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Article

Deduction of tax at source on reimbursements - An unsettled debate!

By **Karanjot Singh Khurana**

Introduction

The question as to whether tax has to be deducted at source on expenditure reimbursed to both residents and non-residents has been a subject matter of judicial scrutiny on various occasions. Even though, it is judicially accepted that the reimbursement of expenditure does not constitute 'real income' of the payee[1], the liability to deduct tax on reimbursements has been a subject matter of dispute and as discussed in following paragraphs, the issue of tax deduction at source on reimbursement of expenditure is far from settled.

Root of controversy

As per the IT Act[2], the payer is liable to deduct tax at source on payments which are chargeable to tax in India and where the provisions of IT Act provide for tax deduction at source on such stream of income. Further, as upheld by Supreme Court, the liability to deduct tax is on the gross sum paid by the payer[3].

The root of the controversy regarding tax deduction on reimbursement can be traced to the difference in claim of the taxpayer and taxman. While the former claims that the receipts in the form of reimbursement of expenditure do not fall in the realm of the term 'income', the latter claims that the gross receipts (including reimbursements) form part of total income even though owing to computation mechanism, the reimbursement may not lead to a tax liability in the hands of the payee. Owing to such divergent view, the taxman contest that the payer should deduct tax on gross sum paid (including reimbursements), even though, owing to the computation mechanism, the payee may not have to pay tax on receipts from reimbursement.

Contrary Rulings

Recently the Kolkata Bench of Tribunal[4] has held that the payee of reimbursements only acts as a conduit owing to which the sum reimbursement is not exigible to tax in the hands of the payee. However, in another case[5], the interpretation by the Bangalore Bench of Tribunal is diametrically opposite to that of the Kolkata Bench wherein the Bench held that the liability to deduct tax cannot be circumvented by making payment through the intermediary and not making the payment directly to the ultimate beneficiary. Although, the latter judgment was rendered in the context of management charged paid to a resident, the rationale should apply in respect of payments made to both residents and non-residents. It is worth mentioning that although, there are plethora of the judgments on the subject, these judgments have been consciously chosen to highlight the difference of interpretation on the subject. Thus, even though the issue is not *res-integra*, the difference in judicial interpretations has led to complications

[1] *Tejaji Farasram Kharawalla Ltd.*: [1968] 67 ITR 95 (SC) and *A.P. Moller Maersk A S* [2017] 392 ITR 186 (SC)
[2] Section 4(2) of Income-tax Act, 1961
[3] *Transmission Corpn. of A.P. Ltd.*: [1999] 239 ITR 587 (SC)
[4] *Timken Company*: [2017] 88 taxmann.com 21 (Kolkata - Trib.)
[5] *Tungabhadra Steel Products Ltd.*: ITA No. 984/Bang/2017

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and uncertainties regarding liability to deduct tax on such payments.

Departmental Circulars

CBDT had issued a Circular[6] wherein it was stated that since the provisions contained in Chapter XVII-B fasten a liability to deduct tax on 'any sum paid', the reimbursements cannot be reduced from the gross sum payable to compute the liability to deduct tax at source. However, Delhi Bench of ITAT[7] has held that the liability to deduct tax on gross sum, as clarified in the aforesaid circular will apply only if there is a composite bill which does not differentiate between the reimbursement and other sum. Thus, there are contrary views with regards to departmental clarification as well.

Relevance of privity of contract and nature of income

The privity of contract will play a pivotal role in determining the liability to deduct tax at source. In a case, where the privity to contract lies between the payer and the ultimate service provider, the intermediary will only act as a conduit or agent of the payer. In such a case, it is worth pondering as to whether the payer is absolved of its liability to deduct tax on the underlying sum merely because the payment is routed through the intermediary. However, in a case, where the payer's privity of contract lies with the intermediary, so much so, that the payer is liable to reimburse the intermediary the sum expanded by it on behalf of the payer, the possibility of deduction of tax cannot be ruled out. Even in such cases, the liability to deduct tax may arise owing to the nature of income paid to intermediary. To illustrate this scenario, reference may be drawn to the judgment of Delhi High Court[8], wherein the payer had reimbursed the salary of seconded employees to the payee. In this regard, the Court held that since the technical services are exigible to tax on gross basis, the payer ought to have deducted tax at source. Further, in cases relating to apportionment of expenditure, an allegation of disproportionate cost sharing may lead to liability to deduct tax in the hands of the payer.

Conclusion

The liability to deduct tax at source on reimbursement of expenditure is a fact specific issue. Where the underlying payments are subjected to tax deduction at source, there are further issues like claim of credit of tax, inclusion of sum in total income, cash flow issues (in case where tax is deducted both by intermediary and payer) etc., that are likely to creep in. Further, the payer may also be required to fulfil certain compliances like obtaining back-to-back invoice to prove the lack of profit element, declaration under Rule 37BA(2) etc. It is therefore advisable that the precise facts of a case are kept in mind rather than applying a rule of thumb. The issue regarding tax deduction at source on reimbursement of sums should be examined at the stage when the transaction is contemplated to avoid any adverse implications at a later point of time.

[The author is a Senior Associate, Direct Tax Practice, Lakshmikumaran & Sridharan, New Delhi]

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[6] Question No. 30 in Circular No. 715 dated 08th August 1995
[7] Dr. Willmar Schwabe India (P.) Ltd.: [2005] 95 TTJ 53 (Delhi)
[8] Centrica India Offshore Pvt. Ltd.: [2014] 364 ITR 336 (Delhi)

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Ratio Decidendi

Expenditure in dividend earned from strategic investments disallowed under Section 14A

The Supreme Court has upheld disallowance of expenditure in acquiring shares of a company for retaining controlling interest or as stock-in-trade, wherein certain dividend was also received. The Court interpreted provisions of Section 14A of the Income Tax Act, 1961 read with Rule 8D of Income Tax Rules, 1962. The assessee had contended that dominant intention for purchasing the share was not to earn dividends income but for the control of the business in the company in which shares were invested. The court however rejected the plea observing that the legislature has inserted Section 14A and made it retrospective with the intention to determine the expenditure in relation to exempt income where the business is divisible and which has elements of both taxable and non-taxable income. For this purpose, the principle of apportionment as manifest in Section 14A was considered to be applicable. It was observed that the expenditure was 'in relation to' dividend (exempted) income, and hence was to be disallowed. Few appeals which were for the period prior to insertion of Rule 8D, i.e. for AY prior to 2007, were decided in favour of the assessees holding said Rule to be prospective in nature. [*Maxxopp Investment v. CIT – Judgement dated 12-2-2018 in Civil Appeal Nos. 104-109 of 2015 & Others, Supreme Court*]

No income tax on non-occupancy & other charges by cooperative societies

The Supreme Court has held that non-occupancy charges, transfer charges, common amenity fund charges and certain other charges received by co-operative societies from its members are not exigible to Income Tax. The non-occupancy charges are payable by a member of the society who does not himself occupy the premises but lets it out to a third person. These charges are utilised for the common benefit of facilities and amenities to the members. Observing that the receipts were indisputably used for mutual benefit towards maintenance of the premises, repairs, infrastructure and provision of common amenities, the Court applied Doctrine of Mutuality, entailing that a person cannot make profit from himself. The Apex Court in this regard also affirmed High Court's view that notification dated 9-8-2001 issued under Section 79A of Maharashtra Cooperative Societies Act is applicable only to cooperative housing societies and not to society consisting of non-residential premises. [*ITO v. Venkatesh Premises Cooperative Society* - Judgement dated 12-3-2018 in Civil Appeal No. 2706 of 2018 & Others, Supreme Court]

Loss return will not qualify as 'tax paid' for purposes of payment of tax by recipient in proviso to Section 201

The assessee contended that he should not be treated as assessee in default for non-deduction of TDS since the recipient (of lease rent) has submitted his return showing loss. It was argued that though no tax was paid by the recipient of rent, the assesse (deductor) could take the benefit of proviso to Section 201 of the Income Tax Act, 1961 which states that the person obligated to deduct tax will not be deemed to be an assessee in default if the person to whom the sum is paid furnished the return of income and has paid tax due on the income declared. The High Court did not agree with the contention of

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the assessee that though no tax was paid, the word paid must be construed liberally to include non-payment because no tax was due. Thus, the High Court held that the assesse was liable for consequences of non-deduction of TDS. [*The Academy of Medical Sciences* v. *CIT* - ITA 232/2014, Judgement dated 7-3-2018, High Court of Kerala]

Voluntary disclosure after survey amounts to concealment – Penalty imposable

The Delhi High Court has held that mere voluntary disclosure without any explanation as to the nature or source of income does not absolve assessee from penalty. The assessee declared Rs. 9,18,060 as her total income but when a survey under Section 133A of the Income Tax Act, 1961 was conducted at her premises she surrendered Rs. 2 Crore and filed a revised return declaring it as additional income. Relying on Supreme Court's ruling *in MAK Data* it was held that revised return was an afterthought and according to Explanation 1 to Section 271(1)(c), penalty was imposable. The Court for this purpose noted that assessee merely made a voluntary surrender, and that she did not offer any explanation as to the nature of income or its source. [*Pr. CIT v. Vandana Gupta - Judgement dated 20-2-2018 in ITA 219/2017, Delhi High Court]*

Human error should not nullify a valid proceeding as mandated by Section 292B

Delhi High Court has held that Notice under Section 147 or 148 of the Income Tax Act, 1961 addressed to Sky Light Hospitality Pvt. Ltd., a company which had been dissolved, was an error and technical lapse on the part of department. However while interpreting mandate of Section 292B, Court observed that the appellant had replied to said notice which concludes that they had understood and were aware that said notice was for them. , It was thus held that human errors and mistakes cannot and should not nullify proceedings which are otherwise valid. [*Sky Light Hospitality LLP v. CIT - Judgement dated 2-2-2018 in W.P. (C) 10870/2017 and CM No. 44503/2017, Delhi High Court]*

Deduction of input tax credit relating to exempted services, permissible

Observing that service tax paid by the assessee is otherwise eligible for deduction, ITAT Mumbai has held that input tax credit relatable to exempted output services is also eligible for deduction, since it cannot be availed as credit by the assessee. The Tribunal for this purpose also agreed with the assessee that method of accounting service tax liability, i.e., exclusive method or inclusive method, does not have any revenue implications. Such expenditure was hence held to be rightly deductible. The case involved provision of both taxable and exempt services and the assessee had charged input credit relatable to the exempt services to the profit and loss account. [*CIT v. Morgan Stanley Capital – Order dated 29-1-2018 in I.T.A. Nos. 4962-4963/Mum/2015, ITAT (Mumbai)]*

Charitable activity - Registration u/s 12A requires only determination of 'object'

Delhi ITAT has allowed registration under Section 12A of the Income Tax Act, 1961 to a society running schools and colleges, observing that education *per se* is a 'charitable activity'. The Tribunal, relying upon various decisions also held that CIT, at the time of registration under Section 12A, is required to only see the objects of the society and not to examine application of income. It was observed that same has to be done by AO when exemption under Section 11 is claimed. [*Vidyadayani Shiksha Samiti v. CIT – Order dated 14-12-2017 in ITA No.309/Del/2016, ITAT (New Delhi)]*

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No capital gain/loss on transfer of shares to second step down subsidiary

ITAT Kolkata has held that the provision of Section 47 (iv) which states that transfer of a capital asset by a subsidiary company to a holding company will be apply to transfer of shares to second step down 100% subsidiary. It was held that the transaction of sale of shares of M/s. Zandu Realty by the assessee to M/s. Emami Rainbow Niketan Ltd which was a subsidiary of Emami Realty Ltd which was a subsidiary of the assessee, was not to be regarded as transfer so as to entail taxation under capital gains in view of provisions of Section 47(iv) of the Income Tax Act, 1961 The Tribunal followed the decision of the Bombay High Court in the case of *Petrosil Oil Co.* for the purpose. Observing that term subsidiary company was not defined in Income Tax provisions, the Tribunal relying on the provisions of Companies Act, 1956 held that a second step down 100% subsidiary company is also a subsidiary. [*Emami Infrastructure v. ITO - Order dated 28-2-2018 in I.T.A No. 880/Kol/2014, ITAT (Kolkata)*]

News Nuggets

E-assessment procedure extended to inquiry before assessment

The CBDT on 19-3-2018 has directed that notice under Section 142(1) of the Income Tax Act, 1961 will be issued in the revised format which is suitable for e-assessment. As part of the move towards e-assessments, the CBDT had earlier mandated the use of the e-filing portal for assessment except in case of assessment related to search and certain specific exemptions. Assessees were also required to submit documents in response to the notice under Section 143(3), electronically. Now, the facility of e-filing has been extended in case of inquiry before assessment also. The format of notice has now been revised to enable e-filing of details. It has also been stated that assesses may respond through e-filing portal even in cases where notice has been issued under the old format.

EU moves to tax digital economy

In the recent press release dated ed21-3-2018 issued by the European Union has communicate its proposals to tax digital economy effectively. According to the press release, the move should held to remove the distortion between traditional and digital business and also ensure uniformity in taxation. The press release states that tax law designed with the traditional, physical presence and brick and mortar business may not even have adequate provisions to tax digital transactions. The EU proposes to tax revenues from digital services based on significant digital presence which would be decided by a monetary threshold or on basis of number of users. It also states the member states would be required to amend the double taxation avoidance agreements. The EU has also proposed an interim tax till the time permanent rules are implemented to cover sale of user data and supply of digital platforms facilitating transaction between users such as peer-to-peer apps.

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NEW DELHI
5 Link Road, Jangpura Extension,
Opp. Jangpura Metro Station,
New Delhi 110014
Phone : +91-11-4129 9811

B-6/10, Safdarjung Enclave
New Delhi -110 029
Phone : +91-11-4129 9900
E-mail : lsdel@lakshmisri.com

MUMBAI
2nd floor, B&C Wing,
Cnergy IT Park, Appa Saheb Marathe Marg,
(Near Century Bazar)Prabhadevi,
Mumbai - 400025
Phone : +91-22-24392500
E-mail : lsbom@lakshmisri.com

CHENNAI
2, Wallace Garden, 2nd Street
Chennai - 600 006
Phone : +91-44-2833 4700
E-mail : lsmds@lakshmisri.com

BENGALURU
4th floor, World Trade Center
Brigade Gateway Campus
26/1, Dr. Rajkumar Road,
Malleswaram West, Bangalore-560 055.
Ph: +91(80) 49331800
Fax:+91(80) 49331899
E-mail : lsblr@lakshmisri.com

HYDERABAD
'Hastigiri', 5-9-163, Chapel Road
Opp. Methodist Church,
Nampally
Hyderabad - 500 001
Phone : +91-40-2323 4924
E-mail :lshyd@lakshmisri.com

AHMEDABAD
B-334, SAKAR-VII,
Nehru Bridge Corner, Ashram Road,
Ahmedabad - 380 009
Phone : +91-79-4001 4500
E-mail : lsahd@lakshmisri.com

PUNE
607-609, Nucleus, 1 Church Road,
Camp, Pune-411 001.
Phone : +91-20-6680 1900
E-mail :lspune@lakshmisri.com

KOLKATA
2nd Floor, Kanak Building
41, Chowringhee Road,
Kolkatta-700071
Phone : +91-33-4005 5570
E-mail : lskolkata@lakshmisri.com

CHANDIGARH
1st Floor, SCO No. 59,
Sector 26,
Chandigarh -160026
Phone : +91-172-4921700
E-mail :lschd@lakshmisri.com

GURGAON
OS2 & OS3, 5th floor,
Corporate Office Tower,
Ambience Island,
Sector 25-A,
Gurgaon-122001
phone: +91-0124 - 477 1300
Email: lsgurgaon@lakshmisri.com

ALLAHABAD
3/1A/3, (opposite Auto Sales),
Colvin Road, (Lohia Marg),
Allahabad -211001 (U.R)
phone . +91-0532 - 2421037, 2420359
Email:lsallahabad@lakshmisri.com

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