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TDS on sea freight – Good times for Time charter?

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Computation of income of non-resident shipping entities posed many challenges and to ease the same Section 44B was enacted *vide* Finance Act, 1975 w.e.f. 1 April 1976. It provided that income of a non-resident assessee engaged in the business of operation of ships, 7.5% of the gross freight will be deemed to be profits and gains chargeable to tax under the head "Profits and gains of business or profession". Section 172 of the Income Tax Act, 1961 ('the Act') overriding all other provisions of the Act provides for procedure of levy and recovery of tax in case of any ship belonging to or chartered by a non-resident which carries passengers, livestock, mail or goods shipped at any port in India.

Hon'ble Chennai Bench of Income Tax Appellate Tribunal (ITAT) in a recent decision in the case of *Sical Logistics*[1] dealt with the issue of interpretation of Section 172 *vis-à-vis* income from time charter. The tax authorities had treated the Indian payer of income as representative assessee with respect to the shipping income of its service providers being Foreign Shipping Companies ('FSCs').

Before the ITAT the tax authorities placed reliance on the decision of Hon'ble Madras High Court in the case of *Poompuhar Shipping Corporation Limited*[2] contending that the payment to shipping company for time charter is in the nature of royalty.

The issue of taxability of time charter payments had come up before Hon'ble Supreme Court in the case of *Gosalia Shipping*[3] wherein the Court had held as under:

- The case is of a time charter i.e. when the owner of the ship is entitled to payment for hire of ship irrespective of its usage
- The payment to shipping company is based on deadweight carrying capacity as against based on volume of goods carried
- Charterers were liable to pay the agreed hire amount, as above, irrespective of whether they carried goods or not
- While the form of agreement and labels used therein are not decisive yet there is no evidence to arrive at a conclusion that real intent differs from words used therein
- Payer of income had the liberty to sub-let the ship
- Captain of the ship was under orders and directions of the payer of income

In the case of *Poompuhar Shipping* (Supra) the court held that the payment to FSCs is in

1 *Sical Logistics Ltd.* v. *ADIT TS* – 701- ITAT – 2016 (Chennai) dated 14 December 2016

2 *Poompuhar Shipping Corporation Ltd.* v. *ITO 360 ITR 257 (Mad)*

3 *UoI* v. *Gosalia Shipping P. Ltd.* 113 ITR 307 (SC)

the nature of royalty because:

- Payer of income had the right of deciding the route and selecting the time as per its requirement
- Possession and control over ship was not a relevant criterion especially after amendments made vide Finance Act, 2012 inserting Explanation 4 & 5
- The expression 'use or right to use' does not have a precise meaning and its meaning varies depending on the context. The test of use has been met in the present case

The cumulative effect of the decisions of Apex Court and Madras High Court cited above is that payment for time charter is royalty under the Act and warrants tax deduction at source accordingly[4].

The Chennai Bench of ITAT in the case of *Sical Logistics* (supra) however has distinguished the decision of Madras High Court by holding that in that case the taxpayer had a facility of berthing at an Indian port. Regarding *Sical* it further observed as under:

- Payer of income has hired vessels from FSCs for transportation of coal
- Vessels were hired admittedly on time charter basis and time charter hire charges have been paid as agreed
- Payer of income would intimate the FSC about availability of cargo and its origin and destination
- The Captain/Master of vessel, crew and other staff are controlled by ship owner
- Vessel is insured by the ship owner

Based on the above mentioned facts the ITAT held that the payment does not constitute royalty because:

- The payer of income did not have any control or possession over the vessel
- Every one cannot operate a vessel as it requires approval from Maritime Authorities which the payer of income did not have
- There is a difference between 'letting the asset' and 'use of the asset by the owner for providing services'; the former results in royalty but latter doesn't
- Taxability of income in the present case is to be governed by Section 172 which is a complete code in itself

The position regarding applicability of TDS in cases governed by Section 172 can be treated to have been settled by the decision of Full Bench of Hon'ble Bombay High Court in the case of *Dempo*[5 & 6]. The Court held that Section 172 is a special provision for collection of tax and overrides the regular collection machinery embodied in TDS provisions. The question is about correct application of Section 172 to facts of a particular case which cannot be determined

4 This will however be subject to beneficial provision in the relevant Double Taxation Avoidance Agreement

5 *CIT* v. *Dempo & Co P. Ltd.* 381 ITR 303 (Bom FB)

6 *Also refer ACIT* v. *Sudha Devi Saraf 58 SOT 65* (Kol) *and ITO* v. *Anchor Cargo 69 SOT 727* (Ahd)

merely by reference to nomenclatures used by parties in their agreements.[7]

To conclude, the agreement may use term 'time charter' as happened in the case of *Sical Logistics* however if the terms of the agreement demonstrate that the vessel is in control of and used by service provider and not let to the payer of income, the payment will not be treated as royalty in view of the decision of ITAT in that case. It is possible to agree with the conclusion of the ITAT that absent control and possession the payment will not be royalty[8]. However, it is not clear as to how the ITAT could apply the test of control and possession relying on the decision of Delhi High Court in the case of Asia Satellite[9] rendered in the context pre-amended law while that test has been considered irrelevant by the Hon'ble Madras High Court after referring to amendments made *vide* Finance Act, 2012.

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Notifications and Circulars

India-Cyprus DTAA notified

Central Government has notified the India Cyprus DTAA *vide* Notification numbered 03/2017 dated 10-01-2017. The new agreement which will come into force with effect from 01.04.2017 will replace the earlier DTAA which was signed by India and Cyprus in June 1994. The new DTAA provides for source based taxation of capital gains. However, grandfathering clause has been provided *vide* Para 2 to Protocol to DTAA to provide that investments made prior to 01-04-2017 will be taxable in the country of residence only.

It is worth mentioning that due to lack of exchange of information, Cyprus was notified under Section 94A *vide* Notification No. 86/2013. However, owing to the revised DTAA, the Central Government has withdrawn the Notification No. 86/2013 as stated in Notification No. 114/2016 dated 14-12-2016. Further, the Notification No. 86/2013 seems to have been withdrawn with retrospective effect (with effect from 01st November 2013) by application of Notification No. 119/2016 dated 16-12-2016.

Notifications in relation to the taxation and investment regime for Pradhan Mantri Garib Kalyan Yojana, 2016

By Notification Nos. 115, 116, 117 of 2016 dated 16-12-2016, Central Government has notified the Taxation and Investment Regime for Pradhan Mantri Garib Kalyan Yojana(PMGKY), 2016 which will come into force from 17th December 2016 and the declarations under such scheme can be made on or before 31st March 2017. The Rules (refer Notification No. 116/2016 dated 16.12.2016) in relation to the PMGKY providing the manner

7 *UoI* v. *Gosalia Shipping P. Ltd.* 113 ITR 307 (SC)

8 For detailed discussion on this please refer https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2486055 and https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2470348

9 *Asia Satellite Telecommunication Co. Ltd.* vs. *DCIT* reported in 332 ITR 340 (Mad)

of furnishing the declarations and the forms for furnishing such declarations have been notified by way of The Principal Commissioner or Commissioner who exercises jurisdiction under Section 120 of the Income-tax Act, 1961 will be the authority for filing the declaration electronically of manually as per Notification No. 117/2016 dated 16-12-2016.

Ratio decidendi

Form of participation in another enterprise as per Section 92A(2) should also be satisfied to deem two entities as AEs

The assessee is engaged in the business of manufacture and sale of polished diamonds. The assessee entered into an international transaction with a Belgian Entity by name Blue Gems BVBA. The Assessing Officer (AO) was of the view that the said entity would qualify to be Associated Enterprises (AEs)on the ground that the assessee and Blue Gems BVBA were controlled by the same family and the assessee made substantial purchases from Blue Gems BVBA. Considering them to be AEs, an Arm's Length Price (ALP) adjustment was made. The CIT(A) deleted the ALP adjustment but did not adjudicate on the primary question of whether the two entities can be termed as AEs at all. Hon'ble Tribunal found the approach of the Ld. CIT(A) to be incorrect holding that the first thing that needs to be adjudicated upon is whether or not the two entities can be considered to be AEs. In the facts of the present case, the AO had invoked clause (j) of Section 92A(2) wherein two enterprises are given to be associated enterprises if *one enterprise is controlled by an individual, the other enterprise is also controlled by such individual or his relative or jointly by such individual and relative of such individual.* The ITAT opined that the assessee being a partnership concern could not be controlled by *'an individual'*. Referring to the Memorandum explaining the provisions of the Finance Bill, 2002 the Tribunal held that Section 92A(2) provides exhaustive illustrations for the purposes of sub-section (1). The Hon'ble Tribunal observed that sub-section (1) and sub-section (2) have to be read together and that if a form of participation in management and control is not recognized by sub-section (2), even if it results in *defacto* or *dejure* participation in management, capital or control, it would not result in the two enterprises being treated as associated enterprises. [*ACIT* v. *Veer Gems [2017] 77 taxmann.com 127 (Ahm-Trib)*]

Setoff of unabsorbed depreciation – 'year' mentioned in Section 72A does not mean previous year

The assessee (amalgamated Company) amalgamated with a Company by name SKUPL (amalgamating Company) as per the order of the Calcutta High Court in 2004. The Assessee Company had set off the brought forward loss of the amalgamating company in the year under consideration. The Assessing officer was of the view that in order to accept the claim of the assessee company, the condition that must be satisfied is that, amalgamating company should have been engaged in the business in which the accumulated loss occurred or depreciation remained unabsorbed for 3 or more years. Since the date of incorporation of amalgamating company was 13-9-2001 and it was only in the process of setting up plant upto 31-2-2001, the claim of the assessee company was not to be allowed.

On appeal to the Commissioner of Income Tax (Appeals) [CIT (A)], the CIT (A) allowed the claimed of the Assessee Company for the reason that that the amalgamating Company was in the process of setting up a plant for manufacturing Ball Pin tips during the first year itself and also taking into consideration that the amalgamating Company was engaged in the said business for more than 3 previous years, the relevant condition to claim was duly satisfied. The Tribunal, however, held that the phrase used 'three or more years' as appearing in Section 72A cannot be interpreted to mean 'three or more previous years'. For this purpose, the Tribunal referred to the General Clauses Act which defines the term 'year' to mean calendar year reckoned according to the British calendar. The Tribunal held that the word 'year' in Section 72A clearly signifies the calendar year and since the amalgamating Company in the present case, was not engaged in the business in which accumulated loss occurred or depreciation remained unabsorbed for three or more calendar years, the assessee company (amalgamated company) was not entitled to claim set off of the brought forward loss of amalgamating company against its income for the year under consideration. [*DCIT* v. *Unique International (P) Ltd* (2016) 76 taxmann.com 181 (Kol-Tri)]

Depreciation of goodwill claimed in revised computation of income in the assessment proceedings, allowable

The assessee had omitted to claim depreciation on goodwill in the return of income and claimed the same by way of revised computation of income made during the course of assessment proceedings. The Ld.AO disallowed the claim which was reversed by the CIT(A). The Hon'ble ITAT noted that at the time of filing the return of income, the question of claiming depreciation on goodwill was not settled and it was only subsequent to the ruling of the Apex Court in *CIT* v. *Smifs Securities Limited* that the issue was settled and it was clear that depreciation could be claimed on goodwill. Therefore, the assessee had claimed the same by way of filing a revised statement of computation of income before the Assessing Officer. The Tribunal held, following the decision of Bombay High Court in *Pruthvi Brokers and Shareholders* that the mere fact that the claim was not made by way of revised return and instead by way of filing revised statement of computation of income would not disentitle assessee of the benefit sought to be claimed by him. [*DCIT* v. *Zydus Wellness Ltd* (2016) 76 taxmann.com 328 – Ahmd-Trib)]

Benefit of indexation under Section 10(38) available for computing book profits under Section 115JB

The return of income filed for the FY 2008-09 disclosed taxable income under the normal provisions of the Act to be *Nil* and that under the provisions of Section 115JB of the Act to be Rs.34,49,26,560/-. The assessee also claimed carry forward long-term capital gains of Rs.1,19,39,267/-. The AO, during the Assessment proceedings, *interalia* denied the benefit of indexation in computing long term capital gains exempt under Section 10(38) while computing book profits. The ITAT noted that as regards indexation of long term capital gains, the provisions of Section 115JB required profits which are exempt under Section 10, other than Section 10(38) to be reduced from book profits. The provisions of Section 10(38) exempt any income in the form of long term capital gains derived from sale of equity share or unit in an equity oriented fund subject to certain conditions. The manner of computing long term capital gains is provided in Section 48 of the Act which provides that cost of acquisition shall be subject to benefits of indexation. Therefore, income referred to in Section 10(38) has to be computed in accordance with Section 48 and it is that income that has to be considered for the purposes of Section 115JB and hence it was held by the Tribunal that benefits of indexation is available. [*Karnataka State Industrial Infrastructure Development Corporation Limited* v. *DCIT (2016)* 76 taxmann.com 360 (Bang-Trib)]

Contribution to IRDA Solatium Fund is an ascertained liability and is allowable as business expenditure

The assessee, a general insurance company, was engaged in the business of general insurance. The central government framed a scheme to compensate victims of hit and run motor accidents. Insurance Regulatory and Development Authority (IRDA) directed all general insurance companies to contribute to Solatium fund at rate of 1% of premium received during subject assessment year. The Assessee accepted the claim, however in the subsequent year, payment to be made to the fund was scaled down to 0.1% by IRDA in May 2005. The Commissioner of Income Tax (CIT) revised the order *vide* order dated 30.03.2014 on ground that the payment was made to Solatium fund only in September 2005 at 0.1 percent and during subject assessment year provision could not be allowed as an expenditure as it was a contingent liability. On appeal the Tribunal held that the provision made for contribution to the Solatium fund as directed by the IRDA was an ascertained liability for the subject assessment year made in terms of directions dated 18.03.2003. On further appeal to the High Court, the Court placing reliance on the decision of the Supreme Court in the case of *Bharat Earth Movers Ltd* v. *CIT* [2000] 245 ITR 428 and Bombay High Court in the case of *Shrikant Textiles* v. *CIT* [1971] 81 ITR 222 (Bom) upheld the order of the Tribunal. [*CIT* v. *Bajaj Allianz General Insurance Co.* Ltd (2016) 76 taxmann.com 308 (Bom)]

Liability to pay interest under Section 201(1A) even when deductee has filed a Nil return of income

The assessee entered into certain contracts with a private party under various models like Build Own Transfer, Demolish Build Own Transfer and Operation & Management Models. One of the questions of law that was raised before the High Court was, when an assessee was liable to deduct tax under Section 194C on payments made under the contract, whether the assessee can be absolved of the interest liability in case the payee had filed the income tax return and declared Nil income. The assessee, in this case relied upon the amendment made by the Finance Act, 2012 in Section 201 by inserting first proviso to sub-section (1) and proviso to sub-section (1A). The first proviso to sub-section (1) provides certain conditions where the assessee shall not be deemed to an assessee in default and these conditions are that the payee should have furnished the return of income, accounted for the income which is the subject matter of deduction and paid taxes on his income. The proviso to sub-section (1A) provides that interest liability shall however be calculated from the date on which tax was deductible till the date of filing of the return by the payee even in scenario where the assessee is not deemed to be in default due to proviso to sub-section (1). The High Court, relied on the judgment of *Hindustan Coco Cola Beverage P Limited* to state that liability under Section 201(1A) for interest existed even prior to the amendment made *vide* Finance Act, 2012. The Hon'ble High Court noted that the language of Section 201 is clear and is not designed to permit the assessee to decide what the liability of the deductee would be before deciding whether or not to deduct tax and that there was a separate provision in the Act by way of Section 197 to enable the deductee assessee to apply and obtain a certificate of Nil/lower deduction where it is estimated that the tax liability will be Nil or negative. The High Court also noted that the provisions of sub-section (1) and (IA) have to be read independently and that the fact that the payee in the instant case filed a loss return would not absolve the payer/assessee of the interest liability. [*CIT* v. *Punjab Infrastructure Dev. Board* TS -690-HC-2016 (P&H)]

Disallowance of provision created for warehousing expenses under Section 40 (a) (ia) for non-deduction of TDS is not valid as it only accrued but did not become due

The assessee created provision for warehousing expenses. The Assessing Officer (AO) disallowed the said expenses by invoking the provisions of Section 40 (a) (ia) of the Act for non-deduction of TDS. On appeal to Dispute Resolution Panel (DRP), deleted the addition by holding that the TDS provision cannot be invoked where the person who received the payment cannot be identified at a stage where the payment only accrued but had not become due. On further Appeal by the Revenue to the Tribunal, the Tribunal relying on the decision of the co-ordinate Bench in the case of *Bosch Limited* v. *ITO* , IT(TP) A No. 1583/Bang/2014 and also finding merits in the observation of the DRP, dismissed the appeal of the revenue. [*DCIT* v. *Nike India Private Limited* TS-1034-ITAT-2016 (Bang)-TP]

Transport subsidy not treatable as revenue receipt

The assessee treated transport subsidy under Transport Subsidy Scheme, 1971 as capital receipt. Upon scrutiny department assessed it as revenue receipt which was added back to assessee's income. CIT (Appeal) reversed the AO's order, against which department filed an appeal before ITAT. There was difference of opinion between the Tribunal Members and the matter was referred to the third Member. The third Member considered the ratio in *Sahney Steel & Press Wok Ltd. and Ponni Sugars and Chemicals Ltd.* but by the time the first decision of jurisdictional High Court was rendered in the case of *Meghalaya Steels Ltd.* in which it was held that transport subsidy should be treated as revenue receipt. The third member relying on the decision of the jurisdictional HC in Meghalaya Steels Ltd. passed the order in the favour of Revenue. Subsequently the decision in Meghalaya Steels Ltd. was reversed by the Division Bench.

The assessee appealed to the High Court and the Court applying *purpose test formulated in Sahney Steel & Press Wok Ltd. and Ponni Sugars and Chemicals Ltd.*, held that the purpose of the scheme was to stimulate industrial activity in backward region, to generate employment opportunity and bring development in North Eastern States and that the same is not meant for higher profit for entrepreneur. Allowing the appeal, it was held that the subsidy intended to encourage investment in difficult and far flung states and that the sum received under such subsidy cannot be treated as revenue receipt. [*Shiv Shakti Flour Mills* v. *CIT*, Judgement dated 29-11-2016 in ITA 6 of 2014, Gauhati High Court]

News Nuggets

Tax on indirect transfers - Circular kept in abeyance

Explanation 5, 6 and 7 to section 9(1)(i) of Income-tax Act, 1961 contain provision in relation to taxation of gains arising from indirect transfers. As per these provisions, gain arising from transfer of shares of a company located outside India may be taxed in India, if such shares derive at least 50% of their value from assets located in India and value of the assets in India exceeds Rs. 10 crores. Further, Section 285A of Income-tax Act, 1961 casts a reporting obligation on the Indian concern whose shares are substantially held directly or indirectly by a company or entity registered or incorporated outside India. CBDT constituted a Working Group on 15th June, 2016 to examine the various representations like raising the monetary limit for triggering applicability of the provisions, fair market valuation etc. Circular No. 41/2016 dated 21-12-2016 was issued to clarify doubts in relation to the scope and reporting obligations in relation to indirect transfers. It stated, *inter alia* that the threshold limit of INR 10 crores is reasonable, FPIs cannot be exempted from requirement to withhold taxes and so on.

Responding to concerns raised by

stakeholders that this circular on indirect transfers does not address the issue of multiple taxation, the operation of the circular has been kept in abeyance. The CBDT has issued a press release dated 17-1-2017 in this regard.

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