Recent Developments in Direct Taxation

Pinakin Desai

14 July 2010

Source Rule : Source of controversy ?

Territorial nexus – A pre condition?

- Source Rule widened for interest, royalty, FTS w.r.e.f 1.6.76
- Key extracts from Ishikawa Jima Harima Heavy Industries Ltd. V/s. CIT [288 ITR 408](SC).

> *"Whatever is payable by a resident to a non-resident by way of fees for technical services, thus, would not always come within the purview of s. 9(1)(vii) of the Act.* ***It must have sufficient territorial nexus with India so as to furnish a basis for imposition of tax."*** *(Page 445)*

> ***"Sufficient territorial nexus between the rendition of services and territorial limits of India is necessary to make the income taxable."*** *(Page 447)*

Source Rule (recent retrospective amendment)

- Deemed accrual amendment in Finance Act 2010 whether or not:
  - NR has a residence / place of business / business connection in India
  - NR has rendered services in India
- Clear intent to overrule following precedents
  - Ishikawajima's Ruling (SC) (288 ITR 408)
  - Jindal Thermal Power Co Ltd (Kar) (225 CTR 220)
  - Clifford Chance vs DCIT (Bom) (221 CTR 1)

Impact Analysis

- Decision of Ashapura Minichem Ltd (Mumbai ITAT) (2010) (5 Taxman 57):
  - IHI no longer a good law post amendment by Finance Act 2010.
  - Scope of Source Rule 'in terms of India –China Treaty requiring payment for **"provision of services of managerial, technical or consultancy nature by resident of China in India"**
- Reopening of past assessments of
  - payer for TDS default
  - payee

Impact Analysis

- Cases beyond the reach of amendment :
  - Absence of Article on Fees for Technical Services in DTAA
  - DTAA on restrictive FIS concept
  - Cases protected by Independent Personal Services Article
  - Interest / royalty / FTS paid for business / source of income outside India [Domestic Source Rule exception - in S.9(1)(vi)(b)]

Bitter taste of Gift ?

Receipt of Closely Held Company' s (CHC) shares by Firm / CHC [S.56(2)(viia)]

- Stated object : Anti abuse provisions to 'prevent practice of transferring unlisted shares at prices much below FMV'
- Tax trigger conditions
  - Recipient is a firm / a CHC
  - Receipt is of property being shares of a CHC
    - Shares can be of any kind; may carry differential voting right
    - Receipt may be of capital asset or stock-in-trade
  - Receipt is from any person
  - Receipt is on or after 1 June 2010
  - Receipt is without consideration and value of shares > INR 50,000
  - Receipt is without adequate consideration and difference between FMV and consideration > INR 50,000
- Taxation w.r.t FMV to be determined in accordance with Rule 11UA
- Consequential cost step up available to the recipient [S. 49(4)]

Scope of ‘receipt’

- Tax trigger requires that firm / closely held company ***‘receives ……………. from any person……………. any property, being shares of a company ……………’***
- The word “receives” implies two persons – the person who receives and the person from whom he receives
- Specific exclusion for shares received in following transactions viz.
  - A foreign company transferring shares of ICo to another foreign company in merger/demerger. [S. 47(via) / (vic)]
  - Business reorganization of a co-operative bank [S. 47(vicb)].
  - Receipt of shares by shareholders pursuant to tax qualifying merger/demerger [S. 47(vid) / (vii)]

Assets which do not constitute shares*

- Mutual fund units
- Convertible or non convertible debt instrument
- Coupon / warrants
- Interest in a partnership firm where firm holds shares as assets

*Even assuming shares, instruments specific to a listed / widely held company are, excluded. Derivatives are excluded

Areas of concern : Some illustrations

- Bonus and rights issue
- Split / Consolidation of shares
- Conversion of compulsorily / optionally convertible debentures into shares
- Call / Put option at pre agreed price
- Buyback of shares
- Conversion into LLP of investment company holding CHC shares
- Amalgamation of investment company holding CHC shares with another CHC

Probable Defences*

- In appropriate facts, interpretation will need to accord with the objects of the section
- Interpretation should not be dehors the concept of ‘income’
- Receipt of shares pursuant to pre-existing right represents receipt for adequate commercial consideration
- Value of sacrifice is the measure of consideration
- Receipt needs to be pursuant to a bilateral transaction
- There needs to be property- much less, existing property!
- Receipt should of beneficial interest
- Receipt should be a capital asset capable of being held and capable of giving benefit of cost step up
- Non resident may have benefit of treaty protection

* Untested and prone to litigation

LLP conversion : Truly tax neutral ?

Conversion of unlisted company to LLP [47(xiiib) (w.e.f 1.4.2011)]

- **Conditions for tax neutral conversions of companies into LLP**
  - Conversion is in accordance with section 56 / 57 of LLP Act
  - All assets and liabilities of company to become that of LLP
  - All shareholders to become partners in LLP with capital contribution and profit sharing ratio in the proportion of shareholding
  - Shareholders not to receive any consideration or benefit, directly/indirectly, in any form except by way of share in profit and capital contribution in LLP
  - Aggregate of profit sharing ratio of the shareholders of company in LLP ≥ 50% for a period of 5 years
  - ***Sales, turnover or gross receipts in business of company in any of 3 years < INR 6 million***
  - No direct / indirect payment to any partner out of accumulated profits of company for a period of 3 years post conversion date

Conversion into LLP : Issues / concerns

- Arguably no DDT Implications for the company – though, no specific tax protection provision
- Exemption limited to capital gains tax
- No provision for cost step up for LLP if capital gains exemption forfeited
- No specific amendments to permit continuing tax holiday in the name of LLP

Conversion into LLP: Issues / concerns

- Scope of ‘sales, turnover or gross receipts in business’:
  - Advances received by the builder
  - SEZ developer offering rental under HP chapter
  - Investment company collecting dividend income
- Share capital of company v/s capital contribution
- Impact of presence of share premium and other capital reserves on company balance sheet
- Does conversion trigger section 79 applicability to losses of underlying company ?

Fluctuating rules of Exchange Fluctuation (EF)

Settled legal positions

- EF loss relating to trading / circulating asset is tax admissible.
- EF loss relating to capital / fixed asset is capital in nature [Sutlej Cotton Mills v/s. CIT (116 ITR 1)(SC)]
- Loss recognized on MTM basis is real loss and admissible in the year of recognition in accordance with accounting principles [Woodward Governor India P Ltd (312 ITR 254)(SC)]
- EF loss relating to capital asset adds to cost of asset / investment in terms of section 43A and not independent thereof

Forex derivatives – CBDT Instruction # 3

CBDT's instructions to Assessing Officers :-

- MTM losses are notional and contingent – despite admitting that MTM restatement is a transparent accounting practice
- Actual losses allowable only if the transactions qualify as 'eligible derivative transactions' under clause (d) of proviso to s.43(5)
- A.O. should examine the accounts to find out if derivative losses camouflaged as 'financial charges', 'foreign exchange loss' or other similar head by making specific enquiry

Life after the Instruction

- Is the instruction valid and binding on the taxpayer / Tax Authority?
- Can MTM loss be considered as notional ?
- Is loss on derivative instruments counter matched by higher exchange realisation and hence not an independent speculative transaction?
- Can taxpayer place reliance on instruction to support taxation of gain only upon settlement?

Company : Where does it reside?

Residence of a company incorporated outside India

- Test of Residency as per Income Tax Act:
  - A foreign company resident in India if, at any time in the financial year, the control and management (C&M) of its affairs is **'wholly'** in India
- Original proposal in DTC:
  - A foreign company resident in India if, at any time in the financial year, the control and management (C&M) of its affairs is **'wholly or partly'** in India
- Concerns raised:
  - DTC threshold very low
  - Single BOD meeting in India can make difference
  - Outbound investment - part control may be in India
  - Uncertainty in taxation to impact FDI

Residence of a company incorporated outside India

- Revised proposals
  - Existing threshold of whole of C&M in the Act is too high
  - Company incorporated outside India resident if Place of Effective Management (POEM) in India
  - POEM is where key management and commercial decisions for entity/ business as a whole in substance are made
  - POEM is internationally recognized. Also, a tie breaker rule in tax treaties

Residence of a company incorporated outside India

- POEM means:
  - Place where BOD or executive directors make their decisions

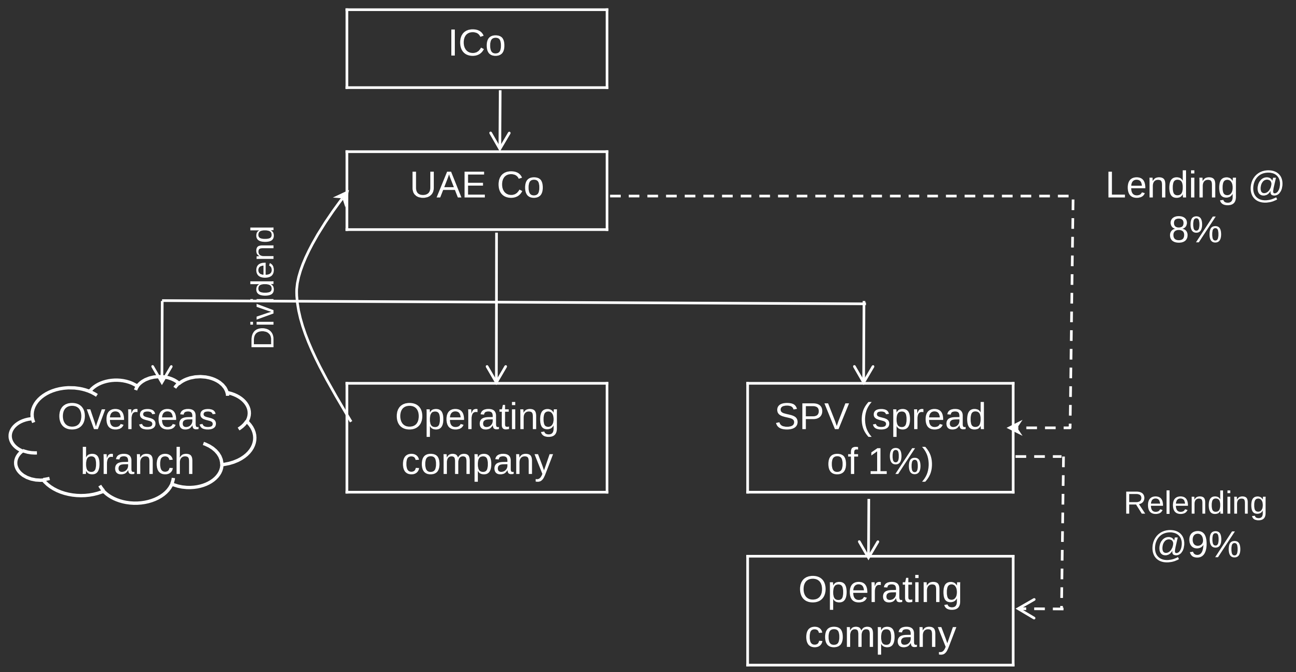
OR

  - Place where such decisions taken by ED or officers, ignoring where BOD routinely approves decisions
- Proposal also to introduce 'Controlled Foreign Corporation' (CFC) provisions to tax passive undistributed income of a CFC of a resident

CFC legislation

- CFC legislation as an anti-avoidance measure
  - Proposal contained in Non-resident Taxation Working Group (Jan 2003, Mr Vijay Mathur Group)
- CFC legislation aims to end tax deferral
  - Undistributed income earned by foreign company included as income of parent shareholder in stated circumstances
  - Prevention of accumulation of funds in Low Tax Jurisdictions (LTJ)
- Taxation of passive income proposed as per RDP
- Passive income earned by a foreign company (FCo) controlled directly or indirectly by an Indian resident
  - Income not distributed shall be deemed to have been distributed
  - Taxed in the hands of resident shareholders as dividends received from FCo

Impact of POEM V/s CFC



CFC applicability	POEM conflict
▶ Applies to ICo ▶ ICo to pay tax on ‘passive income’ of UAE Co ▶ Passive income likely to cover dividend and interest income of UAE Co ▶ Need to avoid double taxation in India – by, say UTC	▶ Relevant to residence of UAE Co ▶ Global tax in the name of UAE Co on Y-O-Y basis ▶ UAE Co to pay DDT on dividend distribution ▶ CFC then not applicable to ICo.

Anti-avoidance Rules

Quality In Everything We Do

Approach to tax avoidance

- Judge made law: Application of anti-avoidance principles emerging from judicial decisions
- Enactment of Specific Anti-avoidance Rules (SAAR)
  - Transfer Pricing
  - Anti-treaty shopping provisions
  - Anti-deferral/ CFC Rules
  - Thin Capitalization
- Enactment of General Anti-avoidance Rules (GAAR)
  - A broad rule that has the effect of invalidating an arrangement that has been entered into by a taxpayer for the purpose of obtaining a tax benefit.

Anti-avoidance principles: General Tenets

- Business Purpose Rule
  - A transaction must have a main or predominant business purpose other than tax avoidance
- Substance over Form Rule
  - Legal form without economic substance; taxpayer has economic power over taxable income without tax liability
  - Sham transaction - Hides the reality of a transaction that exists in form only
- Step Transaction Doctrine
  - Series of connected transactions regarded as single transaction
  - Intermediate steps in a chain of pre-ordained transactions may be disregarded.

Present judicial thinking in India : Tax avoidance is legal; tax evasion is illegal

Dividend stripping – Walfort Share & Stock Brokers Pvt. Ltd.[1]

Particulars	Date	NAV
Investment	24.3.2000	INR 17
Dividend receipt	24.3.2000	INR 4
Transfer of Units	27.3.2000	INR 13

Commercial Position		
Investment (24.3.00)		**(8.00) Cr.**
Dividend (24.3.00)	1.82 Cr.	
Incentive receipt (?)	0.23 Cr.	
Sale price (27.3.00)	5.90 Cr.	**7.96 Cr.**
Difference		**(0.04) Cr.**

Tax Position	
Cost of Purchase	**(8.00) Cr.**
Dividend Income	Claimed exempt
Incentive	Not clear
Sale price	5.90 Cr.
Business loss	**(2.10) Cr.**

Loss denied by tax department invoking provisions of section 14A contending that loss was incurred for earning dividend.

[1] [2010-TIOL-47-SC-IT]

SC Ruling

- Section 14A restricted in its application to expenditure incurred; not applicable to cost of investment
- Price paid for purchase of unit cannot be split up between capital outlay and income embedded
- AS-13 also supports that split of cost is required only when right to receive had crystalised and accrued
- There was actual sale, receipt of sale price and exempt dividend
- Utilizing provision of tax law to obtain tax advantage is not ‘abuse of law’.
- Tax planning, without motive to evade tax through colourable devices, is not frowned upon even in McDowells case.

General Anti-Avoidance Rule (GAAR): DTC Proposal

- Original proposals
  - GAAR provisions to apply where, inter-alia, main purpose of arrangement is to obtain a tax benefit
  - Power to invoke GAAR given to CIT who can call for information as may be necessary
  - CIT can declare an arrangement as Impermissible Avoidance Arrangement (IAA) and can direct adjustments
  - Burden of proof on taxpayer to establish that tax benefit was not the main purpose.
- Concerns raised
  - GAAR may be invoked in routine and arbitrary manner
  - 'De minimis' for GAAR invokation should be prescribed in form of legislative and executive safeguards

GAAR : RDP speaks

- GAAR to stay if while obtaining a tax benefit, the taxpayer fulfills any one of the following four conditions:
  - Arrangement not at arm's length
  - It represents misuse or abuse of the provisions of the Code
  - Lacks commercial substance
  - Entered in a manner not normally employed for bona-fide business purposes
- CBDT to issue guidelines to provide for situations where GAAR can be invoked
- Forum of DRP available when GAAR invoked
- Threshold limit for GAAR applicability to be specified
- Treaty override to operate for GAAR

GAAR : DTC Impact

- Tax consequences if GAAR is invoked
  - Disregard, combine, recharacterize steps or parts of the arrangement
  - Disregard any accommodating party / tax indifferent party.
  - Deem persons who are connected to be one and the same person
  - Recharacterize or re-allocate income
  - Recharacterize multi-party financing transaction
  - Recharacterize debt financing as equity or vice versa

GAAR : Concerns

- Several terms used in GAAR capable of alternative interpretations
- Terms such as ‘commercial substance’ and ‘business purpose’ not defined in an exhaustive manner
- Application could be subjective/ arbitrary
- Can GAAR be applied to court approved schemes or pre-existing arrangements having ‘tax benefit’ after coming into force of DTC?

Recent Rulings

Bad debt write off : Vijaya Bank(SC) [1]

- Credit entry in debtor's account not necessary to constitute 'write off' for the purposes of bad debt write off deduction u/s. 36(1)(vii)
- Concept of write off explained by SC in Southern Technologies[2] :-

  "If an assessee debits an amount of doubtful debt to the P&L Account and credits the asset account like sundry debtor's account, it would constitute a write off of an actual debt. However, if an assessee debits 'provision for doubtful debt' to the P&L Account and makes a corresponding credit to the 'current liabilities and provisions' on the Liabilities side of the balance sheet, then it would constitute a provision for doubtful debt. In the latter case, assessee would not be entitled to deduction after April 1, 1989'.

- Reflection of debtors in the Balance Sheet at net figure sufficient to constitute write off
- Schedule VI requires disclosure of debtors and provision separately (though not as part of current liabilities & provisions)

---

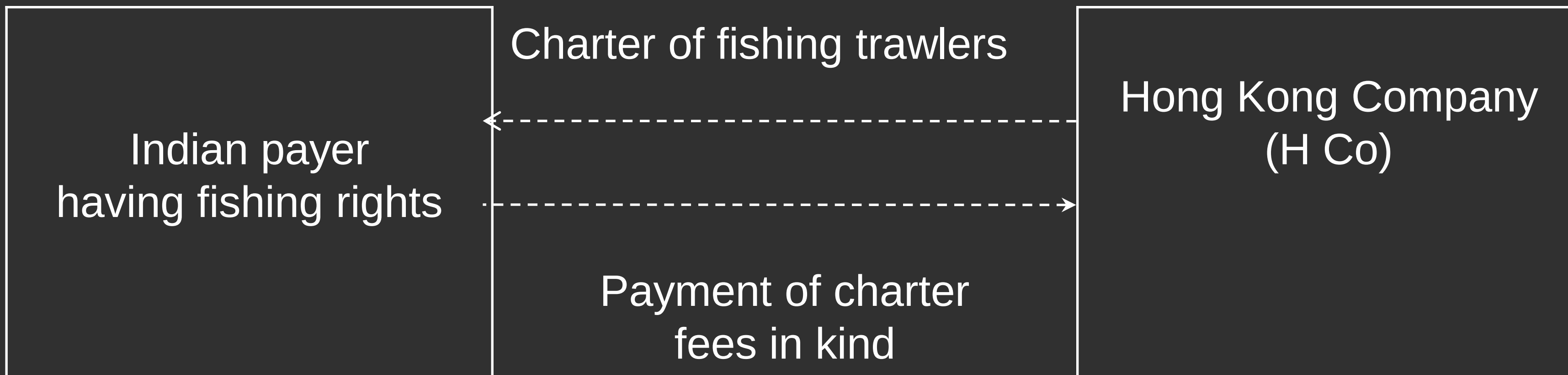
[1] 2010-TIOL-31-SC-IT
[2] 320 ITR 577

Reassessment scope : Kelvinator of India (SC)[1]

- Whether reassessment can be initiated on ‘change of opinion’ of Assessing Officer within 4 years?
- **Tax Department’s contentions**
  - Post amendment w.e.f 1.4.1989, s.147 permits reassessment on change of opinion of A.O. on the basis of information available on record
- **SC Ruling**
  - A.O. does not have power to ‘review’ his own order.
  - S.147 permits reassessment where there is ‘reason to believe’.
  - Reassessment on change of opinion is review of order conferring arbitrary powers
  - Proposal based on ‘opinion’ of A.O. consciously dropped [CBDT Circular No. 549 dated 31.10.1989]
  - Basis is ‘tangible material’ of escapement of income and reasons must have ‘live link’ with formation of belief.

[1][320 ITR 56] (SC) (LB)

Kanchanganga Sea Foods Ltd. Vs. CIT[1]



<u>Terms of charter</u>

- Charter fees fixed at US $ 6 Lakhs subject to maximum of 85% of the catch
- The catch made at high seas brought to Chennai for value assessment and export to destination chosen by H Co

[1] [2010-TIOL-03-SC-INTL]

SC Ruling

- Section 5(2) creates charge for NR Company in respect of income accruing, arising, deemed to be accruing as also income received in India
- Charge of tax on the basis of receipt in India
- First receipt was in India as share of H Co in catch was determined and handed over to H Co at Chennai port
- If first receipt is in India, subsequent sale and realisation outside India does not impact taxation
- Payer liable to withhold taxes as H Co liable to pay tax in India

Maruti Suzuki India Ltd[1]

- Maruti Suzuki India Limited (MSIL) is engaged in the business of manufacture and sale of automobiles since 1983
- Collaboration agreement entered into with Suzuki towards the end of 1992 for use of technical information and trademark for which MSIL paid a lumpsum and a recurring royalty
- TPO held that Suzuki should have compensated MSIL for assistance provided in developing marketing intangibles
- Non-routine advertisement expenditure was adjusted/ disallowed as being the value of marketing intangibles accruing to the benefit of Suzuki – ‘Bright line’ test applied
- Part of the royalty for use of trademark disallowed on the ground that Suzuki should have subsidized/ compensated for co-branding efforts.

[1] [2010-TII-01-HC-DEL-TP]

Bright line test

- Expenses on AMP need not be reimbursed by Fco if it does not exceed the expenses which an independent entity would have incurred under comparable circumstances
- Only if expenses exceed such limit, F Co should compensate I Co in respect of advantage obtained by it in the form of brand building in the domestic market
- Bright line test should be applied where economic ownership in the form of 'marketing intangible' for F Co is created
- Aspect of 'competition' in the market and increase in AMP expenses on account of stiff competition should be considered while deciding bright line limit
- Payment exceeding bright line test but which is offset by corresponding subsidy offered by F Co to I Co (e.g., reduction in royalty rate) does not call for an adjustment

Unabsorbed depreciation: Times Guaranty (Mum)(SB)[1]

Particulars	First Period	Second Period	Third Period
Assessment Years	Up to 1996-97	From 1997-98 to 2001-02	From 2002-03 onwards
Period of carry forward	Indefinite	8 years	Indefinite
Income against which set off can be claimed	Any income	Business Profits	Any income
Treatment of unabsorbed depreciation (UD) of earlier period	UD of First Period to be set off against any income [within 8 years] starting from A.Y. 1997-98 in view of FM concession.	UD of Second Period to be set off against Business Profits for 8 years only.	

ITA No 4917 & 4918/ Mum/ 2008

Ruling of SB

- Law as applicable on 1st day of relevant assessment year applies to carry forward and set off of UD
- UD of second period available for carry forward and set off as per provisions of section 32(2) as subsisted
- Section 32(2) amended substantively from AY 2002-03 and position of first period restored. Such amendment not applicable to UD of second period
- Language of section 32(2) which uses present tense make prospective application of the section clear
- But for FM concessions, UD of first period could not have been set off (i) beyond 8 years from the year of loss (ii) against other income

Is SB conclusion for Second Period consistent with that for the First Period?

Thank you

Ernst & Young

Quality In Everything We Do