The Institute of Chartered Accountants of India

(Setup by an Act of Parliament)

HYDERABAD BRANCH OF SIRC NEWSLETTER

www.icaihyd.org hyderabad@icai.org Volume: 18 / Issue: 12 / April, 2017

Chairman Writes....

At the outset, I wish all the members, Happy Ramnavami, the birth day of Lord Sri Rama who was known as Maryada Purushottama. The life of Lord Rama is not just a story to read but which should be followed by everyone, who stand for his Dharma and Truth in every walks of his life.

I am sure many of us would be busy conducting the Statutory bank branch audits. Keeping in view this fact the branch has decided not to conduct many CPE programmes till 15th April and utilise the space of branch for conducting activities and classes for students. The details of programmes/seminars planned for April /May are as under:

Report on the programmes conducted during the month of March 2017 is as under:

One Day Seminar on Financial and Cyber Frauds-Risks and Emerging Opportunities for CAs

The Branch has organised One Day Seminar on Financial and Cyber Frauds-Risks and Emerging Opportunities for CAS on 11th March, 2017 at The Park Hotel, Hyderabad. I convey my sincere thanks to the Chief Guest of the Programme was Mr. Anurag Sharma, IPS, Director General of Police, Telangana State and Guest of Honour was CA. M. Devaraja Reddy, Immediate Past President of the ICAI for their august presence in the Inaugural ceremony. The programme has covered Trends in Current Cyber Fraud with Case Studies, Risk to Chartered Accountants-How to Convert them into Opportunities, Digitization, Robotics & Cyber Frauds-Risks & Opportunities and a Panel Discussion for Tackling of Frauds & White Collar Offence -Perspective of Cross Functional Agencies. I convey my sincere thanks to CA. Sharat Kumar and CA. Sandeep Baldava for developing the concept of the programme. I also convey my sincere thanks to CA. Naresh Chandra Gelli V & CA. C. Venkatram for co-ordinating the programme. The programme was attended by good number of delegates who were enriched with the knowledge on various technicalities on frauds.

***Prerna* – a Women Seminar** Hyderabad Branch has hosted a Women Seminar – Prerna under the aegis of the Women Empowerment, a Sub Group of Committee for Capacity Building of Members in Practice. The Chief Guest of the programme was Smt. Tejdeep Kaur, IPS, Director General of Police, Special

Protection Force and I convey my sincere thanks to her for sparing her valuable time for the inaugural session of the Seminar. The Guest of Honour of the programme was CA. M. Devaraja Reddy, Immediate Past President. I also convey my sincere thanks to CA. K. Sripriya, Central Council Member for her kind presence in the seminar. It is my duty to convey my sincere thanks to CA. S. Aparna, CA. Rajambal and their team for making the event a grand success. The event has covered many important topics relating to women members for the benefit of their day to day professional life.

Seminar on Bank Audit : A Seminar on Bank Audit has been organised by the Hyderabad Branch on 26th March, 2017 at Hotel Marigold, Hyderabad. Shri Etela Rajender Garu, Hon'ble Minister for Finance & other important portfolios of Telangana Government has kindly graced the Seminar as Chief Guest of the programme and delivered key note address to our professional colleauges. The Guest of Honour of the Seminar was CA. M. Deveraja Reddy, Immediate Past President of the ICAI. The Seminar topics were on Overview of the Bank Audit, Risks & Responsibilities, Case Studies on Restructured Accounts, Audit under CBS Environment-System Generated NPA and Panel Discussion to cover various technical issues of the Bank Audit. The topics were dealt by the distinguished speakers and I am sure that the members were enriched with various important technical issues which would be helpful them to perform their Bank Audits effectively. A large number of members attended the Seminar and my special thanks to them for making the Seminar a grand success.

4 hours Seminar on Approach towards the Bank Audit and Audit Documentation was also organised by Hyderabad Branch at the branch premises for the benefit of the members which was dealt by eminent speakers from Hyderabad.

CSR-Joint Seminar with ROC A Joint Programme with RoC on Corporate Social Responsbility was organised by the Hyderabad Branch on 30th March, 2017 at National Institute for Micro, Small & Medium Enterprises, Hyderabad for covering various technical issues with RoC for the benefit of the members. I convey my sincere thanks to RoC for their kind consent and co-operation in organising the same.

Students: **One Day Seminar on Bank Audit for CA Students:** A Seminar on Bank Audit for CA Students was organised by SICASA of Hyderabad Branch and Hyderabad Branch of SIRC of ICAI on 24th March, 2017 at FTAPCCI, Hyderabad for providing guidance to CA Students who would be assisting in the Bank Audits. The Seminar has covered Bank Audits-Past Present & Future, Audit Documentation, Asset Classification, Income Recognition & Provisioning and Audit under CBS Environmen and Excel as an Audit Tool for Bank Audits. The topics were addressed by eminent speakers from Hyderabad. A large number of students have attended the Seminar and made the event a grand success.

Due to space constraint in the hall, one more Seminar on Bank Audit was organised by SICASA Hyderabad Branch and Hyderabad Branch of SIRC of ICAI on 27th March, 2017 at branch premises for the benefit of CA students who could not be accommodated on 24th March, 2017 at FTAPCCI.

Crash Courses: SICASA Hyderabad Branch is conducting short-term coaching classes for Final, IPCC & CPT students to cover the major areas of the respective subjects before CA examinations which I hope will help the students to a large extent.

Mock Tests: SICASA of Hyderabad Branch is conducting Mock Tests for Final, IPCC & CPT students which will help the students to assess their level of preparation for the examinations. I convey my best wishes to all the students for the forthcoming CA examinations during November, 2016.

I would like to conclude my write up with a quote by ***Swami Vivekananda:***

When an idea exclusively occupies the mind, it is transformed into an actual physical or mental state.

Yours Sincerely,

CA. Chengal Reddy R
Chairman
chairman.hyd@icai.in

Programmes for the Month of April 2017

Day & Date	Name of the Programme	Speaker	Delegate Fee	CPE Hours	Venue
Sunday 02nd April, 2017 10.00AM – 01.00PM	Training Programme on Use of Excel in Bank Audit	CA. D. Premnath, CA. P. Samba Murthy & CA. Siva Prasad Anavarapu	Rs300/-	3	Emerald House
Sunday 9th April, 2017 04.00PM – 08.00PM	Interactive Meet With President & Vice- President of ICAI & Issues in TDS &Taxation of Salaries	CA. Pankaj Kumar Trivedi	Free	3	Branch Premises
Saturday 15th April,2017 05.30PM-08.30PM	Cost Records and Cost Audit under Companies Act, 2013	CA. Zitendra Rao	Rs150/-	3	Branch Premises
Monday 17th April,2017 05.30PM –08.30PM	Analysis of ST-3 Returns in E-Filing	CA. V. S. Sudhir & CA. Sandeep Kumar Baheti	Rs150/-	3	Branch Premises
Tuesday 18th April, 2017 04.00PM -07.00PM	Live Webcast Chale GST Ki Aur	Eminent Speakers	Rs100/-	3	Branch Premises
Saturday 22nd April, 2017 09.30AM -05.30PM	One Day Workshop on GST	Details Given Elsewhere	Rs500/-	6	K.L.N Prasad Auditorium, FTAPCCI
Monday 24th April,2017 04.00PM -07.00PM	Live Webcast Chale GST Ki Aur	Eminent Speakers	Rs100/-	3	Branch Premises
Friday 28th April,2017 05.30PM -08.30PM	Technology is everything for Chartered Accountants- Series	CA. Saran Kumar U	Rs150/-	3	Branch Premises
Saturday 29th April,2017 05.30PM -08.30PM	Issues in E-TDS Returns	CA. Ritesh Mittal & CA. Pamkaj Kumar Trivedi	Rs150/-	3	Branch Premises

GST IMPACT ON AUTOMOBILE DEALERS – AN INSIGHT

CA Sudhir V S & CA. SHILPI JAIN

With the revised model GST Law in the public domain, there is a lot that is being talked about; the advantages & disadvantages of GST, what is missing/what should be incorporated in the GST law, etc. In this regard, one has to also analyse the law in the light of the various business sectors and how the same is going to affect the business practices, decisions, profitability etc. In this article we are analyzing the business of an automobile dealer, which has varied transactions liable to various different taxes that are being subsumed in GST. Also how this subsuming will affect the business will be seen.

In this regard it is important to understand I first list the taxes applicable to this industry that are likely to be subsumed under GST:

- VAT/Sale Tax
- Central Sales Tax
- State Cesses and Surcharges
- Octroi and Entry tax
- Central Excise Duty
- Service Tax
- Cesses and Surcharges charged by Centre

All the above taxes would be done away with and only one tax i.e. either SGST+CGST in case of intrastate supplies or IGST in case of interstate supplies would be charged. Understanding existing taxes and the new taxes it would also be relevant to understand various revenue stream of the automobile dealer (hereinafter referred to as 'Dealer'):

S. No.	Transaction	Description	Tax on purchase/input	Tax on sale/output
1.	Trading	Buying from the manufacturer and selling to end customer	a. Excise duty, b. Infrastructure cess c. VAT and d. Entry tax on purchase from manufacturer	VAT and Road tax, on sale to customer.
			No credit of input a. Excise duty b. Infrastructure cess c. Entry Tax d. Road Tax	

			Is available under existing laws	
1a.	Trading related – Registration, Handing charges	Registration of the vehicle purchased by customer by charging a nominal amount as fee. Getting reimbursement of the registration charges incurred on behalf of the customer. Expenses by the Dealer before delivery of vehicle termed as Handling charges	Generally no amount has been charged as such by the manufacturer, few expenses suffer VAT and few service tax.	Presently these items are disputed, few dealers are subjected to VAT and few ST and few both.
			No credit of input VAT available under existing laws	
1b.	Trading related - Arranging finance for customers and insurance of vehicles	Tie up with Banks/Financial Institutions and Insurance companies who pay commission to the Dealer.	NA	ST on the commission received.
1c.	Warranty service	During the warranty period free service is provided but amount is recovered from the customer for the spares used for servicing only.	VAT on spares purchased.	VAT on the spares sold. No ST on free service
			Credit of input VAT available	
2.	Vehicle servicing	Undertake servicing of vehicles, which involves both	VAT on parts purchased	VAT on sale and service tax on service portion.

		service and sale.		
			Credit of input VAT available. ST credit on specific services used and common services available.	

Now we shall see how the above transactions would look under the GST regime.

S. No.	Transaction	Tax liability	Advantage/Disadvantage
1.	Trading	The vehicle manufacturer charges SGST,CGST/IGST (input GST) based on whether it is an intra-state or an inter-state sale. On sale to customer, Dealer would again charge SGST,CGST/IGST (output GST) based on whether it is an intra-state or an inter-state sale.	**Advantage:** Credit of the input GST would available for utilization for payment of output credit which was earlier not available as it was input Excise duty and output VAT.
1a.	Trading related – Registration and Handling charges	GST would be charged on the registration fee collected from the customers as well as on the vehicle registration charges reimbursed. Valuation under GST would be done based on the transaction value, which also includes reimbursements.	**Advantage:** The credit chain is not broken by levying GST on reimbursements thus enabling seamless credit. No demand of 2 taxes (VAT & ST) on the same transaction in respect of handling charges. **Disadvantage:** Since there would also be customers who are end users who would not be able to get the input credit, they would not prefer collection of GST on the registration charges.
1b.	Trading related – Arranging finance for customers	Commission would be liable to GST	Not much of an impact.
1c.	Warranty	Spares sold during the service would	**Not much of an impact**

	service	be liable to GST.	
2.	Vehicle servicing	Entire amount collected as a whole would be liable to GST.	**Advantage:** No need to bifurcate the transaction into goods and service to charge VAT/ST separately as was earlier done. The entire transaction would be charged to GST. Further the credit of Excise on the spares used which was earlier not available would be available now in the form of GST. **Issue:** The Works contract definition under GST does not include repairs in its ambit thus making it unclear whether the servicing of vehicle would be a supply of goods or supply of service.

This article deals with the changes being applicable in the taxes under the GST regime one has to apply this to the real example to understand the real impact.

Direct tax and transfer pricing updates

(Contributed by CA Vikram Doshi, CA Vaibhav Mehta and CA Kranthi Palivela)

1. **Disallowance of expenditure under section 14A of the Income-tax Act, 1961 ('the Act') cannot be done as the securities are held as stock-in-trade.**

   Recently, the Hon'ble Punjab and Haryana High Court (the 'Hon'ble HC') in the case of **State Bank of Patiala**[1] ('the Assessee') has held that since the securities are held as stock-in-trade by the Assessee, no disallowance of expenditure is to be made under section 14A of the Act.

   - The Assessee filed return of income ('ROI') declaring an income of approx. INR 670 crore which was selected for scrutiny. The ROI showed dividend income exempt under section 10(34) and section 10(35) of the Act of approx. INR 11.07 crore and net interest income exempt under section 10(15)(iv)(h) of about INR 1.12 crore. The total exempt income claimed in the ROI was, therefore, INR 12.19 crore.

[1] Pr. CIT v. State Bank of Patiala (2017) 78 taxmann.com 3 (Punjab & Haryana High Court)

- The Assessee while claiming the exemption contended that the investment in shares, bonds, etc. constituted its stock-in-trade. The investment was not made with the intention of earning tax free income and the tax free income was only incidental to the Assessee's main business of sale and purchase of securities. Therefore, no expenditure had been incurred for earning such exempt income and hence, section 14A was not applicable.

- The Assessing officer ('the AO') applied Rule 8D of the Income-tax Rules, 1962 ('the Rules') for determining the expenditure to be disallowed as per section 14A of the Act. The AO found that the total expenditure allocated against exempt income is INR 40.72 crore, but held that the same should not exceed the exempted income, and therefore, he restricted the expenses to the extent of exempt income claimed by the Assessee of about INR 12.20 crores and added the same to income of the Assessee.

- The Commissioner of Income-tax (Appeal) ['the CIT(A)'] held that the AO had wrongly restricted the disallowance to the extent of exempt income claimed by the Assessee and that the entire sum of INR 40.72 crore of expenditure should have been disallowed by the AO as there was no legal provision either in section 14A of the Act or Rule 8D of the Rules to limit the disallowance to the amount of dividend received.

- The Income-tax Appellate Tribunal ('the ITAT') set aside the order of the CIT(A). The ITAT referred to CBDT Circular no. 18/2015 dated 02 November 2015 ('the Circular') which states that income arising from investment of a banking concern is attributable to the business of banking which falls under the head 'Profits and gains of business and profession'. The Circular states that shares and stock held by the bank are stock-in-trade and not investment. Relying on certain judgments and the Circular, the ITAT held that if shares are held as stock-in-trade and not as investment, the disallowance under Rule 8D would be nil as rule 8D(2)(i) of the Rules would be confined to direct expenses for earning the tax exempt income.

- On further appeal the Hon'ble HC held as follows:

  - The Hon'ble HC noted that the Circular carves out a distinction between stock-in-trade and investment and provides that if the motive behind purchase and sale of shares is to earn profit then the same would be treated as trading profit and if the object is to derive income by way of dividend then the profit would be said to have accrued from the investment.

  - The investments made by the Assessee are part of its banking business and the income arising from trading in the securities is attributable to the business of the bank/ Assessee falling under the head 'Profits and gains of business'. Further, the securities dealt with in the course of such trading constitutes the Assessee's stock-in-trade.

  - The expenditure incurred in relation to stock-in-trade arising as a result of investment in shares and debentures is deductible under section 28 to section 37 of the Act. Further, section 14A provides for amount to be disallowed as expenditure incurred to earn 'exempt' income.

  - That income earned by the Assessee from securities held as stock-in-trade is not exempt from tax and, therefore, the expenditure incurred in relation thereto does not fall within the ambit of section 14A of the Act.

- The entire expenditure including administrative costs was incurred for the purchase and sale of the stock-in-trade and, therefore, towards earning the business income from the trading activity of purchasing and selling the securities. Irrespective of whether the securities yielded any income arising therefrom, such as, dividend or interest, no expenditure was incurred in relation to the same.
- The Hon'ble HC was in agreement with the Hon'ble Karnataka High Court's ('the Hon'ble Karnataka HC') decision in the case of CCI Ltd.[2]. In the said decision, the Hon'ble Karnataka HC held that as the assessee had not retained shares with the intention of earning dividend or interest, but traded in them and interest/ dividend accruing thereon was only a by-product thereof or an incidental benefit, the income will not be subject to provisions of section 14A.
- A financial decision of the Assessee that trades in securities may and, in fact, would factor in the dividend or interest that the securities it acquires as its stock-in-trade yields or is likely to yield. Such a decision would be taken for acquisition, retention and disposal of the securities. The, however, is a financial consideration not with a view to earning the dividend or interest but with a view to assessing the price at which the security ought to be acquired, retained and sold.

In view of the above, the Hon'ble HC concluded that disallowance under section 14A of the Act cannot be done in case the shares or securities are held as stock-in-trade.

2. Lower tax rate as prescribed under the Double Taxation Avoidance Agreement ('the DTAA') will apply even in the absence of a Permanent Account Number ('PAN')

Recently, the Special Bench of Hyderabad Income-tax Appellate Tribunal ('the ITAT') in the case of Nagarjuna Fertilizers and Chemicals Ltd.[3] ('Assessee') has held that the provisions of section 206AA of the Income-tax Act, 1961 ('the Act') will not have an overriding effect on the provisions of the DTAA to the extent they are beneficial to the Assessee by virtue of section 90(2) of the Act.

- During the assessment years ('AY') 2011-12 and AY 2012-13, the Assessee made certain payments in the nature of Fees for technical services ('FTS') to non-residents. Some of such non-residents were the residents of countries with whom India did not have a DTAA and in their cases, tax at the higher rate of 20% was required to be deducted by the Assessee, where the payees failed to furnish a valid PAN as per the provisions of section 206AA of the Act. In case of other non-residents, who were the residents of those countries, with whom India had entered into DTAA, tax at the lower rate as prescribed in the relevant Articles of the DTAA was deducted by the Assessee even in case of payees, who did not furnish a valid PAN.
- While processing the Tax Deducted at Source ('TDS') return filed by the Assessee for both the AYs, the Assessee was held to be liable to deduct tax at source at a higher rate of 20% in such cases for want of PAN of the concerned non-resident payees as per the provisions of section 206AA of the Act.

[2] CCI Ltd v. JCIT (2012) 206 taxmann 563/20 taxmann.com 196 (Karnataka High Court)
[3] Nagarjuna Fertilizers and Chemicals Ltd. V. ACIT (2017) 78 taxmann.com 264 (Hyderabad ITAT)

- The Commissioner of Income-tax Appeals ['CIT(A)'] rejected the Assessee's case and observed that section 206AA inserted in the Act with effect from 1 April 2010 was an overriding provision and there was no escape for the Assessee except to quote the deductee's PAN or to deduct tax at source at 20%. It was held that a PAN was required to be quoted for making declaration under section 197A of the Act for claiming exemption from TDS to be valid. It was held that section 206AA of the Act starting with non-obstante clause overrides all other section including section 90(2), section 115A and section 139A of the Act.

- Reliance was placed by the CIT(A) in this regard on the decision of the Bangalore ITAT ('the Bangalore ITAT') in the case of **Bosch Limited**[4], wherein it was held that non-residents having an income exceeding the taxable limit were bound to obtain and furnish a PAN and if there was a failure to do so, the Assessee was liable to withhold tax at higher of the rates prescribed under section 206AA of the Act i.e. 20%.

- Keeping in view the conflicting decisions of the Bangalore ITAT in the case of Bosch Limited *(supra)* and the Pune ITAT in the case of **Serum Institute of India Limited**[5], a reference was made to constitute a Special Bench to decide the issue and resolve the controversy.

- The Special bench of Hyderabad ITAT held as follows:

  - Any person responsible for paying to a non-resident, not being a company, or to a foreign company, inter-alia, any other sum chargeable under the provisions of the Act (not being income chargeable under the head 'Salaries') shall deduct income-tax thereon at the 'rates in force'[6].

  - The term 'rates in force' used in section 195(1) of the Act is defined in section 2(37A) of the Act which, inter-alia, means the rate or rates of income-tax specified in the Finance Act of the relevant year or the rate or rates of income-tax specified in the DTAAs, whichever is applicable by virtue of the relevant provisions of the Act, as the case may be.

  - Thus, the deduction of tax under section 195 of the Act from the payments made to non-residents in the nature of FTS was made by the Assessee at the rate or rates of income-tax specified in the relevant DTAA which were adopted as rates in force for the purpose of deduction of tax under section 195 of the Act in view of the specific provisions contained in section 2(37A) of the Act.

  - With regard to the issue of whether the rate of tax as provided in the relevant DTAA and adopted for the purpose of tax deduction at source being rate in force by virtue of section 2(37A) of the Act would be applicable or the higher rate as provided in section 206AA of the Act by virtue of the overriding effect given to the said provision, reference was made to the decision of the Hon'ble Andhra Pradesh High Court ('the AP High Court') in the case of **Sanofi Pasteur Holding SA**[7], wherein the Hon'ble AP High Court made reference to decision of

[4] Bosch Ltd. V. ITO (2012) 28 taxmann.com 228 (Bangalore ITAT)
[5] DDIT v. Serum Institute of India Limited (2015) 56 taxmann.com 1 (Pune ITAT)
[6] Section 195(1) of the Act
[7] Sanofi Pasteur Holding SA v. Department of Revenue and others (2013) 30 taxmann.com 222 (AP High Court)

the Hon'ble Supreme Court ('the Hon'ble SC') in the case of **Azadi Bachao Andolan**[8] and **P.V.A.L Kulandagan Chettiar**[9]. It was held that in the case of **Azadi Bachao Andolan** (*Supra*) that when the DTAA becomes operational and is notified by the Central Government for implementation of its terms under section 90 of the Act, provisions of the DTAA, with respect to cases to which they would apply, would operate even if inconsistent with the provisions of the Act. Further, in the case of **P.V.A.L Kulandagan Chettiar** (*Supra*), it was held that the taxation policy is within the power of the government and section 90 of the Act enables the government to formulate its policies through DTAAs entered into by it and such treaties determine the fiscal domicile in one state or the other and this determination in the DTAA prevails over the other provisions of the Act.

- Thus, the ratio laid down by the Hon'ble SC in the case of **Azadi Bachao Andolan** (*Supra*) and **P.V.A.L Kulandagan Chettiar** (*Supra*) as further explained and clarified by the Hon'ble AP High Court in the case of **Sanofi Pasteur Holding SA** (*Supra*) makes it abundantly clear that whenever there is a conflict between the provisions of the DTAA and the provisions of the domestic law, the provisions of the DTAA will prevail and override even the charging provisions of the domestic law.

- The ratio of the two decisions of the Hon'ble SC in the case of **Eli Lilly and Co. (India) P. Limited**[10] and **G.E. Technology Centre (P) Limited**[11] clearly shows that the charging provisions control and override the machinery provisions dealing with tax deduction at source. Similarly, the provisions of DTAAs by virtue of section 90(2) of the Act to the extent more beneficial to the Assessee override the provisions of domestic law as held, inter-alia, by the Hon'ble SC in the case of **Azadi Bachao Andolan** (*Supra*) and **P.V.A.L Kulandagan Chettiar** (*Supra*). Since section 206AA of the Act falls in Chapter XVIII-B dealing with tax deduction at source, it follows that the DTAA provisions which override even the charging provision of the domestic law by virtue of section 90(2) of the Act would also override the machinery provisions of section 206AA of the Act irrespective of non-obstante clause contained therein and the same is required to be restricted to that extent and read down to give effect to the relevant provisions of DTAA, which are overriding being beneficial to the Assessee.

- Further it may be noted that, with respect to Chapter X-A of the Act containing the provisions relating to General Anti-Avoidance Agreement Rule ('GAAR') that has been inserted in the statute by the Finance Act, 2013 with effect from 1 April 2016 and although the provisions of contained in the said chapter are given overriding effect by virtue of non-obstante clause contained in section 95 of the Act, a separate provision has been inserted simultaneously in the form of section 90(2A) of the Act providing specifically that notwithstanding anything contained in section sub-section (2) of section 90, the provisions of Chapter XA (GAAR) of the Act shall apply to the Assessee even if the such provisions are not beneficial to him. The ITAT

[8] UOI v. Azadi Bachao Andolan (2003) 132 taxmann.com (SC)
[9] CIT v. P.V.A.L Kulandagan Chettiar (2004) 137 taxmann.com 460 (SC)
[10] CIT v. Eli Lilly and Co. (India) P. Limited (2009) 178 taxmann.com 505 (SC)
[11] G.E. India Technology Centre (P) Limited v. CIT (2010) 193 taxmann.com 234 (SC)

observed that no such provisions, however, is made separately and specifically in section 90 of the Act to give overriding effect to section 206AA of the Act over the provisions of the relevant DTAA which are beneficial to the Assessee.

Thus the ITAT held that the provisions of section 206AA of the Act will not have an overriding effect on all other provisions of the Act and the provisions of the DTAA to the extent these are beneficial to the Assessee, will override section 206AA of the Act by virtue of section 90(2) of the Act.

3. Mumbai Tribunal held that even one comparable company can be considered for benchmarking the related party transactions; however clarified that tolerance range of + / - 5% as per proviso to section 92C(3) of the Income-tax Act, 1961 will not be applicable.

Background

The Income Tax Appellate Tribunal (Tribunal), Mumbai, in the case of JP Morgan Advisors India Private Limited[12] (taxpayer), allowed the taxpayer's appeal for exclusion of 4 out of 5 comparables to benchmark a particular transaction "there is no mandate in the law that one may choose more than one comparable company only", the taxpayer can benchmark the same from the net profit margin realised by the enterprise or by an unrelated enterprise from a comparable uncontrolled transactions or number of such comparable uncontrolled transactions as mentioned in Rule 10B(1)(e) of the Income-tax Rules, 1962 (the Rules). The Tribunal however clarified that on consideration of only one comparable company, the tolerance range of + / - 5% as envisaged under proviso to section 92C(3) of the Income-tax Act, 1961 (the Act) will not be applicable.

Facts of the case

- The taxpayer is engaged in the business of provision of non-binding investment advisory services to its associated enterprises (AEs) at a remuneration of cost plus margin of 15%. It makes investment recommendations to its AEs and the AEs have the right to make final investment decisions.
- For the assessment year (AY) 2006-07, the taxpayer undertook international transactions with its AEs amounting to INR 24,547,331. The taxpayer in its Transfer Pricing Study (TP Study) demonstrated the arm's length price (ALP) of the said services by selecting Transactional Net Margin Method (TNMM) as the most appropriate method and arrived at an arithmetic mean of 18.91% with 8 comparable companies and concluded the transactions to be at ALP by availing the benefit of + / - 5% tolerance range as per proviso to section 92C(3) of the Act.
- During the assessment proceedings, the Transfer Pricing Officer (TPO) rejected the taxpayer's analysis and undertook a fresh analysis. The TPO selected 8 comparable companies out of which 4 companies were selected by the taxpayer in its TP Study, and arrived at an arithmetic mean of 39.85% and accordingly proposed an adjustment of INR 5,304,358.

[12] ITA No. 7979/Mum/2010

- Aggrieved by the order passed by TPO, the taxpayer approached the Dispute Resolution Panel (DRP). The DRP, after considering the facts of the case and materials placed on record, rejected 3 comparable companies selected by the TPO and arrived at an arithmetic mean of 27.18%. Subsequent to DRP proceedings, the taxpayer filed an appeal before the Tribunal for exclusion of 4 out of 5 comparable companies accepted by the DRP and selected by the taxpayer in its TP Study.

Taxpayer's Contentions

- The taxpayer contended that the 4 companies selected by the TPO and retained by the DRP were into the business of merchant banking and cannot be considered as comparable companies for the taxpayer rendering non-binding investment advisory services.
- Further, the taxpayer contended that there is no provision in law that if one comparable company is selected by the taxpayer during the course of search process, then comparative analysis cannot be performed or that more than one comparable company is necessary to perform comparative analysis.
- The taxpayer contended that there cannot be estoppels on objecting the inclusion / exclusion of any comparable companies, though the same were initially considered as comparable companies by the taxpayer in its TP Study, provided the taxpayer provides a cogent reason for inclusion / exclusion of the comparable companies based on functions, assets and risks (FAR) analysis.
- Further, once the TPO has rejected the entire search process of the taxpayer, then the comparable companies selected by the TPO needs to be properly analysed and the taxpayer has all the right to challenge the inclusion or exclusion of such comparable companies.

Tax Department's Contentions

- The department contended that the companies selected by the TPO were originally selected by the taxpayer, therefore accepting the taxpayer's contentions would amount to cherry picking.
- Further, the department contended that in case of exclusion of 4 out of 5 comparable companies, performing benchmarking analysis would not provide appropriate results as there would be only one comparable company.

Tribunal's Ruling

- The Tribunal relied on the decision of Tata Power Solar Systems Ltd.[13] and Special Bench decision on the case of Quark Systems P. Ltd.[14] and held that there cannot be any estoppels on objecting the inclusion / exclusion of comparable companies which were initially selected by the taxpayer, provided the taxpayer gives a cogent reason for the same based on functions, assets and risks analysis and also based on judicial pronouncements.

[13] TS-14-ITAT-2014(Mum)-TP
[14] TS-23-ITAT-2009(CHAND)-TP

- The Tribunal, relying on various tribunal decisions, excluded the four companies – Centrum Capital Limited, Keynote Corporate Services Limited, SREI Capital Markets Limited and Sumedha Fiscal Services Limited on functional grounds stating that these companies are engaged in the business of merchant banking, which cannot be considered as comparables to the taxpayer.

- The Tribunal concluded that "there is no mandate in the law that one may choose more than one comparable only". The Tribunal, however clarified that on consideration of only one comparable company, the tolerance range of +/- 5% as envisaged in the proviso to section 92C of the Act will not be applicable, accordingly the TPO was directed to benchmark the margin of the taxpayer with one comparable company.

4. The Bombay High Court upheld the order passed by the Mumbai Tribunal deleting the transfer pricing adjustment on account of payment of royalty for technical know-how and usage of brand made by the taxpayer to its associated enterprises; Held that payment of royalty on account of commercial expediency can be allowed even if there is no agreement in support for such payments.

Background

The Bombay High Court (HC) in the case of Johnson & Johnson Ltd.[15] (taxpayer) upheld the Income Tax Appellate Tribunal (Tribunal)'s, Mumbai order[16] deleting transfer pricing (TP) adjustment on account of payment of royalty for technical know-how and usage of brand made by the taxpayer to its associated enterprises (AE) for the Assessment Year (AY) 2002-03. The Bombay HC upheld that the Transfer Pricing Officer (TPO)'s restriction on payment of royalty from 2% to 1% without giving any reasons or justification was arbitrary and adhoc, and that the TPO had not carried out exercise to determine the arm's length price (ALP) by following one of the methods prescribed under section 92C of the Income –tax Act, 1961 (the Act). Further held that, payment of royalty made on account of commercial expediency can be allowed even if there is no agreement in support of such payments.

Facts of the case

During the AY 2002-03, the taxpayer paid royalty to its AEs towards use of brand and trademark at the rate of 1% on net sales and towards use of technical / marketing know-how provided under know-how agreement at the rate of 2% of sales.

- The taxpayer obtained Reserve Bank of India (RBI)'s approval for payment of royalty during November 2001 and accordingly the taxpayer executed the royalty agreement on 14 March 2002, with effect from 1 July 2001.

- The taxpayer in its Transfer Pricing Study (TP Study) selected Transactional Net Margin Method (TNMM) as the most appropriate method for determination of ALP of its international transactions by aggregating the transactions pertaining to payment of royalty to its AEs. The net operating margins earned by each segment of the taxpayer were compared with the net operating margins earned by companies engaged in similar activities, and accordingly the international transactions were considered to be at ALP.

[15] ITA No. 1030 of 2014

[16] ITA No. 4092/Mum/2007 & ITA No. 4070/Mum/2007

- During the assessment proceedings, the TPO held that, there was no basis for payment of any royalty for use of trademarks / brand names as the products sold by the taxpayer had already acquired a reputation of quality before the conclusion of the royalty agreements. Accordingly, the TPO determined the ALP of payment of royalty for technical know-how at the rate of 1% and royalty for brand and trademark at the rate of 1% and proposed an adjustment.
- Subsequently during an appeal before the Commissioner of Income Tax (Appeals) (CIT(A)), the CIT(A) granted partial relief in respect of royalty for traded goods and also held that restricting the royalty paid on account of technical knowhow to 1% was arbitrary and adhoc, as the TPO had not given any reasons justifying the restriction. The CIT(A) also observed that the TPO did not determine the ALP of payment of royalty for technical know-how by adopting any of the methods prescribed under section 92C of the Act.
- Further, the CIT(A) observed that the taxpayer's royalty agreement covered the period from 1 July 2001 to 31 March 2002, which was executed only on 14 March 2002, whereas the RBI approval was granted in November 2001. Based thereon, the CIT(A) disallowed payment of royalty on usage of brand during the period 1 July 2001 to 14 March 2002, as the taxpayer failed to produce minutes of its board meeting recording the decision to make the payment of brand usage royalty at 1% with effect from 1 July 2001. Aggrieved the taxpayer filed an appeal before the Tribunal.

Taxpayer's Contentions

- The taxpayer contended that for payment of royalty during the period 1 July 2001 to 14 March 2002, the taxpayer had submitted the draft royalty agreement to RBI on 10 August 2001 and therefore the allegation of the CIT(A) that royalty was paid without any agreement / board resolution is against the facts of the case.
- Further, the taxpayer contended that the royalty was paid based on the guidelines issued by RBI and the same should be allowed.
- The taxpayer further contended that, assuming there was no agreement in place, payments made having regard to the commercial expediency need not necessarily have their origin in contractual obligation. If the taxpayer, which carries on a business, that it is commercially expedient to incur certain expenditure directly or indirectly, it would be open to such taxpayer to do so notwithstanding the fact that a formal deed does not precede the incurring of such expenditure.

Tax Department's Contentions

- The department contended that the payment of royalty for trademarks / brand and technical know-how was made without any base or unwarranted as the taxpayer already acquired a reputation in the market before conclusion of the royalty agreements.
- Further the rates prescribed under the automatic route are for the use of fresh technology and also for the use of trademarks for the first time, the taxpayer is not getting any fresh technology per se from its AEs.

Tribunal's Ruling

- The Tribunal confirmed CIT(A)'s deletion of adjustment made by the TPO by restricting royalty on technical knowhow from 2% to 1%, as the action of the TPO in not following any of the methods as prescribed under section 92C of the Act is adhoc and arbitrary in nature.
- The Tribunal further reversed the CIT(A)'s disallowance of payment of royalty on brand usage, holding that the CIT(A) had ignored the fact that the copy of the draft brand usage royalty agreement was submitted to the RBI on 10 August 2001 and the approval granted on 20 November 2001, and thereafter, the final agreement was executed on 14 March 2002 which inter alia provided for payment of royalty with effect from 1 July 2001.
- Further, the Tribunal relied on the Madras HC's decision in the case of Associated Electrical Agencies and held that even if there was no agreement to support the payment of royalty, yet where the payment is made on account of commercial expediency, the same ought to be allowed.

Bombay HC's Ruling

- With respect to payment of royalty on technical know-how, the HC upheld the Tribunal's order confirming the order of the CIT(A). The HC observed that the TPO was mandated by law to determine the ALP by following one of the methods prescribed in section 92C of the Act read with Rule 10B of the Income-tax Rules, 1962, which exercise had not been carried out in the instant case.
- The HC also noted that the TPO had given no reasons justifying the restriction of royalty payment to 1%, and confirmed the conclusion of CIT(A) and the Tribunal that the TPO's way of determination of ALP for royalty on technical know-how was arbitrary and ad-hoc.
- The HC noted the Tribunal's finding that there was an understanding between the parties that the payment of royalty would be made with effect from 1 July 2001 as reflected in the draft agreement as well as in the final agreement executed on 14 March 2002. Considering the facts available before the Tribunal as well as reliance on Madras HC's decision in the case of Associated Electrical Agencies, the HC concluded that the view taken by the Tribunal was a possible view. The HC thus dismissed the department's appeal with respect to payment of royalty.