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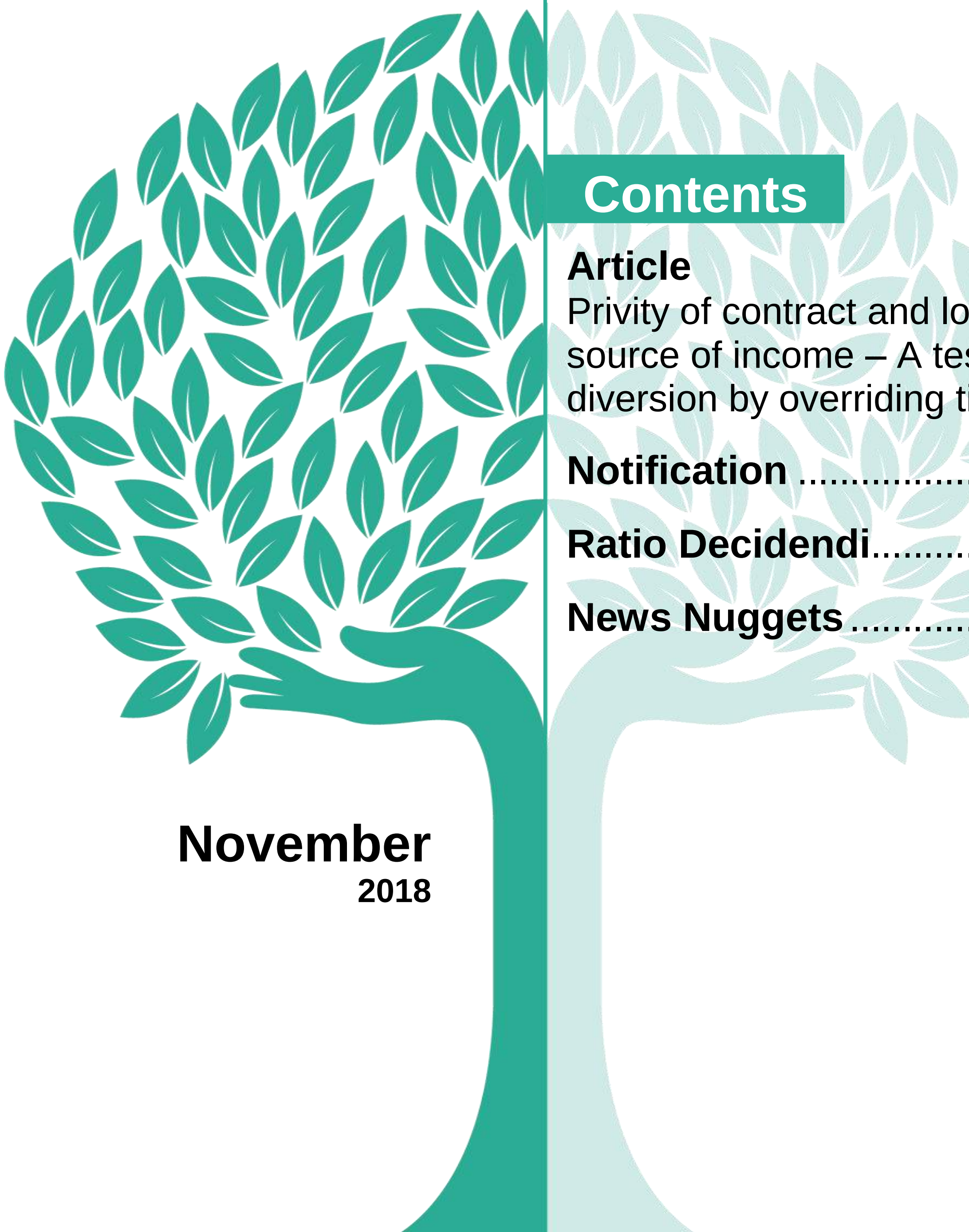

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Article

Privity of contract and locus with a source of income – A test of diversion by overriding title

By **Prachi Goel** & **Saurav Sood**

The manufacturing business can be undertaken either on own account or by way of a job work. In case the job work is chosen as an option, the manufacturer absolves itself from the whole or any part of the activities required to be undertaken. In a recent case of *Pr. CIT v. Chamundi Winery and Distillery I.T.A. No 155/2016,* Chamundi (the assessee) the company engaged in the manufacture and sale of liquor was denied the deduction of allocation of distributable surplus as an expenditure under the provisions of the Income-tax Act, 1961 (the Act).

In the instant case, the assessee was appointed as a job worker by Diageo India under the contract. The state excise license was in the name of Chamundi itself, thus for the purposes of manufacture, the assessee was a registered entity under the provisions of relevant law. Diageo India was the owner of license and trademarks (IP rights) of liquor brands worldwide. These IP rights were given to the assessee for the purposes of manufacture. The sale of liquor was undertaken by the assessee and the revenue was booked accordingly in its books of accounts. From this revenue, the assessee was entitled Rs. 45 per case as its share of profits and after adjustment of all expenses including taxes (indirect), the balance was available as distributable surplus to Diageo India which was offered to tax by Diageo India. This distributable surplus was claimed as expenditure under section 37 of the Act by the assessee. The deduction claimed by the assessee was disallowed by the income tax officer on the pretext of it being first accrued in the hands of the assessee and subsequently applied for the purposes of distribution. The fact that taxes were duly paid by Diageo India on such surplus was not even taken into consideration. This disallowance, however, was overturned by the first appellate authority and the tribunal on the grounds that assessee could be charged to tax only on the real income to which it is entitled to as per the terms of the contract i.e. the bottling fee, in the instant case. Accordingly, the department went on an appeal before the High Court on the grounds that the distributable surplus paid by the assessee to Diageo under the contract being an application of income was expenditure disallowable under section 37 of the Act.

While deciding the case, High Court referred to the contract entered between Chamundi and Diageo India, where one of the clauses of the contract provided Chamundi with an access to IP rights including blending recipes being a key step in the manufacturing of liquor. Even, the working capital requirements of the assessee were met by the Diageo India. The contract also provided Diageo a control on the bank account of the assessee including the authorized signatory being the employee(s) of Diageo itself. Such rights under the contract which were existing with Diageo, also entitled Diageo to the surplus as per the agreed mechanism of computation provided in the contract. Nowhere, the contract provided for any payment of consideration towards IP rights nor it was a contract of partnership or joint venture.

Based on this factual finding, the Karnataka High Court while deciding the case on the question of law posed before it, held that these payments been in the nature of royalty, finance charges etc., could have been naturally allowed as business expenditure, but in the instant case it is more of a device for tax avoidance rather than diversion of income by overriding title at source. The Court appreciated the legality of the contract but while deciding the issue at hand pierced into the contract for seeing the overall and actual purpose of such façade. The real purpose of commercial arrangement was held to be tax avoidance and was thus disregarded. The Court also held that in case of diversion of income by transfer of overriding title at source, it should normally have support of statutory requirements or some decretal binding character of court of law. In case of private contractual obligations also, the real purport and object of such private arrangements have to be carefully examined before giving it a blessing of diversion of income by overriding title at source.

In the instant case, due to absence of real purpose for having such contract followed with the reliance on account entries and methods of maintaining books, it cannot be held as the basis for conclusion of diversion of income at source. Thus, such expenditure was disallowed in the hands of the assessee.

While deciding the case, the Court referred to various judgements wherein this issue was discussed. The judgements referred by the Court provided decisions in favour and against the assessee. This distinction between the divergence of income by overriding title at source and application of income is not on the basis of any fine parameters and is more dependent on the facts of each case.

Thus, it can be concluded that in order to decide taxability of profits, one can say that the person having locus with the source of income and privity of contract with the buyer will be the person in whose hands such income will be taxable. Alternatively, where such source is transferred even before the income is accrued or received (whichever is earlier) there still can be an argument that it is a diversion of income. The reading of this decision also allows us to say that the real purpose of the contract can be deciphered by the Courts through the mechanism of piercing the veil which is now also enshrined under the provisions of GAAR. In case such transaction would have been entered between two associated enterprises while one being a non-resident, it will be interesting to test this proposition while applying the profit split method.

Lastly, one can say that had this payment being made under the subheads of royalty or license fee, then such payments would have been available as a deduction to the assessee upright. Therefore, one can say that taking into consideration the recent trend of judiciary and the anti-abuse provisions incorporated under domestic tax laws and the treaties, the tax planning tools may not come to the rescue of the taxpayer when deeper scrutiny is undertaken by the tax department.

[The authors are Associate & Joint Partner, respectively, in Direct Tax Team, Lakshmikumaran & Sridharan, New Delhi]

Notification

Amended forms for appeal to ITAT notified

By way of Notification No. 72/2018 dated 23-102-2018, the government has notified new form for appeal to ITAT and cross appeal. The new form requires the applicant to fill in particulars regarding the tax effect. It provides that tax effect would be the difference between the tax on the total income assessed and the tax that would have been chargeable had such total income been reduced by the amount of income in respect of the issues against which appeal is intended to be filed (i.e. disputed issues) including applicable surcharge and cess. Tax for this purpose will not include interest except where chargeability of interest itself is in dispute.

Rule prescribed for persons entering into certain financial transactions, to obtain PAN

By way of Notification No. 82/2018 dated 19-11-2018, Rule 114 has been amended to provide for obtaining of PAN by persons who are entering into financial transactions aggregating to INR 2,50,000 or more in a financial year. The notification will come into force on 5-12-2018. As per the amended Rule, the application is to be made on or before the 31st of May immediately following the financial year. The individual entering into such transaction or the person competent to act on their behalf, and managing director, partner, trustee, principal officer, Karta of the company, firm, trust or HUF as the case may be has to apply for PAN if they do not have a PAN. Finance Act, 2018 mandated that person (or the specified officer bearer, director etc.,) entering into specified financial transactions also have to obtain PAN.

Ratio Decidendi

Deduction under Section 80IA(4)(iii) allowed upon completion of 30 Units in the industrial park.

CBDT Notification dated 26.12.2016 stated that the tax-payer is eligible for the benefits of deduction under Sec. 80 IA(4)(iii), i.e. for development and maintenance of industrial park. However, there were two conditions under this Notification, which restricted the tax-payer from claiming the benefits in the year in which the industrial unit was set up. These two conditions were – (i) Certificate of Completion of the project must be obtained from a local body; (ii) Sec. 80IA deduction to be allowed if the industrial park has a minimum of 30 Units. The tax-payer's industrial park was set up under the Industrial Park Scheme, 2008, wherein the Gujarat Industrial Development Corp. (State Govt. Body) supervised the Project. In the year 2009 – 10, tax-payer had completed 30 Units, but the rest of the Project was completed at a later date. Also, date of commencement was decided to be 5th Sept., 2010. (Assessment Year 2011-12). The Court held that the real intent of Sec. 80IA is to provide incentives by giving benefit from the year of beginning of the project. Once the industrial park is set up, the tax-payer can opt for the deduction from the first year itself or opt to wait for a few years to claim the benefit once there are profits. Further, since setting up of units beyond 30 could take huge amount of time, the tax-payer cannot be denied benefit for the existing 30 units. Therefore, once 30 units are set-up, the tax-payer can claim deduction. [*Devraj Infrastructures Ltd. v. Chairman, Industrial Park* [TS-503-HC-2017]

Assessee can opt for treaty benefit for one source out of multiple sources of income

The assessee, a resident of Singapore, offered to tax a service fee earned by it in India following the provisions of Income Tax Act, 1961 and chose to be governed by the India-Singapore Treaty in respect of management support fee, which it claimed was not taxable. The management fee was classified as business income, and in absence of a permanent establishment in India, the assessee claimed that the sum was not taxable. The income tax authorities argued that employee of the assessee had stayed in India beyond the threshold of 30 days this created a Service PE in respect of both the sources of income and was taxable. However, the assessee claimed that, the employees were present in India for only two days for providing management support services and as such no PE was constituted. The Tribunal agreed with the contentions of the assessee that it could opt between the provisions of the treaty and the domestic act differently for separate sources of income and that the management service fee would not be taxable so long as the threshold for creation of PE was not crossed. [*Dimension Data Asia Pacific PTe. Ltd* v. *DCIT*, ITA No. 1635 & 1636 /Mum/2017, Order dated 12-10-2018]

Compounding fee under Section 276C is 100% of the 'tax' sought to be evaded and not income

The tax-payer had claimed deduction for provision of income-tax during AY 2008-09, which was disallowed and an addition of Rs. 8.70 Lakhs was made, giving rise to additional tax of Rs. 2.61 lakhs. The AO also initiated penalty proceedings u/s 271(1)(c) at the rate of 100% of the tax sought to be evaded i.e. Rs. 2.61 Lakhs. Subsequently, the prosecution u/s 276C(1) was also initiated. The tax-payer applied to the CCIT for compounding. For this, the department sent the computation of compounding fees wherein it had computed compounding fees to be 100% of income sought to be evaded and asked the tax-payer to pay the compounding fees of Rs.10,49,000. The Court held that compounding fees should be levied @ 100% of 'tax' sought to be evaded and not @ 100% of 'income addition' with respect to prosecution initiated on tax-payer co. under section 276C. The Court noted that para 12 of CBDT's Circular on compounding of offences prescribes compounding fees for offense u/s 276C(1) at 100% of the 'amount sought to be evaded'. Since this para does not contain any specification of 'the amount sought to be evaded', the Court looked into the statutory provisions of the Income Tax Act in relation to which this compounding fee is prescribed, i.e. Section 276C and observed that Section 276C has different severity of punishment depending on the amount sought to be evaded and this, in turn has relation to the attempt at evasion of tax, penalty or interest. Accordingly, Court concluded that words "amount sought to be evaded" must be seen and understood in light of the provisions contained in section 276C(1), and this term is in essence the tax sought to be evaded and not the income. Therefore, compounding fee for the tax-payer was held to be Rs. 2.61 Lakhs. [*Supernova System (P) Ltd. v. ACIT* , TS - 546-HC-2018 (Guj.)]

‘Sum payable’ for purposes of TDS obligation can include payment in kind: property in goods must pass

In terms of the contract for milling of paddy, the assessee, a state procurement agency paid milling charges as fixed by the government. The tax authorities alleged short-deduction of Tax at source (TDS) stating that since the millers were to retain 33% of paddy allotted to them which would comprise of broken husk and other by products. The tax authorities contended that this constituted payment in kind and TDS ought to have been deducted on the value of paddy (by products) retained by the millers. The Tribunal held that the terms the payment in cash or cheque or draft or ‘any other mode’ would include payments in kind. However, as per the terms of the agreement the charges were fixed independent of the value of the paddy retained and moreover, the government claimed no right nor accepted any responsibility in respect of 33% of the paddy. The Tribunal thus reasoned that the 33% of the paddy in the form of by-products never belonged to the assessee. As per the contract the minute they came into being they were the property of the miller and hence no consideration flowed from the assessee to the miller and the sum could not be covered under Section 194C as sums payable for works contract services. [*ITO* v. *Punjab State Warehousing Corporation*, ITA No. 1309/3110/ CHD/2016 and Ors., ITAT Chandigarh, Order dated 30-10-2018]

Difference between the MRP and discounted price paid by the distributors is not a commission under Section 194H

Tax-payer was a service provider engaged in the business of Direct to Home (DTH) services and entered into an agreement with distributors for sale/ distribution of set-top boxes under which Set Top Boxes (STBs) and recharge vouchers (RCVs) were sold to distributors at a discounted price. The STBs were further sold by distributors to the customers/ subscribers at a price not exceeding the MRP mentioned for the product. Assessment Officer noted that tax-payer had not deducted TDS on discount sale of Set Top Boxes (STBs) and recharge vouchers (RCVs) to distributors. There were various restrictions imposed on the distributor for selling the product and therefore, the transaction clearly established the relationship of 'principal and agent' according to the department. Thus, the AO noted default on account of non-deduction of tax at source under section 194H in respect of the payments made to the distributors as discount/commission for sale of set top boxes, recharge coupons. The Tribunal held that tax-payer not liable to deduct TDS u/s. 194H on discounts given to distributors / dealers on sale of STBs and RCVs. since the tax-payer had not made any payment to the distributor and it only received sale price on sale of products to the distributor. Also the distributors were customers of tax-payer to whom sales are affected and therefore discounts and credit notes credited could not be considered to be commission payment under section 194H. It was thus held that the difference between MRP and the price at which item is sold to the distributor cannot be held to be commission or brokerage. [*Tata Sky Ltd. V. ACIT*, TS-610-ITAT-2018 (Mum.)]

Depreciation under Section 32 also allowed to ‘Deemed User’ of the asset

Tax-payer had claimed depreciation of Rs. 34 Lakh (approx.), which was disallowed on the ground that the business of the tax-payer had closed down and there was no business income during the year and the assets in which depreciation was claimed had not been used for the purpose of business. The reason for the halt in the business operation was that there was a dispute with respect to the trademark “BABUL”, due to which, the manufacturing process was halted on Court orders. Thus, the business did not close permanently, but there was merely a suspension of business activity. It was held that there are two conditions under Sec. 32 – (i) the tax-payer is the owner of the said assets; (ii) asset has been used for the purpose of business. The term "used" in the second condition not only include actual user but also deemed user. Since tax-payer had not stopped the business, it was a constructive user or a deemed user of the assets. Therefore, depreciation was to be allowed. [*PCIT v. Babul Products (P) Ltd,* (2018) 96 Taxmann.com 82 (Guj.)]

News Nuggets

CBDT issues guidelines for scrutiny of service charges collected by hotels and restaurants

The CBDT, on 19-11-2018 has issued guidelines to field formations to scrutinise the accounts of hotels and restaurants to ascertain if there is any under-reporting or non-reporting of service charges collected by hotels and restaurants. As per the Guidelines on Fair Trade Practices issued by the Ministry of Consumer Affairs last year, payment of services charges or tips should be optional. The hotel/restaurant should not collect such charges which are supposed to be paid by the customer to the person servicing him and cannot be made part of the bill which would inherently include a component of service charges. The CBDT in its recent instruction has asked the officers to ascertain whether the service charge collected by the restaurant has been reported as part of its turnover and in case the same is not passed on to the workers it should be assessed as income in the hands of the hotel or restaurant concerned.

India China sign protocol moving closer to the minimum standards under BEPS Action Plan

As per CBDT Press Release dated 26-11-2018, India and China have signed a protocol to amend the Double Taxation Avoidance Agreement (DTAA) which would update the existing provisions for exchange of information to the latest international standards. The press release also states that the countries will incorporate changes required to implement the treaty related minimum standards under Base Erosion and Profit Shifting (BEPS) Action Plans. India and China are signatories to the Multilateral Instrument (MLI) which seeks to align the DTAA(s) with common agreed standards as regards establishment of PE , limitation of benefits and so on to achieve a coordinated approach to implement treaty related BEPS measures.

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

www.lakshmisri.com **www.gst.lakshmisri.com**
www.addb.lakshmisri.com **www.lakshmisri.cn**