregnum, it is the AOP which had been filing the return of income earned during the said period. The High Court has touched upon this aspect in greater detail in para 30 of its judgment.

Jitendra Singh & Sameer Dalal
Advocates

DIGEST OF CASE LAWS
Tribunal

REPORTED

1. Sections 131 & 133 (6) of the Income-tax Act, 1961 – Power to call information – Assessing Officer sent a letter of inquiry to assessee to verify source of said cash deposit – As there was no response to the said letter the A.O. formed belief that income of assessee had escaped assessment and, consequently, assessed such cash deposits – Held A.O. sent an invalid letter of enquiry as no proceeding was pending before him, thus, the assessee's non-response could not constitute material to form belief of escapement of income – Further, the A.O. proceeded on fallacious assumption that bank deposits constituted undisclosed income, over-looking fact that source of deposits need not necessarily be income of assessee. A.Y. 2006-07

Amrik Singh vs. ITO – [(2016) 142 DTR 6 (Asr.) (Trib.)]

The assessee was maintaining a savings bank account in which cash deposits were made by him. Assessee did not file any return of income. The A.O. sent a letter of inquiry to the assessee to verify the source of said cash deposit in the bank account. In absence of any response to said letter, the A.O. formed belief that income of the assessee had escaped assessment, and he issued a notice under section 148 of the Act proposing to assessee the income escaping assessment. In absence of any compliance with the notices the A.O. completed the assessment under section 147 of the Act. The CIT(A) in appeal upheld the order of the A.O.

On appeal Tribunal observed that the letter issued by the A.O. did not make mention of the provision under which it has been issued, thus, the Tribunal examined various provisions of the Act viz., 133 (6), 131 (1), 131 (1A) and 131 (2), to ascertain as to under which provision it was issued. The Tribunal noted that the enquiry letter was issued by the Income Tax Officer, that is, an officer below the rank of the Income-tax authorities referred to in the second proviso to section 133(6). Thus, prior approval was required to be obtained from the competent authority before exercising power under section 133(6) of the Act. In the assessee's case the Tribunal noted that there was nothing on record to suggest that any prior approval was obtained, or letter of enquiry sent by the A.O., mentioned of any such approval taken. Thus, the power exercised by the A.O., without compliance with the second proviso to section 133(6), amounted to an illegal exercise of power. Further, the enquiry letter did not merely ask for information from the assessee, the letter required the assessee to produce, cash book and ledger and documentary evidence for the source of the deposit of cash which is beyond the scope of provisions of section 133(6) of the Act. As regards provisions of section 131(1) of the Act the Tribunal held that it is only during the pendency of some proceeding before the Assessing Officer, that an Income Tax authority can exercise the power vested

in them under section 131(1) of the Act. However, in the fact of the case no proceedings were pending before the A.O. when he issued the letter of inquiry requiring the assessee to, produce evidence. Thus, the letter of inquiry was not validly issued under section 131(1) of the Act also. Thus, the Tribunal held that the letter did not require any cognisance to be taken of, and being so, the assessee was not obliged to respond to this invalid and *non est* so-called letter of enquiry, requiring the assessee, to produce evidence.

Further, the Tribunal following the decision of, *Bir Bahadur Singh Sijwali vs. ITO – [(2015) 68 SOT 197 (URO) (Del.)]* held that the reassessment proceedings so initiated by the A.O. were bad in law and liable to be quashed as the A.O. had initiated the reopening proceedings merely on the fact that the deposits had been made in the bank account without indicating that these deposits constitute income which has escaped assessment.

UNREPORTED

1. Cash credit – Section 68 read with section 133A of the Income-tax Act, 1961 – Merely on the basis of surrender made during course of survey –Assessing Officer could not make addition where the assessee during the course of assessment retracted the statement given by it and also furnished all evidences proving the genuineness of debentures and fixed deposits. A.Y.: 2010-11

Dy. CIT vs. Bansal Credits Ltd. – [ITA No. 3918 / Del / 2013, Order dated: 19-9-2016; Delhi Bench]

The assessee was engaged in the business of financing of automobiles. The assessee for its activities raised funds through debentures and fixed deposits from its investors. During the course of survey action carried out against the assessee as the assessee was not able to file full details concerning the genuineness of the debentures and fixed deposits it surrendered the total income of ` 3.50 crores. Thereafter, the assessee retracted its statement [after almost ten (10) months] given during the survey, filed its return of income and produced voluminous details and evidences to substantiate the genuineness of the debentures and fixed deposits received by it, however, it could not produce debenture holders and depositors. The A.O. made the addition of ` 3.50 crores as unexplained credit under section 68 of the Act. The CIT (A) deleted the addition as according to him the assessee had discharged the onus of proving the cash credit under section 68.

On appeal Tribunal held that the A.O. had made the addition under section 68 of the Act only because of the surrender made by the assessee during the course of survey under section 133A of the Act. The addition in the assessment proceedings should be based upon the evidences/ material gathered during the course of survey rather on the basis of statement recorded during the course of survey. Further, the Tribunal observed that in assessee's case, no material was collected during the course of survey which could establish that the credit was non-genuine.

2. Capital gains – Section 50C of the Income-tax Act, 1961 – Provisions of section 50C of the Act could not be applied to sale of development rights of land owned by assessee. A.Y. 2005-06

Voltas Ltd. vs. ITO – [ITA No. 5330 / Mum. / 2009, Order dated 16-9-2016; Mumbai Bench]

Assessee entered into an agreement with developers for development of a plot of land allotted to it. The assessee disclosed long-term capital gain arising on sale of development rights. The A.O. invoking the provisions of section 50C of the Act, adopted value of stamp valuation authority and substituted it with actual sales consideration shown by the assessee and increased the capital gain declared by the Appellant. The CIT(A) confirmed the action of the A.O.

On appeal the Tribunal held that, the provisions of section 50C are deeming provisions thus, provisions are to be construed strictly. The capital asset transferred by the assessee was, 'Development Rights in the land' and not the 'Land' itself. The term, 'capital asset' mentioned in section 50 C of the Act specifically refers and confines its meaning to 'land or building or both'. Thus, the action of A.O. in applying the provisions of section 50C of the Act and substituting any value other than the amount of actual sales consideration received by the assessee was not justified.

CA Tarunkumar Singhal & Sunil Moti Lala, *Advocate*

INTERNATIONAL TAXATION
Case Law Update

A. SUPREME COURT

1) Apex Court admits SLP on whether for computing arm's length price only the value of international transactions and not the assessee's entire turnover should be considered

CIT vs. Firestone International Pvt. Ltd. – TS-806-SC-2016- TP

Facts

1. The assessee was engaged in the business of exporting diamonds and manufacturing of jewellery. During transfer pricing proceedings for AY 2006-07, the TPO made an addition of ` 1.20 crore in respect of import and export of polished diamonds, adopting TNMM at entity level.

2. The assessee filed an appeal before the Tribunal wherein it was held that since ALP was to be determined only with reference to international transactions, ALP could only be considered on the value of such transactions, and not on the assessee's entire turnover and held that since the assessee was entitled to the benefit of the safe harbour range of 5%, no addition was required.

3. Aggrieved, Revenue preferred an appeal before the High Court on the following substantial questions of law:

"Whether, on the facts and in the circumstances of the case and in law, the Tribunal is justified in restricting the adjustment only on international transactions where the assessee has selected TNMM and applied the same on entity level because presumption underlying arm's length principle is that uncontrolled transactions are at arm's length, and therefore, if the overall margins are less than arm's length margins, the short fall must be on account of AE transactions only and not on pro rata basis."

"Whether, on facts and in the circumstances of the case and in law, the Tribunal is justified in deleting addition … as the adjustment is within + /- 5% as the ITAT has restricted the adjustment only on AE transactions which has resulted in the adjustment being within +/- 5%"

4. The Court observed that the first question itself was academic, and did not arise from the order of the Tribunal and accordingly held that there was no reason to entertain this question of law. In respect to the second question, the Court held that the decision of the Tribunal was a factual determination of the ALP, which was found to be within +/-5% safe harbour range and thus it held that the Tribunal decision was not perverse or arbitrary, and accordingly dismissed this question of law.

5. Aggrieved, the Revenue filed an SLP before the Hon'ble Apex Court.

Judgment

1. The Apex Court admitted the SLP filed by the Revenue against the order of the Hon'ble High Court.

B. HIGH COURT

2. Related party transaction filter to be computed by considering the sales of the comparable in the denominator and not total expenses plus sales – Companies engaged in sale of software products, companies providing high end services requiring superior level of man power and human resources could not be compared to companies providing basic ITES services – Companies having different financial year ending are not comparable in view of Rule 10B(4)

CIT vs. PTC Software I Pvt. Ltd. – TS-788-HC-2016 (Bom.) - TP

Facts

1. The assessee a wholly owned subsidiary of an American Company viz. M.s Para Metric Technology Corporation USA, was engaged in providing Information Technology Services and IT Enabled Services to its holding company. For the year under review, the assessee adopted the Transactional Net Margin Method for determining the ALP of the IT segment services rendered to its AE and computed its average margin at 14.02 percent as against the average margin of 10.70 percent of the comparable companies selected by it. During the Transfer Pricing proceedings, the TPO conducted a fresh search for comparables considering only the relevant year data as against the three-year data considered by the assessee. The TPO further rejected the assessee's comparables on the ground of functional dissimilarities, related party transactions and due to the fact that some of the companies were loss making. He also added some of his own comparables and made an upward adjustment of Rs.10.38 crores, which was upheld by the DRP as well.

2. Aggrieved, the assessee filed an appeal before the Tribunal, wherein the Tribunal rejected a large number of comparable companies selected by the TPO viz. FCS Software Ltd, Compucom Software Ltd., KALS Information Technology Ltd. ('Kals'), Helios Matheson Information Technology Ltd. ('Helios'), Transwork Information Services Ltd., Vishal Information Technologies Pvt. Ltd., Vishesh Infotechnics Ltd. and included one comparable excluded by the TPO viz., Galaxy Commercial Ltd,. thereby deleting the TP addition made.

3. Aggrieved, the Revenue filed an appeal before the Hon'ble High Court

Judgment

1. The Court considered the plea of both the assessee and the Revenue and the findings of the Tribunal and held as under:

RPT Filter - FCS Software Ltd. and Compucom Ltd.: The Court upheld the findings of the Tribunal that the TPO was incorrect in computing the Related Party Transaction filter by taking total expenses as well as sales in the denominator and that only the total sales were to be considered. Accordingly, considering the RPT transactions to total sales (as against total sales + total expenses), the said companies did not satisfy the requirement of having RPT transactions to sales less than 25 per cent and were to be excluded.

Software Products / Service - Kals and Helios: The Court held that the Tribunal was justified in excluding the two companies as comparables since they were engaged in the business of selling software products and therefore could not be compared to the assessee who was engaged in the business of rendering software services to its holding company. Further the said companies were rejected by the TPO himself in the preceding assessment year and no attempt was made by the Revenue to provide any change in the nature of activities of these companies in the current year *vis-à-vis* the previous year.

Period of Financial Data – Transworks Information Services Ltd.: The Court held that the said company was rightly excluded as comparable by the Tribunal the financial data of the company was available for the period July 1, 2006 to June 30, 2007 as against the financial year of the assessee and therefore

in light of Rule 10B(4) which provided that the analysis for comparison was to be on the basis of data relating to the financial year in which the transaction had been entered into, the said company could not be considered as comparable.

Outsourcing – Vishal Information Technologies: The Court affirmed the exclusion of Vishal Information Technologies as comparable since the said company in addition to providing IT enabled services also provided agency services by way of outsourcing to third party vendors and also because its related party transactions to sales exceeded the 25 per cent filter applied by the TPO.

High End Knowledge Services - Vishesh Infotechnics Ltd.: The Court held that the Tribunal was correct in excluding the said company as comparable since the company provided high end knowledge services, requiring superior level of manpower and human resources as compared to the assessee and therefore could not be considered as comparable.

Galaxy Commercial Ltd: The Court held that the said company was wrongly excluded as comparable by the AO on the ground that it was not only engaged in providing BPO services but also earning income from rental and transportation services as the company earned 87 per cent of its revenue from BPO Services and merely 7 per cent from rental and transportation services. Accordingly it upheld the inclusion made by the Tribunal

3. Failure to supply satisfaction note to assessee before making reference of international transaction to TPO was a mere irregularity which did not make the reference void *ab initio*.

Shri Vishnu Eatables (India) Ltd. vs. DCIT – (2016) 74 taxmann.com 89 (Punjab & Haryana)

Facts

1. A search was carried out in the Petitioner's case pursuant to which various documents were seized. The seized documents revealed that the Petitioner had made sales to its AE located abroad and the AO, based on these documents concluded that the Petitioner under invoiced its sales with the intent of evading tax. Accordingly, he issued a show-cause notice requesting the Petitioner to show-cause as to why the said transaction should not have been referred to the TPO. In response to the same, the Petitioner filed objections which were rejected, consequent to which the AO referred the international transactions to the TPO after having obtained permission from the Principal Commissioner.

2. Aggrieved, the Petitioner filed a Writ before the Hon'ble Court challenging the reference made on the ground that the same was in contravention to CBDT Instruction No 3/2016 which provides that passing a reasoned order rejecting the objections raised by the assessee on whether a transaction Is an international transaction or not and the service of the said order on the assessee, were two conditions precedent to making the reference, which was not complied with in the instant case.

Judgment

1. The Court noted that as per law it was necessary for the AO to decide the objections, if any, to the applicability of Chapter X before referring the transactions to the TPO as also before determining the ALP of international transactions himself. Referring to the facts in the instant case, the Court held that the AOs satisfaction recorded contained sufficient reasons and that the AO had clearly indicated the relationship between the Petitioner and the other parties and made a comparative chart pursuant to which he alleged that the sales were under invoiced. It held that the course of action adopted by the AO was sufficient to refer the matter to the TPO and therefore the Petitioner was incorrect in challenging the reference on this ground.

2. As regards the service of order, the Court held that the contention of the Petitioner that the reference was void *ab initio* on account of non-service of the satisfaction note prior to making reference to TPO was misplaced as the failure to supply the satisfaction note prior to reference

was a mere irregularity and did not prejudice the Petitioner in any manner whatsoever.

3. In view of the above, the Petition filed by the assessee was dismissed.

4. Where the Revenue failed to urge the plea that a company was not functionally comparable to the assessee before the CIT(A) or the Tribunal, the same could not be urged before the Hon'ble High Court

PCIT vs. Nortel Network India Pvt. Ltd. – TS-770-HC-2016 (Del.) – TP

Facts

1. The assessee was engaged in the business of marketing and after sales support services to its group companies viz. installation, testing and commissioning services in relation to telecom equipment / IT and other products, including repair and maintenance services in relation to telecom equipment / IT products supplied by the Nortel Group of Companies in India. During the relevant assessment year, the assessee selected TNMM as the most appropriate method to benchmark its transactions with its AE and chose 10 comparable companies having an average margin of 0.67 per cent as opposed to its margin of 7 per cent and therefore claimed that its transactions were at ALP.

2. The TPO rejected 5 comparable companies chosen by the assessee – 3 on the ground that data for the year was not available and 2 on the ground that they were loss making companies. Retaining the remaining companies, the TPO made an upward TP adjustment.

3. Aggrieved, the assessee filed an appeal before the CIT(A) objecting to the exclusion of Himachal Futuristic Communication Ltd. simply because the said company had shown loss in 1-2 years. The CIT(A) allowed the assessee's appeal and held that the said company was comparable. The decision of the CIT(A) had been upheld by the Tribunal as well wherein the Tribunal noted that the Revenue had not assailed the CIT(A)'s finding that the said company was functionally comparable to the assessee and therefore held that merely because the company incurred losses in 1-2 years, it could not be excluded on the ground that it was a loss making company.

4. Aggrieved by the order of the Tribunal, the Revenue filed an appeal before the Hon'ble High Court contending that HFCL was not functionally comparable to the assessee and therefore wrongly included by the CIT(A) and Tribunal.

Judgment

1. The Court noted that the Revenue had not urged this contention before the CIT(A) or the Tribunal and held that where the plea was not taken before the aforesaid authorities, it could not be considered as a question of law. Accordingly, it dismissed the appeal filed by the Revenue.

5. Where the Tribunal remitted the matter back to the TPO for fresh adjudication, directing the assessee to file data from an international database, the order of the Tribunal was to be quashed as it had no jurisdiction to render decision relating to adoption of International database which was not the subject matter of the appeal.

Pentair Water India Pvt. Ltd. vs. CIT – TS- 762-HC-2016 (Bom.)– TP

Facts

1. The assessee was engaged in the manufacture of fibreglass pressure vessels used for water treatment and had two divisions, viz manufacturing division and Engineering Support Services/ITES. During the relevant year, the assessee earned a margin of 12.02 per cent and adopted TNMM as the most appropriate method to benchmark the international transaction in ITES segment. During the transfer pricing proceedings, the TPO considered 20 companies as comparables and derived at mean margin on cost of 24.5%.

2. On appeal, the CIT(A) excluded 2 comparables viz. Infosys BPO Ltd. and Wipro Ltd. on the basis of high turnover, however, confirmed the remaining 18 comparables.

3. Both the assessee and the Revenue filed appeals before the Tribunal wherein the Tribunal noted that the comparables confirmed as well as discarded by the CIT(A) were all in the business of information technology services and held that Information Technology Enabled Services (ITES) were specific to each company (some in relation to finance, some in relation to software which are required for running machinery and some in relation to structural designing) and therefore each type of service would have itself own variation in respect of its speciality, scope and profitability. It further noted that the assessee admitted that its business was not exactly comparable with any business as none similar in nature was available in India and since the assessee had not provided similar services to Non-AEs and considering that similar businesses were available in the international market it concluded that the other companies in the international field, which were doing the similar business of the assessee were to be considered and therefore directed the assessee to furnish relevant data from international databases and restored the matter back to TPO for fresh adjudication.

4. Aggrieved, the assessee filed an appeal before HC on the ground that the Tribunal had no jurisdiction to render decision relating to adoption of International data base which was the disputed issue and was also not the subject matter of the appeal.

Judgment

1. Accepting the contention of the assessee, the Court quashed the order of the Tribunal and restored the file back to the Tribunal directing it to decide both the appeals (i.e. of assessee and Revenue) afresh after hearing the parties in accordance with law and clarified that all the contentions of both the parties were left open.

6. Where data of the comparable companies for the relevant financial year was not available, they could not be considered as comparable. Further, companies engaged in rendering Engineering and Technical Services could not be compared to the assessee engaged in providing routine customer support services.

CIT vs. PTC Software I Pvt. Ltd. – TS-835-HC-2016 (Bom.) – TP

Facts

1. The assessee, PTC (India) Pvt. Ltd., a wholly owned subsidiary of an American Company Para Metric Technology Corporation USA (holding company) was engaged in providing Information Technology (IT) Services and IT enabled Services to its holding company i.e., Associated Enterprise ('AE'). For the relevant year the Tribunal on functional comparability of certain companies selected by TPO for the relevant year excluded 5 companies – 3 (Megasoft Ltd., Software Technology Group International Ltd. and Transworld Infotech Ltd.) on the ground that data for the relevant year was unavailable and 2 (Vishal Information Technologies Ltd. and Ultra Marine & Pigments Ltd.) on the ground that they were functionally dissimilar to the assessee.

2. Aggrieved by the aforesaid exclusions the Revenue preferred appeal before Hon'ble Court.

Judgment

1. The Court noted that the issue of exclusion of comparables due to non-availability of data for the relevant financial year was raised before it in relation to subsequent assessment years as well wherein it dismissed the Revenue's ground holding that this question did not give rise to any substantial question of law. Accordingly, it dismissed the question of the Revenue for this year as well.

2. As regards the exclusion of Vishal Information Technologies Ltd. it noted that an

identical issue had been raised by the Revenue in its appeal before the Court in the assessee's own case for the subsequent assessment year, wherein it upheld the finding of the Tribunal that the functional profile of Vishal was different from that of the assessee, and also that Vishal had entered into RPT at 86% i.e., far in excess of 25% filter. Accordingly, it dismissed the question filed by the Revenue, relying on its order issued for the subsequent year.

3. As regards Ultra Marine & Pigments Ltd., the Court noted ITAT's finding of fact that assessee was not functionally comparable to Ultra Marine & Pigments Ltd. as the said company was engaged in rendering Engineering and Technical Services whereas the assessee was engaged in routine customer support services and therefore the two were functionally dissimilar. Accordingly, it held that benchmarking for the purposes of arriving at ALP was to be done with companies functionally similar and once the functional profile was different, then the resources used and the profits earned would inherently be different. Accordingly, it held that no substantial question of law arose.

7. Mere availability of proportion of the turnover allocable for software product sales *per se* could not lead to an assumption that segmental data for relevant facts were available to determine the profitability of the concerned comparable

Pr. CIT vs. Saxo India Pvt. Ltd. – (2016) 74 taxmann. com 88 (Del.)

Facts

1. The assessee, was a part of Initto Group which had teamed up with Saxo Bank. Assessee was engaged in the business of design and development of customized software applications. It also provided technical support services during the relevant assessment year to some unrelated enterprises in India. The only international transaction in dispute for the relevant year was the provision of software development services to its AE amounting to ` 20.72 crore. In this respect, the assessee adopted TNMM as the most appropriate method and chose 5 comparables with average margin of 17.91% to demonstrate that its margin of 22.63% was at ALP. However, during transfer pricing proceedings, the TPO observed that the overall PLI (Operating Profit/ Operating Cost) as per assessee's P&L account was (-) 15.34%, whereas it had shown profit margin from the international transaction at 22.63%. Thereafter, TPO added 20 comparables and proposed a TP adjustment of ` 8.23 crore. In appeal, the DRP finalised a fresh list of 20 comparables after adding and deleting certain comparables. Accordingly, DRP restricted TP – adjustment to ` 7.76 crore.

2. The assessee filed an appeal before the Tribunal wherein the Tribunal accepted the assessee's contention for exclusion of 4 comparables viz. *E-Infochips Ltd., Persistent Systems & Solutions Ltd., Larsen and Toubro Infotech Ltd.* and *Sasken Communications Technologies Ltd.* on the ground that segmental data of the said companies was unavailable.

3. Aggrieved, the Revenue filed an appeal before the Hon'ble High Court contending that the rationale adopted by the Tribunal with respect to lack of segmental data *vis-a-vis* four of the comparables was contrary to the records since the annual reports of the four companies and other material collected from internet resources were analysed elaborately by the TPO who was able to accurately segregate the volume of transactions allocable to software product sales as opposed to software technology services.

Judgment

1. The Court explained that TNMM method depended on accurate data and held that the mere availability of proportion of the turnover allocable for software product sales *per se* could not lead to an assumption that relevant segmental data was available to determine the profitability of the concerned comparable."

2. Accordingly, the Court held that no substantial question of law arose and hence dismissed the appeal of the Revenue.

C) Tribunal Decisions

8. Transfer pricing provisions do not apply in respect of transactions between the Indian head office and its overseas branch office – Held: No; in favour of the assessee

Aithent Technologies Pvt. Ltd. vs. DCIT – TS-752-ITAT-2016 (DEL)-TP – Assessment Year : 2008-09

Facts

The taxpayer is an Indian company having an overseas BO in Canada and a 100% subsidiary in USA. Transactions between the taxpayer and its overseas BO were treated as international transactions and their arm's length price (ALP) was determined by the Transfer Pricing Officer (TPO). The taxpayer also entered into an international transaction with Aithent Inc., USA, and adopted Transactional Net Margin Method (TNMM) as the most appropriate method. The TPO adopted a number of search filters for selecting the comparable companies and accordingly made a TP adjustment.

Decision

The Tribunal held in favour of the assessee as under:

A) Issue – Determination of ALP in respect of transactions of the taxpayer with its overseas Branch Office

i) The Tribunal, placing reliance on precedents set by the Supreme Court of India in the case of *Sir Kikabhai Prem Chand vs. CIT [1953] 24 ITR 506 (SC)* and various Indian High Courts in the case of *Betts Hartley Huett & Co. Ltd. vs. CIT [1979] 116 ITR 425 (Cal)* and *Ram Lal Bechairam vs. CIT [1946] 14 ITR 1 (All)*, endorsed the 'Principle of Mutuality' and held that there can be no profit from trade with self and there cannot be a valid transaction of sale between BO and its HO.

ii) However, it clarified that if a foreign general enterprise has a BO in India, such BO will be considered as an `enterprise' under Section 92F(iii) of the Income-tax Act, 1961 (the Act) and the transactions between the foreign HO and the Indian BO will be considered as an `international transaction' in terms of Section 92B of the Act.

iii) This is because of the fact that, as per Section 5(2)4 of the Act, the scope of total income in case of non-residents only include such income which is received or deemed to be received in India or which accrues or arises or is deemed to accrue or arise in India. In such circumstances, non-resident taxpayers may resort to under/over-invoicing so as to mitigate the tax burden in India.

iv) In the instant case, even though ***prima facie*** it appears that the overseas BO of the Indian HO is covered under the term 'enterprise' as defined under Section 92F(iii), but considering the fact that, in terms of Section 5(1)5 of the Act, a tax-resident of India is liable to be taxed on its global income, the argument that a transaction between an overseas BO of an Indian HO and the HO itself is subject to TP provisions loses its substance.

v) It further stated that on aggregation of accounts of the HO and its overseas BO, any additional profit earned by the HO would be set off with the equal amount of expense of the BO, thereby not leaving any separately identifiable income on account of this transaction. Thus, over/under invoicing between the Indian HO and its overseas BO is always income-tax neutral.

vi) Making a TP adjustment with respect to international transactions between the Indian HO and its overseas BO will result in charging tax on income which is more than legitimately due to the exchequer which is impermissible. In the instant case, the taxpayer has rightly offered to tax, not only the amount earned by the Indian HO, but also the income earned by its overseas BO.

B) Issue – Application of certain filters resulting in TP adjustment on transactions with AE in USA

i) Non-application of upper turnover filter – Averaging of the profit rates of a whole lot of functionally similar companies having higher or lower turnover vis-à-vis the taxpayer, irons out the effect of such differences. Thus, in view of the Delhi High Court judgment in the case of *Chrys*

Capital Investment Advisors (India) Pvt. Ltd. vs. DCIT [2015] 376 ITR 183 (Del.) wherein it was held that high profit/turnover cannot be criteria to exclude an otherwise comparable company, TPO in the instant case was justified in not applying the upper turnover filter.

ii) Since the taxpayer's export revenue is roughly 21% of total revenue, applying the filter of excluding the companies having less than 25 per cent of the revenue's from export sales, would eliminate companies which are similarly placed as the taxpayer. Both, taxpayer and revenue have now agreed to apply the filter of excluding the companies with export sales of more than 30 per cent of the total revenue.

iii) Both the numerator and denominator should have the same nature of contents. This can be ensured by comparing RPT of purchase with the total purchases or RPT of sales with the total sales of the company. Inclusion/exclusion of a comparable by applying the filter of more than 25 per cent RPT, would depend on the outcome of two such percentages of RPT. If the company fails the threshold in either case, then it will cease to be comparable.

iv) The taxpayer's profit has diminished during the instant year from the preceding year. Thus, companies having diminishing revenue should not be excluded but only companies having persistent losses should be excluded.

v) If the taxpayer's argument that its BO earned only onsite services income is correct, the filter applied by the TPO excluding companies whose onsite income is more than 75 per cent of the export revenues, becomes meaningless. TPO/AO are directed to examine the break-up of the revenues earned by BO for evaluating if the same is from onsite/offsite services and decide on the application of the filter accordingly.

vi) In TNMM, the effect of differences between the international transaction and comparable uncontrolled transactions is always given in the net operating profit margin of the comparable uncontrolled transactions. There is no mandate for adjusting the taxpayer's profit margin under the provisions of Rule 10B(1)(e) of the Income Tax Rules. The adjustment, if any, could have been allowed, if the taxpayer had demonstrated that the comparable companies had more under-utilisation of their labour force vis-à-vis the taxpayer, which the taxpayer could not substantiate. Thus no such adjustment can be granted.

9. Corporate guarantee adjudged as shareholder service under exceptional circumstances; Interest on outbound loans to be determined applying sophisticated manner of loan benchmarking

Tega Industries Ltd. vs. DCIT – [TS-780-ITAT-2016 (Kol)-TP]

Facts

1. The taxpayer is a closely held company engaged in the business of *inter alia* manufacturer of rubber, specialising in the design, production and application of water resistant rubber lining.

2. The taxpayer had set up a special purpose vehicle (SPV) in the Bahamas, Tega Investment Ltd. (Tega Bahamas) with an equity funding of mere INR 23 lakh for undertaking acquisition of two operating companies based in South Africa worth around INR 5.5 crore.

3. The taxpayer also provided a shareholder loan of INR 80 lakh to Tega Bahamas and a corporate guarantee to ICICI Bank, U.K. of INR 500 lakh, in order to make adequate funds available to Tega Bahamas for acquiring the South African entities for a total consideration of ZAR 8,500,000 i.e. approximately INR 5.5 crore.

4. The shareholder's loan and guarantee were provided by the taxpayer as a substitute for equity funding to Tega Bahamas for furthering its own intent of acquiring the two South African entities. Accordingly, the taxpayer classified the loan as performing a shareholder function, thus warranting no charge, and guarantee as shareholder service meriting no consideration.

5. The taxpayer placed reliance on guidelines of Australian Tax Office (92/11), OECD and U.K. Inland Revenue to hold that in the instant case, no third party financier would have lent money to the SPV without the guarantee having been extended by the parent company, having regard to its skewed debt-equity ratio; and that no benefit actually accrued to the SPV, for which it would be willing to pay any guarantee commission.

6. The Transfer Pricing Officer (TPO) and Dispute Resolution Panel disregarded the taxpayer's contention (both in connection with the provision of loans and guarantees) and computed an additional charge on both.

7. In addition to the guarantee, the taxpayer had provided working capital loans to its AEs (operational and not SPVs) in Australia (Tega Industries Australia Pty. Ltd. – Tega Australia) and USA (Tega Industries Inc. – Tega U.S.) on which it charged an arm's length interest on the basis of sophisticated manner of loan benchmarking, with reference to credit ratings and comparability of third party loan agreements.

8. The TPO during the course of the assessment proceedings disregarded the taxpayer's approach by determining credit rating on the basis of bias selection of financial ratios and subjectively downgrading the rating determined through quantitative parameters.

Decision

The Tribunal held in assessee's favour as under:

i) In the context of loan and corporate guarantee provided to its SPV which was set up to acquire step down operating companies, the Tribunal appreciated that the taxpayer's expectation from provision of loan and guarantee are not that of a lender or guarantor i.e. to earn a market rate of interest or guarantee fee, rather, the expectation was of a shareholder to protect its investment interest and help it to achieve acquisition of the South African entities for furtherance of its own business interest and get a return in terms of appreciation in value and dividends. The Tribunal was considerate to the evidence brought on records that no third party would have agreed to grant loans on an independent basis to the tune of INR 5 crore to Tega Bahamas given its skewed debt-equity ratio reflected in the balance sheet with equity funding of mere INR 23 lakh. Therefore, in the present case, the loan was considered to be as quasi-equity and guarantee a shareholder service meriting no charge.

ii) The Tribunal also addressed the issue on working capital loans advanced by the taxpayer to its AEs (operational and not SPVs). The matter has been set aside to the file of the TPO for re-adjudication of the issue as per sophisticated manner of loan benchmarking, with reference to the credit ratings and comparability of third party loan agreements as has already been provided by the taxpayer.

10. Section 9(1)(vii)(b) and Articles 13 & 15 of India-UK DTAA Whether in case payment has been made to a foreign entity with a view to carry on business outside India in the form of a branch office, such payment falls within the exceptions of Section 9(1)(vi)/(vii), hence no TDS need to be made on such payment – Yes: In favour of the assessee

M/s. Kotak Mahindra Bank Ltd. vs ITO 2016-TII-211-ITAT-MUM-INTL – Assessment Year: 2012-13

Facts

i) The assessee company is engaged in the banking business and paid certain legal fees amounting to one legal firm situated in UK. As per the agreement, withholding tax @ 20% on gross amount amounting to USD 9329.72 was the liability of the assessee which was duly deposited. Subsequently, the assessee filed an appeal u/s. 248 before CIT(A) and contended that the impugned payment was not liable to be taxed in India as per the Treaty provisions and also as per domestic laws hence there was no liability to deduct tax at source in respect of this payment.

ii) These contentions were considered but dismissed by CIT(A) on the ground that no new source of income ever came into existence by obtaining these legal services and hence the impugned payment constitute 'Royalty'/'FTS' as per Section 9(1)(vi)/(vii) of the Income-tax Act. Further, impugned payment constitute royalty as per Treaty provisions on the ground that assessee is provided with specialised knowledge, skill and experience in the field of regulatory norms prevalent in the US which can be utilised independently by the assessee on his own without recourse to the service provider. Finally, CIT(A) concluded that impugned payment are taxable both underdomestic laws as well as under the Treaty provisions.

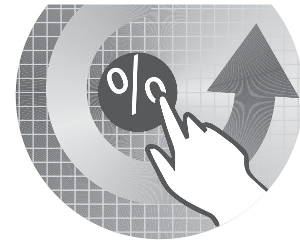
Decision

The Tribunal held in favour of the asessee as under:

i) Assessee has remitted the impugned payments for Phase-1 relating to education where bank officials visited USA and M/s Reed Smith made presentation and discussed with them various legal/regulatory requirement of USA for setting up of a Bank Branch or acquisition of banking company etc. The nature of services are nowhere disputed by the revenue and accordingly, the perusal of documents shows that the payments are, in fact, being made for creating/earning a new source of income outside India by way of establishment of new Bank Branch or acquisition of a Bank. With these objectives, the legal/professional fees have been paid to the attorneys.

ii) Therefore, as observed by us in preceding paragraph, the payment has been made with a view to carry on business outside India and create a new source of Income outside India, and therefore, these payment falls within the exceptions of Section 9(1)(vi)/(vii) and accordingly, not taxable under the domestic law. Further, as per the observation of SC in *CIT vs. Rajendra Prasad Moody*, it is not necessary to show that the expenditure was a profitable one or that in fact any profit was earned. Expenditure in the course of the trade which is un-remunerative is nonetheless a proper deduction, if wholly and exclusively made for the purposes of the trade. It does not require the presence of receipt on credit side to justify the deduction of an expense. It is nowhere necessary that the purpose must be fulfilled to qualify the expenditure for deduction and it is not necessary that the expenditure must fructify into any benefit by way of return in the shape of income. Therefore, we are of the considered opinion that the impugned payments are not taxable under Section 9(1)(vi)/(vii).

iii) The assessee has obtained the legal services and such services find specific treatment as per Treaty Article 15 and therefore, not covered by Article 13 which deals with 'Royalty and Fees for Technical Services'. This view has also been upheld in the case of *Maharashtra State Electricity Board vs. DCIT (ITAT Mumbai)* wherein it has been observed that the provisions of Article 13 have to give way to more specific provisions of Article 15 which will hold field in the present case. The condition of Article regarding stay in India are not satisfied. We are, therefore, of the considered view that the payment of fees for legal consultancy services to the UK based firm of solicitors is taxable only in United Kingdom and is not exigible to tax in India. Moreover, Article 15 applies not only to individual but to firms also as upheld by Special Bench of the Tribunal in the case of *M/s Clifford Chance vs. Asstt. DIT (IT)*. Therefore, in the absence of any business connection in India or permanent establishment of India and considering the fact that services are rendered outside India and no employee of the attorneys were present in India for more than 90 days, we are of the considered view that impugned payments are not taxable in India as per Treaty provisions Hence, the assessee was not liable for tax deduction at source from impugned payment.



CA. Hasmukh Kamdar

INDIRECT TAXES

Central Excise and Customs – Case Law Update

PTC Industries Ltd vs. Commissioner of Central Excise, Jaipur – I
[2016 (340) E.L.T. 563 (Tri.-Del.) decided on 27-7-2016]

Refund

Facts in this case are as follows

The appellants were engaged in the manufacture of steel casting falling under Chapter Heading 73.25 of the First Schedule of Central Excise Tariff Act, 1985. They entered into rate contract with a customer. As per one of the clauses of the said rate contract, the price specified in the contract was not final but was subject to price variation clause based upon RBI Index.

During the relevant period the appellant cleared their final product at the agreed upon price, after payment of duty leviable thereon. However, subsequently in terms of the price variation clause in the rate contract, the value of the goods was brought down and the excess duty paid by the appellant was refunded to their customers by way of making adjustment in the subsequent bills. Simultaneously, the appellant also filed refund claims for refund of excess duty paid by them.

The refund claim was rejected by the original authority on the ground that the duty once having been paid by the assessee cannot be refunded by way of subsequent claims made by the assessee, when they have not opted for provisional assessment during the relevant period. It was also observed that once the assessee has paid duty at the time of clearance under final assessment, subsequent reduction of price due to any reason cannot be adopted for seeking refund.

On appeal against the said rejection of refund order, Commissioner (Appeals) also rejected the refund and observed that having paid the excess duty and having collected the same from their customer, even though adjusted in subsequent bills, the provision of unjust enrichment would apply. He accordingly rejected the appeal. Hence the present appeal.

It was submitted by the appellant that if there is subsequent reduction in the price, which in turn is based upon the price variation clause in the rate contract, the assessment has to be considered as provisional. Non-observance of procedure under Rule 7 of Central Excise Rules, 2004 will not render the assessment as final assessment and refund can be granted in such a situation. Reliance was placed on the decisions of the Tribunal in the cases of *Sankhla Udyog vs. CCE, Jaipur II- 2014 (314) E.L.T. 350 (Tri.-Del.), K J. V. Alloys Conductors P. Ltd. vs. CCE, Hyderabad – 2012 (275) E.L.T. 90 (Tri.-Bang), CCE, Raipur vs. IBP Ltd. – 2013 (288) E.L.T. 385 (Tri.- Del.)*

and in the case of CC & CE, Hyderabad – III vs. Premier Explosives Ltd. – 2008 (226) E.L.T. 729 (Tri-Bang).

As regards unjust enrichment it was submitted that in the same very decisions of the Tribunal it is held that where the excess duty initially collected stands paid back to the customer by way of issuance of credit note or by adjustments in the subsequent bills, principles of unjust enrichment become inapplicable, thus entitling the assessee to claim refund. This has been specifically observed so in the decision of the Tribunal in the case of IBP Ltd., referred to above. It was further submitted that Tribunal in the cases of *Karnataka Vidyuth Karkhane Ltd. vs. CCE & ST, Bengaluru – II – 2015 (327) E.L.T. 658 (Tri.- Bang.) and Bharat Bijlee Ltd. vs. CCE, Belapur – 2010 (262) E.L.T. 369 (Tri-Mumbai)* has also decided the issue in the same manner.

The Department relied upon the Tribunal's decision in the case of *Munjal Auto Industries vs. CCE&ST, Vadodara – 2014 (307) E.L.T. 577 (Tri-Ahmd)*, wherein it was observed that price revised downward at a later date subsequent to clearance of goods from the appellant's factory without observing the provisions of Rule 7 relating to provisional assessment, cannot result in refund of duty excess paid at the time of original clearances. Reliance was also placed on the Hon'ble Supreme Court decision in the case of *MRF Ltd vs. CCE, Madras – 1997 (92) E.L.T 309 (S.C.).*

The Hon'ble Tribunal observed that the said decision of the Hon'ble Supreme Court in the case of MRF Ltd. (Supra) is distinguishable inasmuch as in that case its stand clearly observed by the Hon'ble Supreme Court that there was no contract between the parties. As regards the price variation clause and the appellant have not placed anything on record to show that there existed any agreement between the appellant and their buyers evidencing that the prices were provisional. Similarly, in the case of Munjal Auto Industries (supra) there was no price variation clause in the agreement. It was in these circumstances, the Tribunal further observed that in the absence of provisional assessment, the subsequent reduction in prices will not have the effect of lowering the assessable value and thus refunding the excess duty paid.

The Hon'ble Tribunal further noted that the decisions relied upon by appellant clearly cover the issue involved and stands given in the same set of facts and circumstances. Accordingly, by following the same, the Hon'ble Tribunal set aside the impugned order and allowed the appeal with consequential relief to the appellants.

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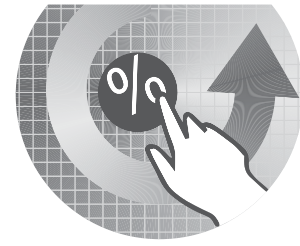


CA Janak Vaghani

INDIRECT TAXES
VAT Update

1. Trade Circular

i) **Trade Circular No. 32T of 2016, dated 27-10-2016**
First Phase Go Live of E Payments under SAP–TRM New Automation Process

The Commissioner of Sales Tax has issued above circular informing trade process relating to E Payments under SAP–TRM New Automation Process in respect of payment of tax under the MVAT and Allied Acts for the return periods from April 2016. It is also clarified the once SAP-TRM system is established payment under all Acts will be routed through "Payment Gateway" option only.

ii) **Trade Circular No. 33T of 2016, dated 27-10-2016.**

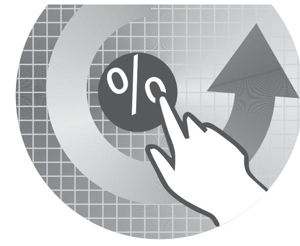
E-returns for Dealers Registered under The Maharashtra Tax on Entry of Goods into Local Area Act, 2002

The Commissioner of Sales Tax has issued above circular to clarify the procedure for filing of e-returns under The Maharashtra Tax on Entry of Goods into Local Area Act.

iii) **Trade Circular No. 34T of 2016, dated 2-11-2016.**

Extension of Due Date for Filing of Monthly Returns for the Period from April 2016 to September 2016 – Exemption from Payment of Late Fees.

The Commissioner of Sales Tax *vide* above circular, in exercise of power conferred under Notification No. VAT/1513/CR124/Taxation-1, dated 1st January, 2014, issued under section 20(6) of the MVAT Act, has granted exemption from payment of whole of late fees in respect of monthly returns for the period from April 2016 to September 2016 provided it is filed on or before 15th November, 2016.



CA. Bharat Shemlani

INDIRECT TAXES
Service Tax – Case Law Update

1. Services

Job work/Contract Manufacturing Service

1.1 Carlsberg India Private Limited vs. UOI 2016 (44) ST 349 (Del.)

The question before High Court was whether job work/contract manufacturing of alcoholic liquors fit for human consumption is liable to service tax or not. It is held that, by application of 'aspect doctrine' it is a tax on service aspect of manufacture which is undertaken by one entity for another. It is amenable to levy of service tax by Parliament under Entry 97 of List I of Constitution of India. It is not 'in pith or substance' tax on manufacture *per se* of alcoholic liquor for human consumption covered under Entry 51 of List II. Hence, the Constitutional challenge to validity of Section 113A(1) of FA, 2009 which amended Section 65(19) and Section 66B of FA, 1994 read with Section 65B(40) and 66D of FA, 1994 is rejected.

Banking & Other Financial Service

1.2 DSP Merrill Lynch Limited vs. CST, Mumbai 2016 (44) ST 436 (Tri.-Mumbai)

The Tribunal in this case held that, following services are not covered under Management Consultants Service:

- Merchant Banking Services
- Advisor and retainership fees received for providing independent/stray opinions and fees received towards activities of financial ties/private placement, financial valuation services etc.
- Services performed in relation to software development projects
- Fees for underwriting Government Securities
- Mergers and acquisition services

Repair & Maintenance Service

1.3 Chhattisgarh State Ind. Dev. Corp. Ltd. vs. CCE&ST, Raipur 2016 (44) ST 642 (Tri.-Del.)

The appellant in this case engaged in leasing Government land and collecting charges for maintenance of street light and repair and maintenance of roads, etc. from entrepreneur-allottees of land. The Tribunal held that, even if these charges are statutorily prescribed, they remain consideration for rendition of service and there is nothing in Section 66 of FA, 1994 which implies that such charges are not liable to service tax. Further, there is nothing in Section 65 of FA, 1994 to imply that service rendered as part of statutory duty/obligation will not be treated as taxable service even if it is satisfied definition of any of taxable service. For such service there is no inherent exemption from levy of service tax merely on the ground that, service provider

or recipient is "Government" or "Government Agency".

Works Contract Service

1.4 Mehta Plast Corporation vs. CCE, Jaipur 2016 (44) ST 651 (Tri.-Del.)

The Tribunal in this case held that, the option for availing composition scheme under Works Contract Service is not required to be given in writing but mere first payment of service tax under the composition scheme acts as an option.

Commercial or Industrial Construction Service

1.5 Central India Engineering Co. vs. CCE, Nagpur 2016 (44) ST 657 (Tri.-Mumbai)

The Tribunal in this case held that, services of laying pipeline for proving water supply to staff quarters of M/s. NTPC Ltd. is not for social or philanthropic purposes. The said staff quarters and welfare of the employees is part of the statutory obligation of M/s. NTPC Ltd. for ultimate object of running the commercial and industrial organisation. Thus services provided by the appellant clearly fall within the category of CIC Service. Since appellant never informed the department about activity even did not bother to take any opinion from department or from any legal professional hence extended period is invocable. However, penalties levied under Sections 76, 77 and 78 waived by invoking Section 80 as the transaction were recorded in the books of account.

2. Interest/Penalties/Others

2.1 Principal CCE vs. Larsen and Toubro Ltd. 2016 (44) STR 369 (Guj.)

In this case SEZ unit of the assessee company providing service to DTA unit of same company without receiving any consideration and department sought to demand the tax on the same. The High Court held that, issue is already decided for earlier period in favour of assessee in 2016 (44) STR 391 (Guj.) holding that although for purpose of taxation, unit situated in SEZ is a distinct entity, no Service Tax is leviable in instant case because value of services is NIL.

2.2 Manpreet Engineering & Const. Co. vs. UOI 2016 (44) STR 384 (Jhar.)

The department in this case rejected application for STVCES as appellant admitted tax liability of ` 3.48 crore, however deposited 50% amount short by ` 60,000/- before due date of 31-12-2013. The High Court held that, rejection of application by department is proper notwithstanding deposit of balance amount with interest subsequently. No liberal approach in interpreting said scheme required as it is provisions already very liberal by providing payment of declared liability in two installments and late payment of final installment with interest. Thus, when no concession in time is given for late payment of first installment, Courts under writ jurisdiction cannot extend payment date fixed as policy decision for realisation of taxes required for country's budget.

2.3 BSL Ltd. vs. CCE, Jaipur-II 2016 (44) STR 419 (Tri.-Del.)

The Tribunal in this case held that, simultaneous penalties under Section 76 as well as Section 78 cannot be imposed. It is further held that, Tribunal cannot extend benefit of reduced penalty under Section 78 if the duty, interest and penalty not deposited either before raising of demand or within 30 days of adjudication order.

2.4 Edelweiss Securities Ltd. vs. CST, Mumbai-I 2016 (44) STR 429 (Tri.-Mumbai)

The appellant in this case claimed refund of excess service tax paid on consideration received for 'brokerage' service due to downward revision of brokerage, which reversed to clients *vide* credit notes. The question before Tribunal was whether credit notes and other accounting documents are sufficient evidence of not having passed on burden of tax to clients. The Tribunal held that, evidence of duty burden not specifically prescribed in section

11B of CEA, 1944 therefore sufficient flexibility impliedly permissible. Credit and debit notes in use for centuries for acknowledgement of dues of debt and are generally enforceable documents in commercial disputes. Merely because of its form is as script on paper does not mean it is unreliable. Rendition of service apparent only on issue of documents and service tax structured entirely on existence of documentation and credence of such documents as evidence of having borne the tax burden cannot be casually dismissed.

2.5 MakeMyTrip (India) Pvt. Ltd. vs. UOI 2016 (44) STR 481 (Del.)

The High Court in this case held that, power to arrest available in Sections 90 and 91 of FA, 1994 to be used with circumspection and not casually. Before arrest, neither DGCEI nor Service Tax Department can presume/suspect, without following procedure under Sections 73A(3) and 73(4), that person has collected service tax and not deposited it to the credit of Government. It is more so where assessee has been regularly filing service tax returns accepted/examined by ST department. DGCEI has to check with Service Tax Department whether the assessee is habitual offender or not and only in those cases, resort to coercive steps straightway can be made by making convincing justification in note in file.

Also refer to decision in *eBiz.Com Pvt. Ltd. vs. UOI 2016 (44) STR 526 (Del.)*

2.6 CST, Mumbai-II vs. Kalpesh Transport 2016 (44) STR 669 (Tri.-Mumbai)

The Tribunal in this case held that, since respondent being an individual dead person, Revenue cannot competent to file appeal against him, hence appeal stands abated against said person.

2.6 Shiva Automobiles Pvt. Ltd. vs. CCE&ST, Coimbatore 2016 (44) STR 696 (Tri.-Chennai)

The Tribunal in the present case held that in case of warranty services, no service tax is leviable on value of spare parts sold during the course of providing services.

3. CENVAT Credit

3.1 Wabco TVS (India) Ltd. vs. CCE, Chennai-II 2016 (44) STR 417 (Tri.-Chennai)

The Tribunal in this case allowed CENVAT credit of service tax paid on photography service used for verification of manufacturing activity, outdoor catering for providing food to employees and R&D services for improving technology as all the services have been justified to be input services as these serve purpose of and integrally connected with manufacturing activity.

3.2 Mangalam Cement Ltd. vs. CCE&ST, Jaipur-I 2016 (44) STR 422 (Tri.-Del.)

The Tribunal in this case allowed CENVAT credit of service tax paid on maintenance of residential colony near factory since factory is located in remote area and appellant would not be in position to run its plant activities properly in absence of residential colony for workers nearby. The Tribunal relied upon judgment in *Commissioner vs. ITC Ltd. 2013 (32) STR 288 (AP).*

3.3 CCE, Chennai-I vs. Hinduja Foundries Ltd. 2016 (44) STR 424 (Tri.-Chennai)

The Tribunal in this case allowed CENVAT credit of service tax paid on payment made to bank for its services to augment funds for establishing foundries near Hyderabad and Sriperumbudur as the said activities are in relation to setting up of factory.

3.4 Red Hat India Pvt. Ltd. vs. Principal CST Pune 2016 (44) STR 451 (Tri.-Mumbai)

The Tribunal in this case allowed CENVAT credit of service tax paid on works contract services used for maintenance of office equipment as the same does not fall under exclusion clause. Further it is held that, department is bound to pay interest for delay in granting refund beyond three months irrespective of circumstances.

3.5 Castex Technologies Ltd. vs. CCE&ST, Alwar 2016 (44) STR 477 (Tri.-Del.)

The Tribunal in this case held that, authorities at recipients end have no jurisdiction to determine either correct classification or tax liability itself. The accommodation facility i.e., guest house is used for official stay, billed and paid by assessee forming part of assessee 's business expenditure hence credit should be allowed.

3.6 Tricity Auto vs. CCE, Chandigarh-II 2016 (44) STR 601 (Tri.-Chan.)

The issue in this case was regarding reversal of credit of common input services used in trading and manufacturing activity. The Tribunal after relying on decision in *Orion Appliances Ltd. 2010 (19) STR 205 (Tri.-Ahmd.)* holding that trading is not a service and hence not an exempt service prior to 1-4-2011, Rule 6(3) of CCR, 2004 is not applicable in the present case, hence the impugned order is liable to be set aside.

3.7 Chandigarh Network Systems Pvt. Ltd. vs. CCE, Chandigarh-II 2016 (44) STR 603 (Tri.-Chan.)

In the present case there was excess opening balance of CENVAT credit shown in ST-3 return. The Tribunal held that, the only document to ascertain whether credit has been availed correctly or not is CENVAT credit account and not ST-3 return. There is no allegation that appellant have wrongly availed credit as per their CENVAT credit account and no corroborative evidence of alleged wrong availment adduced hence, impugned order is not sustainable.

3.8 Indian Additives Ltd. vs. CCE, Chennai 2016 (44) STR 611 (Tri.-Chennai)

The Tribunal in this case allowed CENVAT credit of service tax paid on housekeeping services in factory premise as keeping factory premise neat and clean is a statutory requirement of Section 11 of Factories Act, 1948 and without its compliance manufacturing operations not possible. Further with a clean and tidy factory not only working efficiency improves, but safety standards are also maintained avoiding statutory fines for their flouting.

3.9 CCE, Chennai-II vs. Carboline (India) Pvt. Ltd. 2016 (44) STR 623 (Tri.-Chennai)

In the present case, the Tribunal allowed CENVAT credit of service tax paid on group insurance service and manpower supply service as both the services having relevancy with manufacturing and cost thereof and also included in the cost of manufactured product.

3.10 Perfetti Van Meele India Ltd. vs. CCE 2016 (44) STR 624 (Tri.-Chan.)

The Tribunal in this case allowed CENVAT credit of service tax paid on following services;

- Courier services used for procurement of small engineering items, raw materials and testing equipment directly related to manufacturing activity.
- Record keeping services as record so kept are part of accounting and auditing, which is an input service.

3.11 CCE, Indore vs. Kriti Inds. (I) Ltd. 2016 (44) STR 684 (Tri.-Del.)

The Tribunal in this case held that, service provider having classified services under Technical Testing and Analysis Service and paying service tax accordingly, said classification cannot be challenged by authorities at service receiver's end to deny refund.

3.12 Q. Logic India Private Limited vs. CST, Pune 2016 (44) STR 686 (Tri.-Mumbai)

The appellant in this case claimed refund of opening balance as on 1-4-2012 for the first time in quarter April to June, 2012. The department sought to deny the refund of opening balance. The Tribunal held that, it was not a second refund claim for Jan. to March, 2012 quarter and it was undisputed that entire services of assessee were exported and entire credit availed by them had to be refunded to them.

Janak C. Pandya, *Company Secretary*

CORPORATE LAWS
Company Law Update

Case Law No. 1

[2016] 198 Comp Cas 551 (Karn.)
[In the Karnataka High Court]
Tata Advanced Materials Ltd., In re

Section 391 of the Companies Act, 1956 envisages only one class of equity shareholders and irrespective of the shareholding pattern, an individual holding small fraction of shares does not make such minority shareholder a separate class of shareholder.

Brief Case

The Company petition is filed under Sections 391 to 394 read with Section 100 of the Companies Act, 1956 ("Act"), read with Rule 70 of the Companies (Court) Rules, 1959. ("Rules").

The petition is to obtain the approval of the Court for the scheme of arrangement ("Scheme") between the Company and its creditors and members. The facts and details of the scheme are as follows:

1. Scheme shall be effective from April 1, 2015.
2. Company was originally a listed company but delisted since 2001.
3. Company has accumulated losses of ` 192,84,18,067 till March 31, 2015.
4. Company has a freehold land having book value of ` 57,50,696 with current price at ` 112,00,00,000.
5. Company to revalue the above land at market rate and create a capital reserve to that extent in its books.
6. Against the above capital reserve, the Company will partially write off debit balance in profit & loss account and un-absorbed depreciation.
7. It also envisages the reduction of equity capital by extinguishing 1,32,107 equity shares held by non-promoter shareholders by paying them a fair value of such extinguished shares.
8. Fair value is decided based on a valuation report of an Independent Chartered Accountant.
9. The main promoter company holds around 99.91% of equity share capital. It has consented for the approval of the scheme.
10. Company has obtained the consent of 99% of its secured creditors and 86% of its unsecured creditors approving the scheme.
11. Based on the above, the Court has allowed the Company to dispense withholding meeting of shareholders

and creditors for considering the scheme.

The Court directed the Regional Director ("RD"), Registrar of Companies ("RoC") to issue the notice and publish the same in English and in regional language. The RoC filed its affidavit and the Company also replied to it.

The objection from the RD are as follows:

1. Scheme envisages a selective reduction of equity share capital.
2. As per the provision of Sections 100 to 104 of the Act and Articles of Association, the reduction would require the approval of all shareholders through a special resolution passed in their meeting.
3. Company has not produced such approvals from the shareholders.
4. The directors report for the year ended March 31, 2014 provides the brief details as to reduction, the request from the non-promoter shareholders for giving exit route etc.
5. The above report also states that the Company will seek member's approval in the forthcoming annual general meeting.
6. The notice of annual general meeting of 2014 includes reduction of share capital and relevant disclosures as one of its agenda items.
7. Company has not disclosed to the court as to outcome of the said annual general meeting, details of filing of the petition or reason for not filing the petition.
8. Thus, the Company has suppressed the above material facts.
9. The Scheme is offered to only one class of minority shareholders.
10. No consent of minority shareholders was obtained and filed with the court.
11. The proposed accounting treatment in the Scheme is not in accordance as per accepted accounting standards and practice issued by the Institute of Chartered Accountants of India.
12. One of the minority shareholder has filed objection. The objection is similar to that of the observation of the RoC.

The submission made from Company's side is as follows:

1. The reduction of capital is purely a business decision arrived by the shareholders.
2. The Company has filed the application with this court seeking dispensation of holding of the meeting of the equity shareholders and creditors.
3. The Court has by its order allowed the application for dispensing the holding of meeting of the equity shareholders and creditors.
4. That all procedural aspects had been complied with and that the necessary accounting treatment was also followed.
5. The disclosure as to results of last annual general meeting where the special resolution was approved with majority shareholders was also presented before the Court.
6. It is submitted that as per the provision of Section 129 of the Companies Act, 2013, the Company has to comply with the accounting standards for true and fair view of its accounts. Further, provisions of Section 129(5) allows the disclosure if any for deviation from accounting standard with effect to the same. The relevant paragraph No. 26 of the decision in 2015 SCC online Guj. 3356 was reported.
7. The contention that the non-promoter minority shareholders are to be treated as separate class is not tenable as

such class of classification of equity shareholder is not permissible under the Act.

8. Reliance was also placed on relevant paragraph Nos. 12, 17 and 19 of the judgment in the case of *Ram Kohli vs. Indrama Investment P. Ltd. [2014] 186 Comp Cas 358 (Delhi).*

The arguments and objections put forward by one of the non-promoter minority equity shareholder is as follows:

1. Such minority shareholder was not informed about holding of the annual general meeting.
2. A separate meeting of the minority shareholder ought to have been called.
3. Reliance was placed on decision in *[1996] 87 Comp Cas 792 (SC); [1996] JT (8) SC 205 in the case of Miheer H. Mafatlal vs. Mafatlal Industries Ltd.*

Judgment and reasoning

The Court observed that the proposed arrangement is not unfair or inequitable and allowed the petition and approved the Scheme of arrangement on the following grounds:

1. That Company had filed the application and which was allowed by this court and which further dispensed with holding of the meeting of the shareholders and creditors.
2. Based on the proposal made in the Scheme and payment to be made to the non promoter minority shareholders and by looking at the valuation report etc., it is observed that the Company is paying double the amount of market value of shares and thus, the contention of the minority shareholder and also that of the RoC that the non-promoter shareholders will be put into financial loss or injury is not acceptable.
3. On RoC's contention that the non-promoter equity shareholders are separate class, the Court has relied on the Company's reference to the judgment in *Ram Kohli vs. Indrama Investment P. Ltd.* In the said judgment, it was observed that "all equity shareholders constitute the same class of shareholders. Merely because individuals held small fraction of shares, that would not make them a separate class. All equity shareholders irrespective of the shareholding pattern would constitute the same class. The creation of class within a class is not contemplated in the scheme of Section 391 of the Act.

   Thus, the Court accepted the contention of the Company that there cannot be a class within one class of shareholders.
4. On objection that the minority shareholder has not received the notice of annual general meeting, the Court has reviewed the post department records, procedure followed in annual general meeting, the report of scrutinisers on results of poll etc. and noted that all procedural aspects as to approval of special resolution for reduction of share capital had been followed.
5. On accounting treatment, upon review of provisions of Section 129 of the Companies Act, 2013 and affidavit filed by the Company on compliance of accounting standards and procedure, certificate of the Statutory Auditor and reporting of deviation to be made in the accounting statements, the Court observed that the Scheme is in compliance of Sections 129 and 129 (5) of the Companies Act, 2013.

CA Mayur Nayak, CA Natwar Thakrar &
CA Pankaj Bhuta

OTHER LAWS
FEMA Update

In this article, we have discussed recent amendments to FEMA through Circulars issued by RBI:-

1. Participation of Foreign Portfolio Investors (FPIs) in Government securities on NDS-OM platform

In terms of RBI circular **FMRD. DIRD.06/14.03.007/2014-15 dated March 20, 2015**, FPIs are currently permitted to transact in the Over-The-Counter (OTC) market for Government securities with T+2 settlement.

As announced in paragraph 36 of the First Bi-monthly Monetary Policy Statement for the year 2016-17 on April 5, 2016, RBI *vide* **Notification no. RBI/2016-17/86 dated 20th October, 2016** has allowed FPIs to trade in Government securities in the secondary market through the primary members of NDS-OM including the Web-module. The primary members of NDS-OM shall be responsible for settlement of the trades, which will be on T+1 basis. This facility will become available with effect from 1st December, 2016.

The existing OTC route with T+2 settlements shall continue to be available to FPIs and subject to review.

[FMRD.DIRD.08/14.03.007/2016-17 dated 20th October, 2016]

2. Import Data Processing and Monitoring System (IDPMS)

In order to enhance ease of doing business and facilitate efficient data processing for payment of import transactions and effective monitoring thereof, Import Data Processing and Monitoring System (IDPMS) which has been developed in consultation with the Customs authorities and other stakeholders will go live with effect from October 10, 2016. The operational guidelines are provided in the Circular.

The platform also provides operational directions/ guidelines for Outward Remittance Message (ORM), Settlement of ORM with Bill of Entry (BoE), Extension and Write Off, Follow-up for Evidence of Import, etc.

[A.P. (DIR Series) Circular No. 5 dated 6th October, 2016]

(Comments: It has been widely reported in news papers that during past 44 years, India has lost trillion of rupees to scams relating to exports & imports. Monitoring systems like these may help in proper and timely monitoring of import transactions and reduction in leakages.)

3. Review of sectoral caps and simplification of Foreign Direct Investment (FDI) Policy

RBI has formally issued circular to give effect to the amendments made in the Consolidated FDI Policy Circular 2015 *vide* Press Note No. 6 (2015 Series) dated June 3, 2015, Press Note No. 7 (2015 Series) dated June 3, 2015, Press Note No. 8 (2015 Series) dated July 30, 2015, Press Note No. 11 (2015 Series)

dated October 1, 2015 and Press Note 12 (2015 Series) dated November 24, 2015 as also Notification Nos. 354/2015-RB dated 30 October, 2015, 361/2016-RB dated 15 February, 2016 & 362/2016- RB dated 15 February, 2016.

[A.P. (DIR Series) Circular No. 6 dated 20th October, 2016]

(Comments: Though several relaxations were notified by DIPP for FDI in various sectors, in absence of corresponding Circular/ Notification from RBI in many cases, the investors were required to approach FIPB even in case of investments which became eligible under the automatic route on account of these relaxations. This will reduce considerable hardship and delay to the investors and bring uniformity between RBI and DIPP regulations.)

4. Investment by a Foreign Venture Capital Investor (FVCI)

RBI has formally issued circular for relaxations notified *vide* Notification No. FEMA 363/2016 dated April 28, 2016. As per the relaxations, any FVCI which has obtained registration under the Securities and Exchange Board of India (FVCI) Regulations, 2000, will not require any approval from Reserve Bank of India and can invest in:

i. Equity or equity linked instrument or debt instrument issued by an unlisted Indian company engaged in any of the following sectors:
   - Bio-technology
   - IT related to hardware and software development
   - Nano-technology
   - Seed research and development
   - Research and development of new chemical entities in pharmaceutical sector
   - Dairy industry
   - Poultry industry
   - Production of bio-fuels
   - Hotel-cum-convention centers with seating capacity of more than 3,000
   - Infrastructure sector (This will include activities included within the scope of the definition of infrastructure under the ECB guidelines/policies notified under the extant FEMA Regulations as amended from time-to-time).

ii. Equity or equity linked instrument or debt instrument issued by an Indian 'startup' irrespective of the sector in which the startup is engaged. A startup will mean an entity (private limited company or a registered partnership firm or an LLP) incorporated or registered in India not prior to five years, with an annual turnover not exceeding ` 25 Crore in any preceding financial year, working towards innovation, development, deployment or commercialization of new products, processes or services driven by technology or intellectual property and satisfying certain conditions given in the Regulations.

iii. Units of a Venture Capital Fund (VCF) or of a Category-I Alternative Investment Fund (Cat-I AIF) (registered under the SEBI (AIF) Regulations, 2012) or units of a Scheme or of a fund set up by a VCF or by a Cat-I AIF.

Such VCFs or Cat-I AIFs which have received investment from FVCI, shall have to comply with the provisions for downstream investment as laid down in Schedule 11 of the Principal Regulations.

Other important points in relation to the circular are:

i. The investments by FVCIs shall be made out of inward remittance from abroad through normal banking channels or out of sale / maturity proceeds of or income generated from investment already made in the manner mentioned above.

ii. There will be no restriction on transfer of any security/instrument held by the FVCI to any person resident in or outside India.

iii. FVCI may open a foreign currency account and/or a rupee account with a designated branch of an Authorised Dealer for the purpose of making transactions only and exclusively under this Schedule.

iv. An entity receiving investment directly from a registered Foreign Venture Capital Investor (FVCI) will be required to report the investment, *mutatis mutandis*, in form FCGPR.

[A.P. (DIR Series) Circular No. 7 dated 20th October, 2016]

(Comments: The relaxation will help in attracting FVCI investments in the sectors mentioned in the circular under the automatic route. Further, sector specific restrictions will not apply for FVCI investment in Startups.)

5. Foreign investment in Other Financial Services

RBI has provided through this circular salient features of the policy changes/relaxations notified *vide* Notification No. FEMA 375/2016- RB dated September 9, 2016/Press Note No. 6 (2016 Series) dated 25th October, 2016 for foreign investment up to 100% under the automatic route in 'Other Financial Services'.

Other Financial services include activities which are regulated by any financial sector regulator viz. Reserve Bank of India (RBI), Securities and Exchange Board of India (SEBI), Insurance Regulatory and Development Authority (IRDA), Pension Fund Regulatory and Development Authority (PFRDA), National Housing Bank (NHB) or any other financial sector regulator as may be notified by the Government of India in this regard. Such foreign investment shall be subject to conditionalities, including minimum capitalisation norms, as specified by the concerned Regulator/ Government Agency.

In unregulated financial services activities or partly regulated by any financial sector regulator or where there is lack of clarity regarding regulatory oversight, foreign investment will be allowed up to 100% under the Government approval route.

Other important points in relation to the circular are:

i. Foreign investment in an activity which is specifically regulated by an Act will be restricted to foreign investment levels/limits, if any, specified in that Act.

ii. Downstream investment by any entity engaged in 'Other Financial Services" will be subject to extant sectoral regulations and provisions of Principal Regulations.

[A.P. (DIR Series) Circular No. 8 dated 20th October, 2016]

(Comments: The clarifications are welcome. However, there is still lack of clarity as regards FDI in Peer to Peer lending because of the uncertainty revolving around the classification of such activity as a financial service or not despite RBI announcing in April, 2016 the need for guidelines for regulating Peer to Peer lending platforms.)

6. Trade related remittance limit under the Rupee Drawing Agreements (RDAs)

Vide this Circular, the RBI has fixed the upper limit for a trade transaction under Rupee Drawing Arrangements of ` 15 lakhs per transaction.

[A.P. (DIR Series) Circular No. 9 dated 20th October, 2016]

(Comments: Earlier amount exceeding ` 15 Lakhs was allowed subject to satisfaction of certain conditions. This circular has withdrawn the discretion given to ADs.)

7. Extension and conversion of ECB

Under the existing ECB guidelines, designated AD banks can approve requests from borrowers for changes in repayment schedule during the tenure of the ECB, i.e., prior to maturity, provided average maturity and all-in-cost are in conformity with the applicable ceilings/ norms.

To simplify the procedure relating to ECB, RBI has further delegated powers to designated AD banks to approve requests from the borrowers for extension of matured but unpaid ECB, subject to the following conditions:

i. No additional cost is incurred;

ii. Lender's consent is available;

iii. Reporting requirements are fulfilled.

Further, powers are also delegated to designated AD bank to approve cases of conversion of matured but unpaid ECB into equity subject to same conditions as set out in the above paragraph while ensuring that conversion is within the following terms as mentioned in paragraph C.14 of Annexure to **Circular dated November 30, 2015** :

i. The activity of the borrowing company is covered under the automatic route for Foreign Direct Investment (FDI) or approval from the Foreign Investment Promotion Board (FIPB), wherever applicable, for foreign equity participation has been obtained as per the extant FDI policy;

ii. The foreign equity holding after such conversion of debt into equity is within the applicable sectoral cap;

iii. Applicable pricing guidelines for shares are complied with.

It should also be noted that if the concerned borrower of ECB has availed credit facilities from the Indian banking system including overseas branches/subsidiaries, any extension of tenure/ conversion of unpaid ECBs into equity (whether matured or not) shall be subject to applicable prudential guidelines issued by the Department of Banking Regulation of RBI, including guidelines on restructuring. Further, such conversion into equity shall also be subject to consent of other lenders, if any, to the same borrower or at least information regarding conversions shall be exchanged with other lenders of the borrower.

[A.P. (DIR Series) Circular No. 10 dated 20th October, 2016]

(Comments: This is a welcome move which will remove the procedural hurdles and enhance ease of doing business in India by delegating powers to AD *banks with specific and clear guidelines.)*

8. Foreign Exchange Management (Manner of receipt and payment) Regulations, 2016

The Foreign Exchange Management (Manner of Receipt and Payment) Regulations, 2000; Foreign Exchange Management (Receipt from, and payment to, a person resident outside India) Regulations, 2000 and Foreign Exchange Management Notification (Transactions in Indian rupees with residents of Nepal or Bhutan) Regulations 2000, as amended from time to time have been repealed and superseded by the Foreign Exchange Management (Manner of Receipt and Payment) Regulations, 2016 notified *vide* G.S.R. No.480 (E) dated May 3, 2016.

RBI, through this circular has notified the synopsis of the new Regulations.

[A.P. (DIR Series) Circular No. 11 dated 20th October, 2016]

9. ECB by Startups

The A.P. (DIR Series) Circular No. 13 dated 27th October, 2016 has provided a framework for permitting Startup enterprises to access loans under ECB. An overview of the framework is as follows:

i. **Eligibility**: An entity recognised as a Startup by the Central Government as on date of raising ECB.

ii. **Maturity**: Minimum Average Maturity (MAM) period will be 3 years.

iii. **Recognised lender**: Lender / investor shall be a resident of a country who is either a member of Financial Action Task Force (FATF) or a member of a FATF-Style Regional Bodies; and shall not be from a country identified in the public statement of the FATF as:

  a. A jurisdiction having a strategic Anti-Money Laundering or Combating the Financing of Terrorism deficiencies to which counter measures apply; or

b. A jurisdiction that has not made sufficient progress in addressing the deficiencies or has not committed to an action plan developed with the Financial Action Task Force to address the deficiencies.

***Exclusion**: Overseas branches/subsidiaries of Indian banks and overseas wholly owned subsidiary / joint venture of an Indian company will, however, not be considered as recognized lenders under this framework.*

iv. **Forms**: The borrowing can be in the form of loans or non-convertible, optionally convertible or partially convertible preference shares. The funds should come from a country which fulfils the conditions at 2(c) above.

v. **Currency**: The borrowing should be denominated in any freely convertible currency or in Indian Rupees (INR) or a combination thereof. In case of borrowing in INR, the non-resident lender, should mobilise INR through swaps/outright sale undertaken through an AD bank in India.

vi. **Amount:** The borrowing per Startup will be limited to USD 3 million or equivalent per financial year either in INR or any convertible foreign currency or a combination of both.

vii. **All-in-cost**: Shall be mutually agreed between the borrower and the lender.

viii. **End-uses**: For any expenditure in connection with the business of the borrower.

ix. **Conversion into equity**: Conversion into equity is freely permitted, subject to Regulations applicable for foreign investment in Startups.

x. **Security**: The choice of security to be provided to the lender is left to the borrowing entity. Security can be in the nature of movable, immovable, intangible assets (including patents, intellectual property rights), financial securities, etc., and shall comply with foreign direct investment / foreign portfolio investment / or any other norms applicable for foreign lenders / entities holding such securities.

xi. **Corporate and personal guarantee**: Issuance of corporate or personal guarantee is allowed. Guarantee issued by non-resident(s) is allowed only if such parties qualify as lender under paragraph 2(c) above.

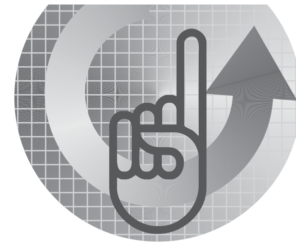
***Exclusion:** Issuance of guarantee, standby letter of credit, letter of undertaking or letter of comfort by Indian banks, all India Financial Institutions and NBFCs is not permitted.*

xii. **Hedging**: The overseas lender, in case of INR denominated ECB, will be eligible to hedge its INR exposure through permitted derivative products with AD banks in India. The lender can also access the domestic market through branches/ subsidiaries of Indian banks abroad or branches of foreign bank with Indian presence on a back to back basis.

xiii. **Conversion rate**: In case of borrowing in INR, the foreign currency - INR conversion will be at the market rate as on the date of agreement.

[A.P. (DIR Series) Circular No. 13 dated 20th October, 2016]

(Comments: The relaxation will provide a big boost to Startups in easing funding requirements from overseas lenders in INR or FCY. Most of the conditions are relaxed as compared to those applicable to Track I, II & III borrowers under the existing ECB Guidelines. However, RBI has ensured that no round tripping takes place by providing exclusions in the policy. However, due to the fundamental nature of a "start-up" being a company which inherently would not have a track record, RBI has limited borrowing per Startup to USD 3 million or equivalent per financial year either in INR or any convertible foreign currency or a combination of both.)



Ajay Singh, *Advocate* & CA Namrata Bhandarkar

BEST OF THE REST

1. Advocate's right to practice – Advocate not on roll of State Bar Council – Cannot appear; act or plead unless files appointment along with local Advocate – Allahabad High Court Rules 3, 3A obligating lawyer outside State to seek local lawyer's appointment – Valid, legal – Does not violate right to practice under Article 19(1)(g) of Constitution, Advocate Act, Ss. 30, 34

Appellant, as an Advocate, had filed a writ petition in the High Court at Allahabad but the Registry of the High Court refused to accept his petition as the appellant is not enrolled with the Bar Council of U.P. and that he had not fulfilled the requirement of the Rules 3 and 3A by filing appointment along with a local Advocate. Accordingly, appellant engaged a local Advocate for Allahabad cases at Allahabad. At the same time, he filed the writ petition in question challenging the validity of the Rules.

The Hon'ble Allahabad High Court observed that Article 19 of the Constitution of India guarantees certain freedoms to the citizens of this country which includes right to practice any profession, or to carry on any occupation, trade or business. It, therefore, naturally follows that right to practice law, which is a profession, is a fundamental right that is conferred upon all citizens of this country. Therefore, it can be said that the appellant has right to appear in any Court in India which would include right to appear and argue the matters even in High Court of Allahabad. Rules 3 and 3A of the Rules are regulatory provisions and do not impose a prohibition on practice of law. These Rules prescribe that an Advocate who is not on rolls of Advocate in the High Court is obligated to file an appointment along with a local Advocate. There is no absolute bar to appear. In fact, with the leave of the Court, an Advocate is still permitted to appear even without a local Advocate. In essence, an Advocate who is not on the roll of Advocates in the High Court can appear along with a local Advocate. Alternatively, even without fulfilling this requirement, an Advocate who is not on the rolls of Advocates in the High Court can move an application before the Court seeking leave to appear without even a local Advocate and in appropriate cases, such a permission can be granted.

The administration of justice is a sacrosanct function of the judicial institutions or the persons entrusted with that onerous responsibility and principle of judicial review has now been declared as a part of the basic structure of the Constitution. Therefore, if anything has the effect of impairing or

hampering the quality of administration of justice either due to lack of knowledge or proper qualification on the part of the persons involved in the process of justice dispensation or they being not properly certified by the Bar Council as provided under the Act and the Rules made there under, it will surely affect the administration of justice and thereby affecting the rights of litigants who are before the Courts seeking justice. The whole object of the Rules in question is furtherance of the administration of justice and to ensure that the advocates who can be easily located or accountable to the Courts are allowed to practice before the Court. Therefore, the Rules provide that the name of such advocates whose names are not on the roll of the Advocates in the High Court should appear with a local Advocate of the High Court. The easy identification of the person who appears before the Court when he is the enrolled advocate of another Bar Council or is not on the rolls of Advocates of the High Court is to ensure his presence whenever the cases are listed and to minimise the cases being dismissed for default which may result in serious consequences to the litigants and multiplicity and inordinate delay in proceedings whether it be a criminal case or civil dispute is the objective of Rule 3 or 3A of the Rules. That objective is achieved when he is permitted to appear along with the local Advocate of the High Court.

The Hon'ble High Court further observed that the respondents have given appropriate justification and rationale behind the Rules viz. to fix accountability on the advocates practising before the High Court. Such Rules are also aimed at helping in regulating the functioning of the Court. It is important for the orderly functioning of the Allahabad High Court that rolls are maintained in order to effect service of notices and copies of pleadings and ensure regular procedural compliances. The same will not be possible if proper records of Advocates practising in the High Court are not maintained in the High Court. The administration of justice will suffer if no person is held accountable for non-compliance of office reports etc. There may be occasions when Advocates may be called upon by the Court in pending matters and the dispensation of justice will suffer if there is no record of Advocates who do not generally practice in the High Court, may not attend matters in which they may have filed their vakalatnama before the High Court. It is imperative for the smooth and effective functioning of the court that the court is able to fix responsibility on Advocates, which is not possible if roll of advocates is not maintained in the High Court. Moreover, an advocate is permitted to file vakalat on behalf of a client even though his appearance inside the court is not permitted. Conduct in court is a matter concerning the Court. But the right to appear and conduct cases in the court is a matter on which the court must and does have major supervisory and controlling power. Hence courts cannot be and are not divested of control or supervision of conduct in court merely because it may involve the right of an Advocate.

From the above discussion, it becomes clear that High Court is duly empowered to make rules and Rules in question are not *ultra vires* Section 30 of the Act. It is more so when power under Section 34 of the Act is given to the High Courts, which are Constitutional Courts.

The High Court, therefore held that Rules 3 and 3A of the Allahabad High Court Rules, 1952 are perfectly valid, legal and do not violate the right of the appellant under Article 19(1)(g) of the Constitution of India and the appeal was dismissed.

Jamshed Ansari vs. High Court of Judicature at Allahabad and Others. AIR 2016 SC 3997 (All HC)

2. FIR – Supply of copy to accused – Guidelines stated – Copies of FIRs, except in sensitive cases like sexual offences, offences pertaining to insurgency and terrorism – Should be uploaded on websites within 24 hours of registration. Criminal P.C. S. 154

The petitioner, Youth Bar Association of India had filed a writ in nature of mandamus, directing the Union of India and the States to upload each and every First Information Report (FIR) registered in all the police stations within the territory of India in the official website of the police of all States as early as possible, preferably within 24 hours from the time of registration.

On deciding the petition, the Hon'ble Apex Court issued the following directions:

a) An accused is entitled to get a copy of FIR at an earlier stage than as prescribed u/s. 207 of Cr.P.C

b) An accused who has reasons to suspect that he has been roped in a criminal case and his name may be finding place in a FIR can submit an application through his representative for grant of a certified copy before the concerned police officer on payment of fee which is payable for obtaining such a copy from the Court. On application being made, the copy shall be supplied within 24 hours.

c) Once the FIR is forwarded by the police station to the concerned Magistrate or any Special Judge, on an application being filed for certified copy on behalf of the accused, the same shall be given by the Court concerned within two working days. The aforesaid direction has nothing to do with the statutory mandate inhered under Section 207 of the Cr.P.C.

d) The copies of the FIRs, unless the offence is sensitive in nature, like sexual offences, offences pertaining to insurgency, terrorism and of that category, offences under POCSO Act and such other offences, should be uploaded on the police website, and if there is no such website, on the official website of the State Government, within 24 hours of the registration of the FIR so that the accused or any person connected with the same can download the FIR and file appropriate application before the Court as per law for redressal of his grievances.

e) The decision not to upload the copy of the FIR on the website shall not be taken by an officer below the rank of Deputy Superintendent of Police or any person holding equivalent post.

f) The word 'sensitive' apart from the other aspects which may be thought of being sensitive by the competent authority as stated hereinbefore would also include concept of privacy regard being had to the nature of the FIR.

g) If an FIR is not uploaded, needless to say, it shall not ensure *per se* a ground to obtain the benefit under Section 438 of the Cr.P.C.

h) In case a copy of the FIR is not provided on the ground of sensitive nature of the case, a person grieved by the said action, after disclosing his identity, can submit a representation to the Superintendent of Police or any person holding the equivalent post in the State. The Superintendent of Police shall constitute a committee of three officers which shall deal with the said grievance. As far as the Metropolitan cities are concerned, if a representation is submitted to the Commissioner of Police who then shall

constitute a committee of three officers. The committee so constituted shall deal with the grievance within three days from the date of receipt of the representation and communicate it to the grieved person.

i) In cases wherein decisions have been taken not to give copies of the FIR regard being had to the sensitive nature of the case, it will be open to the accused/his authorised representative to file an application for grant of certified copy before the Court to which the FIR has been sent and the same shall be provided in quite promptitude by the concerned Court not beyond three days of the submission of the application.

j) The directions for uploading of FIR in the website of all the States shall be given effect from 15th November, 2016

Youth Bar Association of India vs. Union of India and Others. AIR 2016 SC 4136

3. Quit Notice – Phrase 'in absence of contract to contrary' – Cannot be read to mean that parties are free to contract out of express provisions of law, thereby defeating its very intent – It envisages a valid contract – Transfer of Property Act Ss. 106,107

Karnani Properties Limited, a company was the owner of the suit premises. It had let out the suit premises in favour of the appellant herein with the right to sublet the same or portions thereof. The appellant entered into an agreement dated 15-10-2004 with the respondents subletting the suit premises for the purpose of carrying out business from the 'Blue Fox Restaurant'. Subsequently, the respondents requested the appellant to allow them to run franchise or business dealing with McDonald's family restaurant from the suit premises. In pursuance of the same, the agreement dated 15-10-2004 was terminated, and a tenancy of the suit premises was created in favour of the respondents on the basis of an unregistered agreement dated 7-8-2006 at a rent and on the terms and conditions agreed. In terms of the said agreement, the tenancy commenced from 1-8-2006, at a rent of ` 20,000/- per month, payable by the tenants-respondents by the 7th day of every succeeding month. Further, as per the terms of the agreement, in case of breach of the agreement, the landlord-appellant was entitled to terminate the tenancy after serving a notice of period of thirty days. On 30-10-2008, the appellant issued a notice under Section 106 of the Transfer of Property Act, 1882 terminating the monthly tenancy of the respondents in respect of the tenanted premises upon the expiry of 15 days from the date of receipt of the said notice. Upon the expiry of the period of 15 days, the respondents did not vacate the suit premises.The appellant thus, filed suit for recovery of khas possession and mesne profits of the suit premises before the City Civil Court at Calcutta. The respondents contested the suit *inter alia* contending that by necessary implication the parties had agreed to not terminate the lease of the premises before 30 years, and that it was for this reason, a clause was incorporated for enhancement of monthly rent at the rate of 15% after expiry of every 3 years. The respondents further urged that the appellant had permitted them to invest a substantial sum of money for further repair and renovation of the tenanted premises suitably for their business. Thus, the appellant, by its declaration, acts and omissions had intentionally caused and permitted the respondents to believe that they will not terminate the lease of the respondents in respect of the tenanted premises before the expiry of the franchise agreement for running the McDonald's family restaurant from the

tenanted premises. It was thus, urged by the respondents that the notice of termination of lease is bad and not in accordance with law.

The Trial Court, after examining the evidence on record, decreed the suit in favour of the appellant relying on the clause in the agreement which deals with determination or termination of breach of tenancy in case of non-payment of rent for 3 consecutive months despite notice. The High Court set aside the order of the Trial Court and remanded the matter to it for reconsideration from the stage of examining the question of validity of the notice dated 30-10-2008.

On further appeal, the Apex Court observed that while the agreement dated 7-8-2006 can be admitted in evidence and even relied upon by the parties to prove the factum of the tenancy, the terms of the same cannot be used to derogate from the statutory provision of Section 106 of the Act, which creates a fiction of tenancy in absence of a registered instrument creating the same. If the argument advanced on behalf of the respondents is taken to its logical conclusion, this lease can never be terminated, save in cases of breach by the tenant. Accepting this argument would mean that in a situation where the tenant does not default on rent payment for three consecutive months, or does not commit a breach of the terms of the lease, it is not open to the lessor to terminate the lease even after giving a notice. This interpretation of the clause 6 of the agreement cannot be permitted as the same is wholly contrary to the express provisions of the law. The phrase 'contract to the contrary' in Section 106 of the Act cannot be read to mean that the parties are free to contract out of the express provisions of the law, thereby defeating its very intent. The contract between the parties must be in relation to a valid contract for the statutory right under Section 106 of the Act available to a lessor to terminate the tenancy at a notice of 15 days to not be applicable. In view of the above reasoning and conclusions recorded, the impugned judgment and order passed by the High Court was set aside.

M/s Park Street Properties Pvt. Ltd vs. Dipak Kumar Singh & Anr. AIR 2016 SC 4038

4. Medical negligence – Complainant alleged that Aesthetist not qualified, negligence by the doctors and hospital – Held that there was serious negligence by the hospital in rendering services to the patient – Consumer Protection Act

Complainants are the parents of a child named Shruti, aged 5 years was admitted to opponent No. 1 hospital for removal of stones from kidney under the care and supervision of opponent No. 2 i.e. Dr.Balwant Singh Ratta, a qualified Euro Surgeon, who carried the operation. Opponent No. 3 Dr. Rusi Nariman Marolia, claimed to be qualified anaesthetist attached to the opponent No. 1 hospital administered pre-operative anaesthesia to the patient. The patient child was allegedly clinically examined on admission by opponent No. 2 and decided to carry out the operation for removal of the kidney stones from the left kidney (not both kidneys) and operation was carried out. Complainant's (parent's) consent was taken on the blank consent form. Operation was only planned for removal of stones from left kidney. However, for the reasons best known to the opponent No. 2 he proceeded to operate right kidney for removal of the stones, simultaneously. Complainant's parents never gave consent to perform operation of both the kidneys simultaneously. On the day of operation, in the evening the patient became critical as the heart beats were reduced though put on ventilator. Unfortunately, child (patient) died.

Complainants have filed this consumer complaint alleging serious medical negligence leading to death of their child because of deficiency of service and claimed lump-sum compensation of ` 95.50 lakhs under various heads. It was alleged by the complainant that opponent No.3 – Dr. Rusi Nariman Marolia is not the qualified anaesthetist, yet, he offered his services to administer anaesthesia to the patient. Prior to operation various diagnostic tests were carried out and the patient was found to be fit for operation. Opponent No.2 - Dr. Ratta as alleged was negligent as he had carried out surgery on both the kidneys in single sitting which is not permitted even in emergent medical condition. There was no eminent danger of death or life threat to patient to carry out operation of both kidneys for removal of stones since it was a planned surgery. Third opponent i.e. Dr. Marolia without requisite qualification to work as anaesthetist was assigned to attend the patient for administration of anaesthesia, who failed to prevent unexplained cardiac arrest during the effect of anesthesia.

The Hon'ble State Consumer Disputes Redressal Commission observed that the decision of the operating surgeon has to be in the best interest of the patient to justify action. In this regard opponent No.2 rightly relied on the rulings in the matter of *Kusum Sharma and Others vs. Batra Hospital & Medical Research Centre and Ors., Civil 1385/2001* decided by Hon'ble Apex Court on 10-12-2010. The decision of the operating surgeon has to be taken as ultimate since he handled the patient only after certifying that the patient was fit for surgery. In view of this fact, they did not find that any separate consent was required to be taken before proceeding for operation. The Hon'ble State Consumer Disputes Redressal Commission further observed that Dr. Marolia without having requisite qualification as required under the statute rules and regulations has been working as Anaesthetist since 1975 with the hospital which *per se* establishes guilty of negligence against him and also warrants action by competent authorities, i.e. Indian Medical Council and Maharashtra Medical Council. It is unassuming that the public Trust running the hospital to render services to the patient has employed opponent No. 3 – Dr. Marolia as anaesthetist, even though, he does not possess the required qualification as per the norms and standards laid down for the post of anaesthetist.

In view of the above Dr. Marolia and the opponent No.1 are liable for negligence *per se* in rendering services to the patient. In view of the above, the commission was convinced to hold deficiency in service against opponent Nos.1 and 3 for serious medical negligence. The claim quantified by the complainants appeared to be highly exorbitant and excessive. However, at the same time irreparable loss of love and affection and the mental agony suffered by the complainants for loss of child could not be ignored. Therefore, they awarded lump-sum compensation to the complainants of ` 10,00,000/- and awarded expenses incurred on the diet of the child, funeral and conveyance totalling to ` 50,000/- and costs of litigation of ` 30,000/-.

Mr. Hanumant Mukinda Alkute & Sau Jayshree Hanumant Alkute vs. Grant Medical Foundation Ruby Hall Clinic,

[Before The State Consumer Disputes Redressal Commission Maharashtra, Consumer Complaint No. CC/12/32 dt. 26-9-2016]

5. Apex Court directs that only lawyers, doctors and architects if staying in their residential flat can conduct professional activities in that flat using 25% of Floor Area Ratio

(FAR) – No other commercial activity allowed in a residential flat

On 5-12-2011, the Apex Court has disposed of Civil Appeal No. 10535 of 2011 and issued certain directions. In the said direction, one of the directions 5 was that the doctors, lawyers and architects can use 30% of the area on the ground floor in their premises in residential sector for running their clinics/offices.

On 23-1-2012, it was pointed out before the Supreme Court that 30% of the ground floor area permitted to be used under Direction (5) above is contrary to the bye-laws and master plan of NOIDA. It was urged before the Supreme Court that the expression 'ground floor' used in the same clause may be clarified as 'any floor' because somebody may be having a two-storeyed house and may himself be living on the first floor only. In the circumstances, the court modified the Direction (5) quoted above and clarified that 25% of the permissible FAR is allowed to be used for their professional purposes by doctors, lawyers and architects.

It was then modified that the doctors, lawyers and architects can use 25% of the permissible FAR of any floor in their premises in the residential sector but only for running their personal office or personal clinic in it restricted sense. In the said order it was also directed that the NOIDA Authorities shall, issue a final notice to all the owners of the residences requiring them to stop use of the premises for banking or any other commercial activity and requiring them to shift from the residential areas. The NOIDA Authority shall also issue an advertisement stating therein the premises which can be offered to the banks as per the policy of the NOIDA Authority. This policy shall clearly state the terms and conditions for allotment and the manner in which the allotment of the alternative site/land would be made to the banks and/or other commercial activities in appropriate sectors i.e. commercial, institutional or industrial-commercial. Such policy should be fair and transparent.

The Hon'ble Supreme Court directed that individual doctors would not be entitled to any benefit under the Scheme that the NODIA will declare under said order. A clinic simpliciter can be run by a doctor within such area as already specified, of his or her residence. This clinic would mean one as per the bye-laws. To put the matters beyond ambiguity, it was clarified that the doctor can have his clinic with a table, a bed to examine the patient and such facilities which may be necessary to provide first aid. A dentist may have a dental chair in his clinic. Under this head, neither a polyclinic nor a nursing home can be run in the residential area. Further, no doctor would be permitted to run a polyclinic or a nursing home in the garb of a clinic. Therefore, the question of keeping the patients in the clinic overnight would not arise. The purpose of permitting a clinic is strictly in accordance with the directions of this court as already issued as well as the bye-laws. The doctors will be permitted to run a clinic to provide personal service to the outdoor patients and nothing more. The doctors would be permitted to conduct professional practice, by the resident doctor alone, within the scope of the directions already issued by this court.

Chairman & Chief Executive Officer Noida & Anr. vs. Mange Ram Sharma (D) through LRs. & Anr. and Dr. Anupama Bisaria & Ors. [I.A Nos.4-6 of 2012 IN Civil Appeal No.10535 of 2011 (SC)]

CA Hinesh R. Doshi, CA Haresh P. Kenia
Hon. Jt. Secretaries

The Chamber News

Important events and happenings that took place between 8th October, 2016 and 8th November, 2016 are being reported as under.

I. ADMISSION OF NEW MEMBERS

1) The following new members were admitted in the Managing Council Meeting held on 24th October, 2016.

LIFE MEMBERSHIP

1	Mr. Pradhan Jyotirmay Binod Behari	CA	Bhubaneshwar
2	Ms. Kulkarni Varsha Sudhir	CA	Thane
3	Mr. Prabhudesai Parag Shrikant	CA	Thane
4	Mr. Mundra Sandesh Satyanarayan	CA	Ahmedabad
5	Mr. Mehta Sanjay Vilaschandra	Advocate	Kolhapur
6	Mr. Sikka Ashok R. D. (Ord. to Life Mem.)	Advocate	New Delhi
7	Mr. Katariya Yogesh Kanakmal	CA	Pune
8	Mr. Saraf Subhash Chandra Radheshyam	CA	Kolkata
9	Mr. Garg Tushar Virendra	CA	Lucknow
10	Mr. Mukherjee Agnibesh Sujit Kumar	PGDM (Fin.)	Howrah
11	Mr. Fofaria Ankur Mahendrabhai	CA	Gujarat

ORDINARY MEMBERSHIP

1	Mr. Mehta Brijen Chetankumar	CA	Ahmedabad
2	Mr. Vaja Rashmin Shashikant	CA	Ahmedabad
3	Mr. Gulechha Abhinav Anand Raj	CA	Mumbai
4	Mr. Doshi Kiran Mohanlal	CA	Kolhapur
5	Mr. Shah Jinesh Dharmendra	CA	Mumbai
6	Mr. Patkar Nishad Umesh	ICWAI	Mumbai
7	Mr. Gupta Rahul Rishi	CA	Mumbai
8	Mr. Chittavarjula Seshagiri Rao Venkata	CA	Secunderabad
9	Mr. Chavan Kumar Balaso	ITP	Kolhapur
10	Mr. Desai Dhaval Ajitbhai	CA	Mumbai

11	Mr. Patil Yuvaraj Appaso	STP	Kolhapur
12	Mr. Sridhar V. R. Rengachary	ICWAI	Padi
13	Mr. Lasiyal Ajay Vijay	CA	Mumbai
14	Mr. Pawar Sanjay Harishchandra	CA	Mumbai
15	Mr. Teli Ravikumar Bipinbhai (Half Yearly Membership)	CA	Mumbai
16	Mr. Sharma Kamal Rajkumar	CA	Mumbai
17	Mr. Nahar Anand	CA	Aurangabad
18	Mr. Deora Nawalkishore Girdharilal	CA	Mumbai
19	Mr. Salunke Sandeep Bapu	Advocate	Thane
20	Ms. Paswan Laxmi Suchitram	CA	Thane
21	Mr. Acharya Kalmanje Gururaj	CA	Bengaluru
22	Mr. Kothari Mahavir Ashoklal	CA	Pune
23	Mr. Shah Keval Shailesh	CA	Mumbai
24	Mr. Selvaraj Dinesh Kumar P. (Half Yearly Membership)	B.Com	Navi Mumbai
25	Mr. Pandey Hanuman Ramakbal	CA	Mumbai
26	Mr. Bavisi Vishwas Khushalchand	ICSI	Mumbai

STUDENT MEMBERSHIP

1	Mr. Sengupta Partha Tapan	PGDBA Student	Kolkata
2	Mrs. Furia Aakruti Anil	CA Final	Mumbai
3	Mr. Gala Pranav Amrutlal	CA Student	Thane
4	Mr. Raichura Gaurav Piyush	CA Student	Mumbai
5	Mr. Agarwal Saurav Pawan	CA Student	Thane
6	Mr. Gosar Mayank Bhupendra	CA Student	Mumbai

II. PAST PROGRAMMES

1. INDIRECT TAXES COMMITTEE

For the 1st time ever **Webinar (live session) on "Basic Concepts of Model GST Law"** was held on 26th October, 2016.

The session was addressed by CA Naresh Sheth. The registration for the webinar was above 100 members, which includes ten members from outstation.

2. INTERNATIONAL TAXATION COMMITTEE

The **Basic Intensive Study Course on FEMA** was held on 14th, 15th, 21st and 22nd October, 2016 at M. C. Ghia Hall.

The Course was inaugurated by CA Dilip Thakkar and was addressed by eminent faculties in the field of FEMA.

3. LAW & REPRESENTATION COMMITTEE

Representation on - Pre-Budget Memorandum – 2017

Representation on Suggested Amendments in respect on Direct Tax for Finance Bill, 2017 was submitted to CBDT on 7th November, 2016.

4. DELHI CHAPTER

The **Full Day Seminar on "Inbound Investments & Exit Strategy – Structuring, Funding, Business Models, Legal, Regulatory & Taxation Aspects"** was held on 22nd October, 2016 at India International Centre, New Delhi.

5. MEMBERSHIP & PUBLIC RELATIONS COMMITTEE

The **Half Day Seminar on Survey, Search & Seizure** jointly with Vapi Branch of WIRC of ICAI was held on 22nd October, 2016 at Vapi Branch of WIRC of ICAI, Vapi.

(For Details and Study Material of the Past Programme, kindly visit www.ctconline.org)

III. FUTURE PROGRAMMES

(For details of the Future Programmes, kindly visit www.ctconline.org or refer The CTC News of November, 2016)

1. ALLIED LAWS COMMITTEE

The **Certificate Training Course in IND–AS (40 HRS) (With Knowledge Assessment)** jointly with **Corporate Members Committee** will be held on 12th, 19th, 26th November, 2016 & 3rd, 10th, 17th December, 2016 at Babubhai Chinai Hall, IMC.

2. CORPORATE MEMBERS COMMITTEE

The **Full Day Seminar on Alternative Fund Raising options for Corporates** jointly with **Bombay Chartered Accountants' Society** will be held on 25th November, 2016 at Walchand Hirachand Hall, IMC.

3. DIRECT TAXES COMMITTEE

The **Full Day Seminar on Surveys under Income-tax & TDS Surveys** will be held on 19th November, 2016 at M. C. Ghia Hall.

4. INDIRECT TAXES COMMITTEE

A) The **Orientation Course on GST Model Law** will be held on 15th, 16th, 17th & 18th November, 2016 at Jai Hind College.

B) The **5th Residential Refresher Course on Service Tax** will be held from 26th to 28th January, 2017 at Bogmallo Beach Resort, Goa.

5. INTERNATIONAL TAXATION COMMITTEE

A) The **Workshop on Taxation of Foreign Remittances** will be held on 25th & 26th November, 2016 and 9th & 10th December, 2016 at M. C. Ghia Hall.

B) The **Publication on Transfer Pricing an Industry & Technical Perspective** (Reprint July 2014 Edition) on Special Price for members only ` 950/- [Book MRP – ` 1995].

6. RESIDENTIAL REFRESHER COURSE & SKILL DEVELOPMENT COMMITTEE

The **40th Residential Refresher Course** will be held from 16th to 19th February, 2017 at The Golden Palms Hotel and SPA Resort, Bengaluru.

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10 Compelling Reasons

1. **Income-tax/Company Law/Indirect Taxes/GST**
   An Authentic & Largest Database of Acts, Rules, Circulars, Notifications and Case Laws on Income Tax (1886 onwards), Company Law (1913 onwards), Service Tax, Excise Laws, CST, All India VAT Laws/GST & other Corporate Laws.

2. **Case Law Research & Data Integration**
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Example	Particulars	Conclusion as per OECD
5	I Co, a resident of state I, specialises in providing engineering services and employs a number of engineers on a full time basis. J Co, another engineering firm resident of state J, requires temporary services of an engineer to complete a contract on a construction site in state J. I Co agrees to send one of its engineers to J Co for four months under the direct supervision and control of J Co. J Co will pay I Co an amount equal to the remuneration, social contributions, travel expenses and other employment benefits of that engineer for the relevant period, together with a 5 per cent commission. J Co also agrees to indemnify I Co for any eventual claims related to the engineer's work during that period of time.	In that case, the work performed by the engineer on the construction site in State J is performed on behalf of J Co rather than I Co. The direct supervision and control exercised by J Co over the work of the engineer, the fact that J Co takes over the responsibility for that work and it bears the cost of the remuneration of the engineer for the relevant period are factors that could support the conclusion that the engineer is employed with J Co.
6	K Co, a company resident of state K, and L Co, a company resident of state L, are part of the same group. A large part of the activities of that group are structured along function lines, which requires employees of different companies of the group to work together under the supervision of managers who are located in different states and employed by other companies of the group. X is a resident of state K employed by K Co, in charge of supervising human resources functions within the multinational group, is required to travel frequently to other States where other companies of the group have their offices. During the last year, X spent three months in state L in order to deal with human resources issues at L Co.	In this case, the work performed by X is part of the activities that K Co performs for its multinational group. These activities, like many other activities, are often centralised within a large group of companies. The work that X performs is thus an integral part of the business of K Co. Thus X should be regarded as an employee of K Co.

In various judicial precedents it has been held that the OECD Commentary can be referred to for guidance, but the same is not of binding one.

2.4.3 Key judicial precedents[1]

Various judicial precedents has laid down the factors to be considered for examining the employer and employee relationship, which are summarised below:

— Test of control and supervision.

— Right to terminate the employment i.e., control on employment

— Right to impose disciplinary sanctions

— Who has ultimate authority on performance of workers

— Integration of the worker's services into the business carried on by an enterprise

— Who provides necessary tools and materials to undertake the activities

Implications under alternative possibilities of 'who' can be regarded as employer are discussed in the ensuing paragraphs.

2.4.4 In case I Co is regarded as a 'real/ economic' employer

Based on the aforementioned factors, if I Co qualifies as an employer of the secondee, the arrangement may not be visualised as F Co providing services to I Co. Employment costs which are initially paid by F Co and later recovered from I Co should be regarded as reimbursements in the hands of F Co. Further, the presence of secondees in India may not result in creation of any PE in India (either fixed place PE or Service PE) for F Co since the secondees are rendering services in the capacity of employees of I Co and carrying on the business of I Co.

For payments to qualify as 'reimbursement'[2], it should be repayment of Actual expenditure incurred without any mark-up.

In the case of Temasek Holdings Advisors (I) (P.) Ltd. [2013] 38 taxmann.com 80 (Mum.), the Mumbai Tribunal held that the taxpayer was not liable to deduct TDS under Section 195 on the reimbursement of salary of seconded employees either as FTS or a service PE. The facts in the said case were as under:

The Singapore Holding Company had seconded two employees to the Indian subsidiary, the taxpayer. Key highlights of the secondment agreement were:

- Supervision, direction and control of the secondees was with the taxpayer
- The Holding Company did not bear any responsibility or risks for the results produced by the work of the secondees
- The salary cost of the secondees is paid by the Holding Company and cross charged to the taxpayer without any mark-up.

---

1. Judicial precedents relied upon to arrive at factors to be considered in examining the employer and employee relationship:
   - *DC Works Ltd. vs. State of Saurashtra (1957 AIR 264) (SC)*
   - *Carborandum Co. vs. CIT (108 ITR 335) (SC)*
   - IDS Software Solutions (122 TTJ 410) (Bangalore ITAT)
   - AT&S India (287 ITR 421) (AAR)
   - Tekmark Global Solutions (131 TTJ 173) (Mumbai ITAT)
2. Few Judicial precedents in relation to tests to be applied for payment to qualify as 'reimbursement':
   - Bovis lend lease [36 SOT 166] (Bang. ITAT)
   - C. U. Inspections (I) Pvt. Ltd. v. DCIT [2013] 142 ITD 761 (Mum.)
   - ITO v. CMS (India) Operations & Maintenance Co. Pvt. Ltd. [2013] 38 taxmann.com 92 (Chen.)
   - Siemens Aktiongelgsellschaft (310 ITR 320) (Bom.)

It was observed that the Holding Company had not rendered any services to the Indian taxpayer. In fact it was the Indian taxpayer who had rendered services to the Holding Company. It specifically distinguished various unfavourable decisions where the F Co. was actually the service provider to the I Co., wherein the contentions regarding non-taxability of the salary reimbursements were not accepted by the judiciary. The Tribunal also observed that for the same reason that no services have been rendered by the Holding Company to the Indian taxpayer, no service PE can be said to have to come into existence.

Similarly, the Delhi Tribunal in the case of HCL Infosystems (76 TTJ 505) accepted that the secondment of employees, though in relation to a collaboration agreement, resulted in employment relationship with I Co in view of other factors like discretion, command, control over services of assignees is exercised by I Co. This decision was also affirmed by the Delhi High Court (274 ITR 261).

Recently, Kolkata Tribunal in the case of *Reckitt Benckiser (India) Ltd. vs. JCIT (70 TM 143)* observed that the remuneration of secondees was partly paid by I Co and partly by UK Company, which was subsequently reimbursed by I Co to UK Company. I Co deducted taxes from the entire remuneration. It also noted that there was an employer-employee relationship between the I Co and employees. Hence, payments by I Co to UK Company is in the nature of 'reimbursement' and is not subject to withholding tax.

2.4.5 In case F Co is considered as 'real/ economic' employer

In the event, the F Co qualifies as employer of the secondee, the arrangement would be seen as provision of services to I Co by F Co through its employees in India. In such case, payments made by I Co to F Co would be treated as consideration for F Co's services unless F Co is able to demonstrate that no services have been rendered by F Co to I Co and the employees have been working solely for F Co or have discharged stewardship functions in India.

It is worth noting the ruling of the Delhi HC in case of Centrica India Offshore Private Limited (44 TM 300) wherein the Delhi HC disregarded the secondment agreement with the Indian company and held overseas company to be the real and economic employer of the seconded employees. The HC noted that the important factors like no clear entitlement or obligation cast on Indian entity to bear salary cost of the secondees, retention of rights by seconded employees in overseas social security benefits, absence of right to sue the Indian entity, absence of right of Indian entity to modify or terminate employment contract of the secondee are important factors to determine the real employer of the secondees. The Delhi HC affirmed the decision of the AAR and held that the presence of secondees constitutes a Service PE of overseas entity in India.

The SC has dismissed the Special Leave Petition ('SLP') filed by Centrica India Offshore Private Limited.

Another interesting ruling of Bangalore Tribunal in case of Food World Supermarkets Ltd. (63 TM 43) is important wherein it was an instance where F Co was resident of Hong Kong (India does not have Tax Treaty with Hong Kong). In this case, I Co had entered into secondment agreement with F Co for deputation of five employees. I Co reimbursed F Co salary paid by F Co to such secondees and contended that the said payment is not taxable as it is in the nature of pure reimbursement. In this recent judgement, the Tribunal observed that neither there was any employment agreement between I Co and secondees, nor secondees were made party

to the agreement between I Co and F Co. The secondees were performing their duties for or on behalf of F Co. Further, the secondees were under legal obligation as well as employment of F Co and assigned to assessee only for short period of time. The Tribunal also noted that all the employees were deputed on high level managerial/executive positions providing expert managerial services. Accordingly, the Tribunal held that the payments made by assessee to F Co amounts to FTS under the provisions of the Act and cannot be regarded as reimbursement of cost.

2.5 Rendering of services and FTS

2.5.1 Rendering of services – Reimbursement vs. Fees

As discussed above, in case the I Co is the economic employer, then the position is that the F Co is not providing services. Arguably, F Co could be providing the services of identifying and seconding its employees including managing administrative aspects of secondment. However, in those cases, generally no remuneration is charged by F Co to I Co for these services and consequently there should be no taxation for F Co as the amount would represent reimbursement. Even in such a scenario, if mark-up is charged by F Co, then the colour of arrangement would change and it would tantamount to rendering of services.

On the contrary, if F Co is the economic employer, then the presumption would be in favour of F Co being the service provider and consequently, the payment could qualify as FTS.

2.5.2 Stewardship services

In case of joint venture arrangement or high-value subsidiary scenario, the F Co generally deputes few of its employees to Indian entity on a short term basis to supervise the activities of the Indian entity or to ensure the quality of the products or services delivered by I Co is in compliance with the set standards. Invariably, the entire cost of the secondees is incurred and absorbed by F Co. In such a scenario, the activities of F Co should neither be regarded as provision of services to I Co nor be regarded as carrying on of business by F Co in the country of I Co.

This aspect was examined by the Supreme Court in the case of Morgan Stanley Inc., wherein the SC, after examining the facts of the case especially the activities of the secondee. Morgan Stanly and Company (MSCo) seconded employees to Morgan Stanley Advantages Services Private Limited ('MSAS') Indian company and it also had sent its personnel for undertaking stewardship activities to ensure that the services rendered by MSAS meet the standards of MSCo. MSCo paid the salary to seconded personnel and thereafter cross-charged the same to MSAS. In the given facts, the SC observed that in the instance case, MSAS is actually the service provider and the personnel sent to India for overseeing the services of MSAS was a stewardship activity which was for safeguarding the interest of MSCo. i.e., its term of confidentiality, quality control, etc. Accordingly, the presence of those employees should not lead to any permanent establishment of MSCo. in India.

Similar issue was examined by Delhi Tribunal in case of JC Bamford Excavators Ltd. (43 TM 343) wherein two sets of employees came to India – one who was seconded to I Co and another temporary one who came to protect the interest of the UK Company. The Tribunal held that the activities of testing and inspections carried out by temporary technical consultants to ensure quality standards for JCB's own interests amounted to stewardship activities which cannot be considered for

constituting Service PE in light of the SC ruling in the case of Morgan Stanley.

2.5.3 Services whether FTS

As discussed in detail in para 2.2 above, not all services would be classified as FTS. The classification would depend on the nature of the services and that it also differs from Act as that of Tax Treaty. Under the Tax Treaty, the definition FTS is narrower and the concept of "make available" further narrows down the scope of taxation of payments as FTS. Therefore, it is important to understand the terms of the agreement, facts of the arrangement, services provided by the employees, etc. In some Tax Treaty like India-Thailand, India - Greece, there is no article on FTS and hence, rendering of services through personnel (deputed or otherwise) would not be taxable as FTS; but would become taxable as business income if F Co has a PE in India. In the absence of a PE in India, the income would not be taxable in India. Important to note the AAR ruling in case of Teniskil (Sendirian) Berhard, Malaysia (222 ITR 551).

2.5.4 Free Services and FTS

Rendering of free services by F Co to its Indian subsidiary or joint venture could be regarded as FTS depending on the nature of arrangement and services rendered. F Co should not be subject to any taxation in India in the absence of any consideration. However, the risk of constitution of PE and consequential tax issues could make situation worse. Further, the free service arrangement would need to meet the "arm's length" test under Transfer Pricing so that there are no adjustments made in the hands of F Co. In case of free services, invariably, "base erosion" concept is applied while defending any transfer pricing adjustments; but, such argument may prove feeble in case where I Co is claiming tax exemption under the Act e.g., SEZ or Infrastructure Company.

2.6 Rendering of services and PE

2.6.1 Fixed Place PE risk

Typically, short term deputation arrangement does not result in fixed place PE as the duration is generally less than six months as such arrangement would not meet the fundamental tests of fixed place PE specified in Article 5(1) read with Article 5(2) of Model Tax Treaty. The OECD Commentary as well as Indian judicial rulings support this position.

On the contrary, long term secondment arrangement could pose a fixed place PE risk if the arrangement is not properly documented and F Co is regarded as economic employer providing services through such seconded employees to I Co. The duration of stay and the space made available at the disposal of such employees would satisfy the tests of fixed place PE. However, if the arrangement is properly crafted coupled with strong fact pattern, there is a case to contend that secondment arrangement does not constitute a fixed place PE in India.

This aspect has been examined by the SC in detail in case of Morgan Stanely (supra), wherein the SC categorically held that MSAS India was not a fixed place PE of overseas Morgan Stanley entities despite the secondment arrangement.

2.6.2 Service PE risk

Service PE concept was introduced in UN Model Convention and many Indian Tax Treaties have Service PE clause e.g., India-US, India-Singapore, India-UK, etc. The Service PE is typically defined as furnishing of services, which are not in the nature of FTS as defined in Article 12, within the Source state (say India) through employees of other personnel and such activities continue in the Source state for a specified period which ranges from 30 to 180 days. This period gets truncated to a single day in case where the services are provided

by F Co to its associated entity in Source state e.g., India-US Treaty provides for a single day.

Therefore, the fundamental test is to ascertain that whether services are in the nature of FTS or not as explained above. In certain Tax Treaties, Service PE would get triggered only when the services do not qualify as FTS. Then, the next criteria of number of days need to be satisfied, which is also a complex through subject altogether.

A challenge would arise when the services are rendered though other personnel. In that case, one need to examine whether the term "other personnel" would include all types of hired persons including independent third party service providers? An argument can be taken that independent third party service providers, which are not under the control, supervision and direction of F Co should not be regarded as "other personnel" and their period of days should not be counted while examining Service PE. This subject is very vast and cannot be covered in this article.

The issue of Service PE in the context of seconded employees was examined by the SC in great detail in case of Morgan Stanley (supra), wherein the SC held as follows:

"As regards the question of deputation, we are of the view that an employee of MSCo when deputed to MSAS does not become an employee of MSAS. ***A deputationist has a lien on his employment with MSCo.*** *As long as the lien remains with the MSCo the said company retains control over the deputationist's terms and employment. The concept of a service PE finds place in the U.N. Convention. It is constituted if the multinational enterprise renders services through its employees in India provided the services are rendered for a specified period. In this case, it extends to two years on the request of MSAS. It is important to note that where* ***the activities of the multinational enterprise entails it being responsible for the work of deputationists*** *and the employees continue to be on the payroll of the multinational enterprise or they continue to have their lien on their jobs with the multinational enterprise, a service PE can emerge. Applying the above tests to the facts of this case we find that on request/ requisition from MSAS the applicant deputes its staff. The request comes from MSAS depending upon its requirement. Generally, occasions do arise when MSAS needs the expertise of the staff of MSCo. In such circumstances, generally, MSAS makes a request to MSCo.* ***A deputationist*** *under such circumstances is expected to be experienced in banking and finance. On completion of his tenure he is repatriated to his parent job. He retains his lien when he comes to India. He* ***lends his experience to MSAS in India as an employee of MSCo as he retains his lien and in that sense there is a service PE (MSAS) under Article 5(2) (l).*** *We find no infirmity in the ruling of the ARR on this aspect. In the above situation,* ***MSCo is rendering services through its employees to MSAS. Therefore, the Department is right in its contention that under the above situation there exists a Service PE in India (MSAS).***

In the similar fact pattern, the Delhi Tribunal in case of JC Bamford Excavators Ltd. (43 TM 343 2014) upheld the Service PE of UK Company following the ruling of SC case discussed above. In this case, JC Bamford Excavators Ltd. ('JCB'), UK Company entered into TTA for technical assistance and for which JCB and I Co entered into International Personnel Assignment Agreement ('IPPA'), pursuant to which, JCB seconded employees to work with I Co. JCB received royalty for grant of licence and providing technical know-how and fees for services of secondees for provision of strategic functions relating to the day-to-day management of the I Co. JCB also provided 'Temporary' technical consultants for provision of assistance to I Co's personnel to study, analyse and advise on problems faced in manufacture of licensed products (no separate

consideration was agreed for the same). The income was offered to tax by JCB as Royalty and FTS under Article 13 of India-UK Treaty @ 15%. The Tax Authorities contended that presence of secondees constituted a Service PE for JCB and receipt of Royalty and FTS are effectively connected to such PE and hence, the same should be taxed as business profits under Article 7.

The Tribunal held that the secondees continued to remain as employees of JCB, therefore they rendered services to I Co in their capacity as employees of JCB creating a Service PE for JCB in India. The Tribunal noted the following critical facts while delivering its judgment:

— There was no separate secondment agreement executed formalising employer-employee relationship between I Co and secondees;

— As per IPPA between JCB and I Co, JCB would re-employ the secondees after termination of the deputation agreement. Further, if during such deputation certain disciplinary matter arises, those would be looked into by the Director of the JCB and not I Co;

— Agreements clearly mentioned that the secondees would be subject to the rules and regulations of the I Co but would not be considered its employees;

— Secondees continued to be on the payroll of JCB and maintained lien on their employment;

— Salary for these employees was sole responsibility of JCB.

2.6.3 Consequences of PE – taxation of FTS

In case where the secondment arrangement constitute PE in the Source State (say India), then payments received by F Co would become taxable as business income under Article 7 read with the provisions of the Act. In that case, ideally the income should be taxable on net basis (after reducing allowable expenses) @ 40% plus applicable surcharge (say in India) subject to the provisions of the Act. However, often, the issue of applicability of restrictive provisions of Section 44DA comes into play and the expenses, which are otherwise allowable to F Co, are not allowed as the F Co would not be able to satisfy the conditions of Section 44DA. Consequently, the entire FTS income of F Co could get taxed @ 40% plus applicable surcharge. Albeit, the question of applicability of Section 44DA is a matter of litigation and argument in favour of non-application is that the Section 92(iii) covers only fixed place PE scenario and does not include any other PE including Service PE. There are contrary rulings on this subject. Infact, the Delhi Tribunal in the case of Food World Supermarkets Ltd. (supra) the Tribunal set aside the matter to the tax officer to adjudicate whether the concept of Service PE specified under Section 92(iii) of the Act can be applied and accordingly, whether the income should be considered as taxable on net basis under Section 44DA of the Act.

Further, there is an additional exposure in the hands of seconded employees as they would not be able to claim short term exemption under Article 15 (Dependent Personnel Services) as their salary would have been paid (borne?) by such artificial PE of F Co and consequently, their salary could become taxable in the Source State (say India) as well as their home country, thereby resulting in double taxation in their hands as they could face challenge in claiming credit in their home country of taxes paid in Source state (India).

In such a scenario, effectively, there could be triple adverse effect – non-allowability of expenses for PE in the Source state, taxability

of salary of secondee in Source State and non-availability of credit of tax paid in Source state in home country.

3. Secondment of personnel

The secondment arrangement apparently looks simple, but is fraught with many complex issues as discussed above. Therefore, secondment arrangement between F Co and I Co (whether between related parties or not) should be structured carefully and also proper documentation should be executed among the respective parties including secondees to ensure that the arrangement is not subject to challenge by the Indian tax Authorities on all counts – payment is not reimbursement but FTS, arrangement constitutes PE, restrictive provisions of Section 44DA is applicable, etc. Further, appropriate transfer pricing study should be carried out to ensure that the arrangement is at arm's length between the associated entities and is not subjected to any transfer pricing adjustments.

The biggest challenge is post due to dual employment as the employees of F Co invariably would like to continue to be on the payroll of F Co for continuity benefits as well as social security benefits or may like ti retain lien over the F Co so that they can go back to the employment of F Co on completion of secondment term. Here the issue arises as to "who is the economic employer?" and the consequential issues that we discussed above creeps in. Therefore, one need to assess the benefits and downside of dual employment *vis-à-vis* adverse tax consequences. Appropriate, fine balancing need to be achieved and the arrangement needs to be structured very carefully to mitigate against adverse tax consequences in India and retaining the talent pool.

Following are some of the precautionary measures one could take to mitigate against the adverse tax consequences discussed above, though there is no assurance that the Indian tax Authorities will not challenge the arrangement. Certainly, it would serve as a decent "fire wall".

- Robust documentation maintained and ideally, secondees should be made a party to the relevant documents;
- Documents should clearly provide for the I Co has the control and supervision over the secondees;
- The HR Policies such as leave, holidays, office timings, dress code, appraisal etc. of the I Co should apply to secondees;
- The Secondees services should be supplementary and ingrained with the business of the I Co;
- I Co should have the right to take disciplinary action against the secondees;
- F Co. should not be rendering any other services to I Co which can be linked to the secondment arrangement;
- Documentation should provide that it is the responsibility of the I Co to remunerate the secondees and F Co is making payment on behalf of I Co;
- Payment by I Co to F Co should be actual reimbursement of costs incurred by F Co without any mark-up;
  - — I Co. should have right to terminate services of secondees during the period of secondment;
  - — Many other aspects.....

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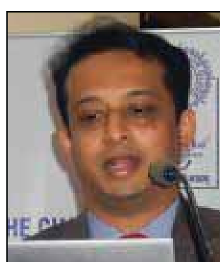
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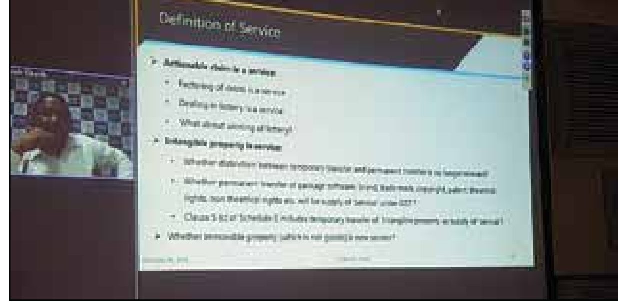
INDIRECT TAXES COMMITTEE

1st Webinar on "Basic Concepts of Model GST Laws" held on 26th October, 2016.

CA Hitesh R. Shah, President delivering opening speech.



CA Naresh Sheth addressing the Members.

Study Circle Meeting on the subject "Issues in amended set off rules and fixed sales price and its impact in Audit in Form – 704" held on 7th November, 2016 at SNDT Committee Room.

Ms. Nikita Badheka, Advocate chairing the session. Seen from L to R : S/Shri CA Atul Mehta, Convenor, CA Hinesh Doshi, Hon. Jt. Secretary, CA Deepali Mehta, Faculty, CA Vikram Mehta, Chairman, CA Sumit Jhunjhunwala, Convenor.

MEMBERSHIP & PUBLIC RELATIONS COMMITTEE

Half Day Seminar on "Survey, Search & Seizure jointly with Vapi Branch of WIRC of ICAI" held on 22nd October, 2016 at Vapi Branch Premises, Vapi

Seen from L to R: CA Hemant Parab, Chairman, Membership & Public Relations Committee, CTC, Mr. Ajay R. Singh, Faculty, CA Devendra Jain, Faculty and CA Chhaya Kothari, Chairperson, Vapi Branch of WIRC of ICAI, CA M. D. Prajapati, Member, CTC, CA Lalit Panchal, Convenor and other Members of CTC and Vapi Branch of WIRC of ICAI.

INTERNATIONAL TAXATION COMMITTEE

Intensive Study Group on International Taxation jointly with Study Circle on International Taxation Meeting on "Permanent Establishment including BEPS impact – A way forward" held on 12th October, 2016 at CTC Office.

Dr. Amar Mehta addressing the Members

FEMA Study Circle Meeting on the subject "Recent Changes in FEMA and its Implications (Covering July 2015 to October, 2016) held on 25th October, 2016 at CTC Office.

Ms. Tanvi Vora addressing the members. Seen from L to R : S/Shri CA Ujwal Thakrar, Member and CA Pankaj Bhuta, Session Chairman.

DIRECT TAXES COMMITTEE

Intensive Study Group (Direct Tax) Meeting on "Recent Important Decisions under Direct Taxes" held on 18th October, 2016 at CTC Office

Mr. Dharan V. Gandhi, Advocate addressing the Members.

MEMBERSHIP & PUBLIC RELATIONS COMMITTEE

Self Awareness Series on the subject "Goal Setting – Workshop for Professionals" held on 19th October, 2016 at CTC Office.

CA Atul C. Bheda addressing the Members.

ALLIED LAWS COMMITTEE

Study Circle Meeting on "Resolving legal dilemmas and practical difficulties in negotiating and concluding Share-Purchase/Shareholders Agreement" held on 21st October, 2016 at IMC.

Mr. Sharad Abhyankar addressing the Members.

STUDY CIRCLE AND STUDY GROUP COMMITTEE

Study Circle Meeting held on 26th October, 2016 at SNDT Committee Room.

CA H. M. Suthar addressing the Members on the subject "Concept of Capital Value for the purpose of Property Tax".

CA Sanjay Chokshi addressing the Members on the subject "Dispute Resolution Scheme".

DELHI CHAPTER

Seminar on "Inbound Investments & Exit Strategy – Structuring, Funding, Business, Models, Legal, Regulatory & Taxation Aspects" held on 22nd October, 2016 at India International Centre, New Delhi.

Dignitaries on dais: Seen from L to R : S/Shri CA Anup P. Shah, Faculty, R. P. Garg, Chairman and CA G. S. Ahuja, Member.

Dignitaries on dais: Seen from L to R : S/Shri CA Amit Maheshwari, Arun Gupta, CA Amithraj A. N., Faculty, V. P. Verma, Advisor and CA Prakash Sinha, Member.

CA Anup Shah addressing the Members.

CA Amithraj A. N. addressing the Members.

STUDY CIRCLE AND STUDY GROUP COMMITTEE

Study Circle Meeting on "Penalty for under reporting & Misreporting of Income – Sections 270A & 270AA of I. T. Act, 1961" held on 9th November, 2016 at IMC.

CA Yogesh Thar addressing the Members.

CTC Diwali Get-together and Musical Evening held on 24th October, 2016 at Club House, ERA CHS Ltd., Lower Parel.

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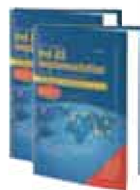

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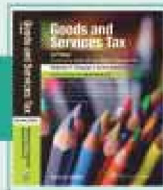

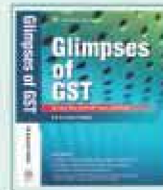

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