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An e-newsletter from
Lakshmikumaran & Sridharan, India

July 2016 / Issue–23

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July
2016

Article

New Foreign Tax Credit Rules – Certain grey areas

By **Lakshmi Pavan**

Recently, the Central Board of Direct Tax ('CBDT') has issued a notification[1] notifying Rules[2] for granting of Foreign Tax Credit ('FTC') to resident taxpayers on income earned in foreign jurisdiction *(hereinafter referred as 'foreign income')*. Before, notifying these Rules, a letter was issued by CBDT seeking public comments on the draft FTC rules, however, without much modification, the draft rules were brought into effect as final in the notification.

Before proceeding ahead, let's have a glance at the Rules as notified by the CBDT:

- The FTC shall be granted only when the taxpayer has *paid* the foreign tax on the income taxable in India.
- The FTC shall be granted in the year in which such income is offered to tax / assessed to tax in India.
- If such income is offered to tax / assessed to tax in India in more than one year, then the FTC shall be granted in proportionate to the income in which it is offered to tax / assessed to tax.
- FTC is available only in respect of tax, surcharge and cess payable on such income but not against interest or penalty.
- If the foreign tax or part thereof is a subject matter of dispute in foreign country, then FTC shall not be granted, unless such dispute attains finality and evidences to such extent should be furnished within six months from the end of the month in which dispute attains finality.
- FTC shall be the lower of the tax payable under the Act on such income and the foreign tax paid on such income, computed separately for each source of income arising from a particular country or specified territory. Any foreign tax paid in excess of domestic tax shall be ignored.
- FTC shall be determined by conversion of the currency of payment of foreign tax at the telegraphic transfer buying rate on the last day of the month immediately preceding the month in which such tax has been paid or deducted.
- FTC is available even in the case of tax payable under MAT scenario.

The new rules do not take into account certain critical issues.

Differences in taxable year

For better understanding the issue, let's begin with an example. Take a foreign jurisdiction which adopts Calendar Year ('CY') as a taxable year and collects taxes in December by way of self-assessment tax on income earned in that CY, in contrast, India follows April to March (i.e., Financial Year ('FY')) as taxable year and

[1] Notification No. SO 2213(E) [NO.54/2016(F.NO.142/24/2015-TPL)] dated 27-06-2016

[2] Rule 128 has been inserted

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collects taxes by way of TDS and / or advance tax.

An issue may arise with regard to timing difference in adoption of different taxable year by different jurisdictions. Income earned for the period January 2017 to March 2017 would be taxed in India in the FY 2016-17, whereas in such foreign jurisdiction, the income is taxed in CY 2017 and the tax on such income is collected /paid in December 2017 in such foreign jurisdiction.

Rule 128(1) states that FTC is available only when foreign tax is *paid*. In the above situation, foreign tax is paid in FY 2017-18, whereas income is offered to tax in India in FY 2016-17. Now a question arises regarding the year in which FTC will be granted. Whether FTC will be granted in FY 2016-17, i.e., the year in which income is offered to tax even though no foreign tax is paid in the said FY; or, FTC will be granted in the FY 2017-18, i.e., the year in which foreign tax have actually been paid.

The new Rules do not provide any guidance on dealing with this difference in timing. As the Rules are silent, one may argue that the FTC will not be granted in FY 2016-17. The tax payer, after making payment of foreign taxes has to file a revised return[3] or rectification petition[4] to claim such FTC in FY 2016-17. However, these correction mechanisms have their own limitations.

Alternatively, one may argue that the objective of Sections 90(1), 90A and 91(1) is to give relief from taxation in India to the extent taxes have been paid abroad and these relief provisions do not specify any condition that the payment of taxes should also be made in the same previous year. A useful reference can be made to the judgment of Bombay High Court in the case of *Petroleum India International*[5], wherein the High Court upheld the ruling of the Tribunal that if taxpayer had paid taxes in Kuwait in respect of the same income in subsequent year, relief under section 91(1) cannot be denied.

Where tax liability is enhanced by the tax officer whether FTC should also be increased?

Another issue for consideration is in cases where tax officer increases the income of the taxpayer by way of making additions to the taxable income declared by the taxpayer, such increase would result in enhanced tax liability. A question arises as to whether FTC claimed by the taxpayer in his return of income has to be enhanced by tax officer in light of the additions made by him.

Rule 128 is silent on this aspect. As rules are silent one may make a useful reference to the decision of Delhi Tribunal in the case of *Birla Soft India Ltd*[6], wherein the Delhi Tribunal has held in favour of the tax payer that tax officer is bound to enhance the FTC to the extent the additions made by the tax officer, if there remains any unclaimed FTC by the tax payer.

3 Under section 139(5) of the IT Act
4 Under Section 154 of the IT Act
5 [2013] 351 ITR 295 (Bom.) and (2009) 122 TTJ 0650 (Mum.)
6 [2014] 32 ITR (Trib) 117 (ITAT[Del])

Allowability of FTC in loss making scenarios

Let's begin again with an example, A Ltd, an Indian company, in respect of its Japan business was assessed as loss in India, whereas in Japan, the same was assessed at a positive figure and taxed in Japan. Whether the FTC for taxes paid in Japan is allowable even though it is assessed as loss in India?

Rule 128 is silent even in dealing with this type of scenario. The Calcutta High Court in the case of *Jeewanlal Ltd*[7], in a similar factual backdrop has held that as no income has been assessed to tax in India, no double taxation arises and hence, the taxpayer would not be entitled to any FTC.

Treatment of Partnership firms

Partnerships in India are opaque entities (i.e., India levies tax in the hands of partnership), whereas there are few foreign jurisdictions wherein partnership are treated as transparent entities (i.e., levy of tax is in the hands of partners).

Let's consider an example, XYZ, an Indian partnership has a branch in a foreign jurisdiction where tax is levied in the hands of Partners on the income earned in such jurisdiction. In FY 2016-17, the income earned in such foreign jurisdiction is taxed in the hands of partners, whereas under the Indian tax laws, such foreign income is taxable in the hands of partnership.

Now a question arises, whether taxes paid by the partners in the foreign jurisdiction is available as FTC in the hands of Indian partnership. As stated above, Rule 128(1) specifically uses the phrase that foreign taxes have to be *'paid by him'* (i.e., taxpayer). Applying this Rule, tax authorities will always contend that foreign taxes have to be paid by the partnership in order to claim the FTC in India by the partnership.

Joint filing of tax return - whether splitting of taxes is permissible?

In countries like, UK, USA, there is an option of joint filing of tax return by the married couple. The taxes in those case will be borne by the married couple. However, India does not follow joint filing of tax return. The married couple have to separately file their return of income in respect of foreign income in India, unless clubbing provisions apply. An issue may arise that in order to comply with the tax laws of India, whether the married couple has to split their income and taxes and arrive at the tax liability under the Indian tax law.

Rule 128 does not provide any guidance on handling this situation. In fact Rule 128(1) enhances the complication by using the phrase foreign taxes have to be *'paid by him'* (i.e., taxpayer). This leads to a scenario where there is no judicial precedent on this subject. Hence, CBDT has to provide a specific set of guidelines dealing with similar issues.

Conclusion

The above are few issues which require the guidance from CBDT. Since appropriate guidelines have not been provided, tax payers may face difficulty in availing credit of taxes to which they are entitled.

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7 (1971) 79 ITR 147 (Cal)

Notifications and Circulars

Relaxation from deduction of tax at higher rate under Section 206AA

Section 206AA was amended vide Finance Act, 2016 to provide that tax would not be deducted at higher rates for payments made to non-residents not having permanent account number. Rule 37BC has been introduced vide Income-Tax (17th Amendment) Rules, 2016 to notify the conditions provided in section 206AA of the Income Tax Act, 1961. The Rule provides that tax should not be deducted at higher rates for payments made to non-residents in the nature of interest, royalty, fees for technical services and transfer of any capital asset. The non-resident would be required to provide details of name, e-mail id, contact number; address in the country of which it is a resident; Tax Residency certificate if the law of that country provides for issuance of such certificate and Tax Identification Number of the non-resident in the country of its residence.

Collection of tax at source on cash component of sale alone

Section 206C of Income Tax Act, 1961 was amended vide Finance Act, 2016 to provide *inter-alia* that a person in receipt of any consideration in cash exceeding two lakh rupees for sale of any goods or provisions of any services shall collect tax at source from payer at the time of receipt of such consideration at a rate of 1 per cent. It has been clarified *vide* Circular 23/2016 dated 24-6-2016 that where the consideration is received partly in cheque and partly in cash and the cash component for the consideration does not exceed two lakh rupees, then tax is not required to be collected at source. It has been further clarified that in case the consideration is received partly in cash and partly in cheque/other banking modes, the tax is required to be collected only on cash component of the sale consideration and not on the entire consideration.

Income Declaration Scheme - Certain clarifications

Income Declaration Scheme was one of the key highlights of Finance Act, 2016. Circular No. 24/2016 dated 27-6-2016 and Circular No. 25/2016 dated 30-6-2016 have been issued to clarify the doubts of the taxpayers regarding the provisions of the scheme. The circular is in FAQ format and clarifies inter-alia following issues:

- If the tax, penalty and surcharge are not paid within stipulated time period as provided in Section 178(3) of Finance Act, 2016, the declaration would be declared as invalid.
- The amalgamated company can make declaration in its name for declaring undisclosed income of the amalgamating company
- The scheme is open to both residents and non-residents
- It is mandatory to furnish PAN in the Form of declaration
- Assessee would not be eligible to make declaration for the assessment years in respect of which the proceeding is pending

before the settlement commission

- The information declared under the income declaration scheme would not be shared with other law enforcement agencies
- The scheme provides immunity only under the Income Tax Act, 1961, Wealth Tax Act, 1957 and Benami Transactions (Prohibition) Act,1988. Immunity from other economic laws such as Companies Act, SEBI, Service Tax etc. would not be provided.
- The value of the immovable property shall be determined as per Rule 3 of Income Declaration Scheme Rules even though such value is lower than the stamp duty value
- Credit for tax deducted at source in relation to undisclosed income (if not already claimed) would be given for computing the tax payable
- The department would not enquire the source of income and payment of tax, surcharge and penalty
- The declarations made under the scheme can be revised before 30.09.2016 provided the undisclosed income in the revised declaration is more than the undisclosed income in the declaration already filed.
- The cases of the declarant shall not be selected for scrutiny under the CASS only on the ground that there is increase in capital in the balance sheet as a result of the declaration made under the Scheme
- Property transferred by Benamidar to the beneficial owner (which is a prerequisite to get immunity from Benami Transactions (Prohibition) Act, 1988 would not be subject to capital gains under the Income Tax Act, 1961
- Where tax, penalty and surcharge is paid through undeclared income, immunity for such undeclared income shall not be given under the scheme.

TDS need not be deducted by IFSC Banking Units on interest paid

It has been clarified by way of Circular No. 26/2016 dated 4-7-2016 that IFSC Banking Units (IBU) fulfill the necessary conditions for being considered as Offshore Banking Units as defined in Clause (u) of section 2 of the Special Economic Zones, Act 2005 owing to which IBU's will not be required to deduct tax at source on interest paid by such IBU's on deposits made after 1-4-2005 by a non-resident or a person who is not ordinarily resident in India or on borrowing made on or after 1-4-2005 from such persons.

Ratio decidendi

Transfer pricing method and PLI for Sogo Shosha companies

Taxpayer a subsidiary of Japanese conglomerate had two kinds of transactions with its AEs namely 'indenting' and 'proper trading'. In indenting it received commission for facilitating sales and in proper trading it acquired title over the goods purchased and sold, though for a brief moment (flash title). Taxpayer, in arriving at its PLI (Berry ratio) aggregated the commission income and trading profit and divided the sum by its operating expenses. TPO alleged that (a) Berry ratio is not mentioned in Indian TP rules; (b) it is in any case not applicable where taxpayer uses intanibles (here marketing network) and (c) it is not applicable for commission income as the same is based on value of goods. The High Court held that (I) Berry ratio is supported by Rule 10B(2)(e) as the same uses phrase 'having regard to any other relevant base' (II) existence of intangibles or even substantial fixed assets would oust the applicability of Berry ratio since the value contributed by such assets would not be captured in Berry ratio however no such fact has been proved by revenue in this case (III) prima-facie Berry ratio should not apply to commission income as the same is based on value of goods transacted and not based on functions performed. With these remarks the court remanded the matter to ITAT. [*Sumitomo Corporation India P. Ltd.* v. *CIT* ITA 381/2013 decided on 22 July 2016]

Annual Value of house property vacant throughout the year

Section 23(1)(c) dealing with vacancy allowance provides that where a property which is let out remained vacant for whole or part of the year then the annual value to be subjected to tax would be lower of (a) reasonable rent and (b) rent actually received / receivable. Taxpayer in this case could not let out its property even for a part of the year. Revenue authorities contended that vacancy allowance can be granted only if the property is let out at least for some part of the year. Rejecting this contention the ITAT held that the phrase 'where property is let out' cannot be understood as suggesting 'where property is actually let out'. Accordingly the taxable annual value for the property was accepted to be NIL. [*Vikas Keshav Garud* v. *ITO* [2016] 71 taxmann.com 214 (Pune - Trib.)]

TDS need not be deducted on professional fee which is not in money terms

The assessee contended that expenditure on gifts to actors who worked in a film was in nature of a gift while the revenue department was of the view that it was professional fee on which TDS had to be deducted. While the Tribunal agreed that the instead of paying professional fees cash it had been paid in kind, it ruled in favour of the assessee that TDS need not be deducted. The Tribunal reasoned that 'any sum' as referred to in Section 194J, would only relate to payment made in money terms and not to payment in kind. [*Red Chillies Entertainment P Ltd* v. *ACIT,* Order dated 31-5-2016,ITAT, Mumbai]

Expenses incurred voluntarily towards CSR, when deductible

The assessee had voluntarily incurred certain expenses as part of its corporate social responsibility (CSR). The revenue department argued that the expenditure was not wholly laid out for purpose of business and in view of the specific disallowance under Explanation 2 to Section 37(1) in respect corporate social responsibility expenses as under Section 135 of the Companies Act, 2013, the assessee could not deduct the expenses. However, the Tribunal held that the said provision was not applicable with retrospective effect and in any case there was no bar on deduction of expenses incurred voluntarily for purpose of business even if they were part of CSR. The express disallowance is in respect of expenses incurred as part of the statutory obligation under Companies Act, 2013. [*ACIT* v. *Jindal Power Ltd,* I.T.A. No.: 99/BLPR/2012, Order dated 23-6-2016, ITAT, Raipur]

Delay by builder in completing the project does not disentitle capital gains exemption of buyer

Taxpayer had sold a plot and claimed deduction of investment made in under construction flat under the provisions of Section 54F of the Act. The registration of title documents of the new flat was not over even after three years from the sale of plot as the delay regarding completion of project and documentation was attributable to builder. Rejecting the stand of Revenue Authorities, ITAT held that it is not in taxpayer's control to get the flat completed and get it registered in his name. The intention of taxpayer is very clear that he has invested almost the entire sale consideration of land in purchase of this residential flat and therefore cannot be denied of legitimate claim of deduction under Section 54F.

Consideration for software licenses is not royalty

Taxpayer, a Dutch company earned income from Indian customers by licensing its "off the shelf software". The customer in India would place an order with a distributor in India who would in turn pass on the order to the taxpayer. On acceptance of the order, the taxpayer would send the CD containing the software to India through distributor while license-keys would be given directly to the customer. The taxpayer also carried out 'other general services' related to software. Admittedly no right in the nature of 'copyright' within the meaning of that word under Indian Copyright Act was given to any customer. ITAT held that Explanation 4 inserted in domestic legislation retrospectively cannot be imported into the treaty and therefore the payment for software licenses does not constitute royalty under the treaty. [*ADIT* v. *Baan Global BV* [2016] 71 taxmann.com 213 (Mumbai - Trib.)]

Consideration for seismic survey and mobilisation charges taxable under Section 44BB

Taxpayer was engaged in business carrying out seismic survey for oil exploration companies. It claimed its income computation to be governed by provisions of section 44BB however the Revenue Authorities referring to amendments to section 44DA and 44BB made vide Finance Act 2010 held that the income has to be computed under regular provisions of the Act. The taxpayer had also earned income in the nature of mobilisation and demobilisation charges which he did not offer to tax but the Revenue Authorities contended that the same accrues and arises in India and therefore taxable in India. ITAT held that the services of taxpayer are governed by un-amended law as the Assessment Year in question was 2010-11 and following decisions of High Court in case of *Baker Hughes Asia Pacific Ltd.* and *OHM Ltd*. held that income is determinable as per Section 44BB. On the issue of mobilisation charges it followed its earlier order and held that the same is also taxable under Section 44BB. Lastly on the issue of taxability of service tax reimbursement following the decision of Delhi High Court in *Mitchell Drilling* it held that the same is not taxable. [*Western Geco International Ltd.* v. *ACIT* [2016] 71 Taxmann.com 166 (Del Trib)]

Taxable situs of intangibles like trademarks and goodwill is location of owner thereof

Taxpayer, an Australian company, had licensed its trademarks to various group companies including a subsidiary in India. On sale of business, the taxpayer also transferred these trademarks to the buyer. Authority for Advance Rulings (AAR) answering the question of taxpayer held that the exploitation and value enhancement of trademark happened in India on account of usage by Indian subsidiary and therefore some portion of income from transfer of trademark is taxable in India. Reversing this decision, the High Court has held that situs of legal owner of the intangible would be the taxable situs of intangible as well and on that basis no tax liability in India can arise in the hands of taxpayer. [*CUB Pty Ltd.* v. *UOI* [2016] 71 taxmann.com 315 (Delhi)]

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