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Contents

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Article

Taxation of income from shipping business

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Introduction:

The shipping industry plays a vital role in the international trade. The recent UNCTAD report provides that more than four fifths of world merchandise trade by volume is carried by sea.[1] Indian companies also generally use foreign vessels or avail the carriage services of foreign shipping companies for transportation and other business activities. The amount paid to these foreign shipping companies may be taxed in India if the income accrues or is received in India.

In this article, the author has discussed the nature of income of foreign shipping companies arising from a number of transactions such as operation of ships for carriage of passengers, live-stock, mail or goods; leasing of ship; operation of special vessels, and the issues arising in the taxation of such income in India.

Income from operation of ships:

The term 'operation of ships' is generally understood to mean operation of ship for carriage of passengers, livestock, mail or goods. The foreign shipping company involved in the business of carriage may earn freight on account of carriage of goods shipped at any port in India; and/or carriage of goods shipped at any port outside India.

The Income-tax Act, 1961 ("domestic law") seeks to tax the freight earned on account of carriage of passengers, live-stock, mail or goods shipped at any Indian port as also any port outside India; whereas the treaties provide exclusive right of taxation to the country of residence or place of effective management of the foreign shipping co, if the carriage of passengers, live-stock, mail or goods is not confined to Indian territory/waters.

This part of the article discusses the taxability of the income from the operation of ships under the domestic law as well as treaty.

a) Income from operation of ships under the domestic law:

The income of a foreign shipping company which is received or is deemed to be received in India; or accrues or arises or is deemed to accrue or arise in India is taxable in India as per section 4 and 5 of the domestic law.

The domestic law further provides for certain special provisions i.e. section 44B and section 172 for taxation of income of foreign shipping companies on account of carriage of passengers, live-stock, mails or goods. Section 172 is a self-contained code and applies in a case where a foreign company has earned income form carriage of passengers, livestock, mail or goods shipped at a port in India. The provision deems 7.5% of the amount paid to the foreign company, whether in or outside India, as its income from such carriage.

Further, in terms of section 44B of the IT Act, the profits and gains of the foreign company from the business of operation of

[1] The Review of Maritime Transport 2019, UNCTAD.

ships will be taken at an amount equal to 7.5% of the amount paid or payable to the foreign shipping co, on account of the carriage of passengers, live-stock, mails or goods shipped at any Indian port as also of the amount received or deemed to be received in India on account of the carriage of passengers, live-stock, mail or goods shipped at any port outside India.

Section 172 is applicable only when the shipment happens at a port in India and section 44B is applicable when shipment happens at a port in India or outside India (if amount is received or deemed to be received in India). The quantum of income determined as per these provisions (i.e. 7.5% of the freight) shall be taxed at the applicable tax rate i.e. 40%[2] in case of a foreign company.

b) Income from operation of ships under Treaty

(i). Operation of ships in international traffic:

The income earned by foreign shipping companies by operation of ships in international traffic cannot be taxed in India if the ship was operated in international traffic. It is the country of residence of the foreign shipping company or the country where the foreign shipping company has its place of effective management, which will have a right to tax such income.

The meaning of the term 'international traffic' is generally defined as 'transport by a ship operated by an enterprise of a Contracting State/which has its place of effective management in a Contracting State, except when the ship or aircraft is operated solely between places within the other Contracting State'. Therefore, if the operation of the ship is not restricted solely to the places within India, the condition of international traffic will be satisfied.

(ii). Income from operation of ship in Indian waters

A foreign shipping company may be engaged in the carriage of passengers, livestock, mail or goods in the Indian waters only. In such cases, the ship will not operate in international traffic and therefore, the relevant article of Treaty relating to shipping income will not provide any relief to the foreign company. However, the activity of carriage being the business of the foreign shipping company, the profits will be considered as business profits and will be taxable in India only if there is a permanent establishment in India and the income can be attributed to such permanent establishment.

In such cases as well, the question will arise whether the vessel itself can be said to be a permanent establishment of the foreign company. The detailed analysis as to whether a vessel can constitute a permanent establishment has been made in part IV (Income from vessels having certain specific uses) of this article.

Income from leasing of ships or vessels:

A foreign company may provide ships or vessels on lease; the nature of lease may be a full charter i.e. charter fully equipped, manned

[2] Plus applicable surcharge and cess.

and supplied ("time charter" or "voyage charter") or a bare boat charter. In such cases, the question of determination of nature of income and the consequent taxation may arise.

a) Income from time charter or voyage charter where the lessee operates in international traffic:

The income of a foreign shipping company from time charter or voyage charter of a ship is considered as income from operation of ship in international traffic and covered under article relating to shipping income under Treaty if the ship is used by the lessee in international traffic. Thus, if an Indian lessee company/another foreign lessee company takes a ship on time charter or voyage charter and operates it international traffic, the income of the foreign lessor company will not be taxable in India. In cases of time charter or voyage charter, the condition of operation of the ship in international traffic is mandatory for it to be covered under the article relating to shipping income under Treaty.

In such cases, a question may arise as to how the condition relating to operation of vessel in international traffic has to be examined. One possible view is to go by the terms of the contract between the parties. If as per the terms of the contract, the vessel is to be used in international traffic, one can argue that the condition relating to operation of vessel in international traffic stands satisfied. However, this position is not free of ambiguities. It may so happen that even if the vessel owner has contractually agreed to use the vessel in international traffic, it may choose to operate the vessel in the Indian waters alone. Thus, it may lead to an absurd position where a vessel which is operating solely between places in India will be treated as being operated in international traffic. Also, such a conclusion may invite treaty abuse where the vessel owner may agree to operate the vessel in international traffic merely to avoid paying taxes in India. Another possible view is to look into the actual usage. However, this view will require the vessel owner to demonstrate that the use of the vessel was not restricted to places within India. According to the Author, the actual usage test is the correct approach for demonstrating that the vessel was operating in international traffic.

b) Income from bare boat charter where the lease is incidental

The income from leasing of ship on bare boat charter basis is not considered as arising directly from the operation of ship and will not be considered as income from operation of ship unless such leasing is incidental to the lessor's business of operation of ships. In such cases, the place of use of ship (i.e. international traffic or domestic water) by the lessee is irrelevant. However, the determination of nature of such lease i.e. whether incidental or not becomes significant. For determining whether a lease is incidental or not, factors such as duration, frequency and economic significance to the foreign lessor have been considered as important.

c) Income from leases not covered above

A foreign shipping company may earn income from lease of ships or vessels,

which may not be covered under above categories. Such income, for example, income from time charter or voyage charter of ship which is not operated in international traffic, will not be covered under the article relating to shipping income under Treaty. Similarly, in cases of bare boat charter, where the leasing is not incidental or casual, the income will not be covered under article relating to shipping income. In such cases, the issue of taxation of income as royalty or as business income may arise.

The provisions of section 9(1)(vi) of the domestic law classify income earned from granting use or right to use an industrial, commercial and scientific equipment as royalty. The definition to this extent is *pari-materia* to the definition of royalty in many of the tax treaties entered by India. Thus, it is worth examining if the income earned by the ship or vessel owner from such leasing transactions can be classified as royalty wherein India can claim a right to tax such income.

The question of taxability of income as royalty arose before the Madras High Court in *Poompuhar Shipping*[3] wherein the Court held that the payment under a time charter agreement and bare boat cum demise charter represented consideration for right to use an equipment (ship) and therefore, amounted to royalty under section 9(1)(vi) of the domestic law as well as Treaty. In this case, the ships were not operated by the lessees in international waters. However, in a later decision, the Income Tax Appellate Tribunal, Chennai in **Sical Logistics**[4] while dealing with the payment under time charter party held that the payment was not in nature of royalty. The Tribunal held that the essence of the agreement executed between the parties was for utilisation of the space in the vessel by the assessee and not that the assessee was authorised to operate or exercise control over the vessel. The Tribunal distinguished between 'letting the asset' and 'use of asset by the owner to provide services' and held that while in the former case the consideration paid will be royalty, in the latter case, payment relates to use of asset by its owner, the same cannot be treated as royalty. In this case as well, the ship was used in Indian waters.

Thus, in cases where the article relating to shipping income under Treaty does not apply, the taxpayer must determine whether the payment can be treated as consideration for use or right to use industrial, scientific or commercial equipment amounting to royalty.

In cases of commercial leases on bare boat charter basis (other than those covered under article relating to shipping income), the income will fall under the article relating to royalty. If the relevant treaty does not include 'income from leasing of industrial equipment' in the article relating to royalty, the income will be taxed in terms of the article relating to business profits and the income of lessor will be taxable only if it has a permanent establishment in India.

[3] *Poompuhar Shipping Corporation Ltd.* v. *ITO* [2014] 360 ITR 257 (Madras).

[4] *Sical Logistics Limited* v. *ADIT* [2017] 78 taxmann.com 158 (Chennai - Trib.)

Income from vessels having certain specific uses:

The shipping business may also involve certain special vessels which are not used for the purpose of transportation but for certain special purposes, such as tug boats, museum ships, icebreaker ships, fishing vessels (not used for transportation), floating docks, etc. The profits from operation of these vessels will not be covered under article relating to shipping income under Treaty.

In such cases, the question of determination of nature of income will arise. It may be in the nature of royalty or business profits. If it is in nature of royalty (i.e. right to use vessel is granted), most of the treaties grant right to India to tax the royalty. However, if it is in nature of business profits, it will not be taxable in India, if the foreign shipping company does not have a permanent establishment. Moreover, if income is considered as royalty and the foreign shipping company has a permanent establishment in India, the income will be taxable under the article relating to business profits under Treaty.

The permanent establishment in such cases may be any fixed place through which the foreign shipping company carries on its business. A place is fixed if there is a link between the place of business and a specific geographical point in the source state[5]. A vessel by its very nature is a mobile equipment and does not rest at a given physical location for long durations. Despite this, in certain cases it has been observed that presence of a vessel in India can constitute a permanent establishment. In *SeaBird Exploration FZ LLC*[6], the Authority for Advance Ruling held that the assessee had a fixed place Permanent Establishment in India in the form of its vessels engaged in seismic surveys in the Mumbai High area. In *Poompuhar Shipping* (Supra), the Court held that the place where the ship is docked is the place of business and the fact that the ship moved from one point to another is the result of the nature of business contract and the movement is an integrated one having business and geographical coherence.

The Author believes that the determination of permanent establishment, being a detailed factual and legal exercise, requires examination of several aspects of the transaction. In cases where the vessel is not stationary but a moving vessel, the area of operation of the vessel is also not defined or limited, the vessel is not used for any specific task, the period of operation of vessel is short, etc, the question of determination of the existence of permanent establishment becomes significant for the taxpayer.

Conclusion:

The shipping transactions are complex web of transactions involving several issues. As discussed above, the taxation of shipping income has been subject to litigation. The Author believes that for determining the nature of income/taxability, no straight jacket formula can be applied, and the taxation will depend on the nature and substance of the transactions. The Author believes that tax payers should be cautious while determining their tax liability, especially in the borderline cases as the taxability of the income in India carries involves certain obligations on the payer of income, such as deduction of tax at source and consequent penal actions.

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[5] Para 5 of Article 5 of OECD Commentary on Model Tax Convention
[6] *SeaBird Exploration FZ LLC*., In re, [2018] 403 ITR 82 (AAR – New Delhi)

Notification

Taxation Laws (Amendment) Bill, 2019

The Taxation Laws (Amendment) Bill, 2019 was introduced on 25-11-2019. Certain significant modifications have been made in the Bill as compared to the Ordinance issued in September. Reduction in corporate tax rates and special provisions for reduced rate of tax for newly established manufacturing companies were the highlights of the Ordinance. However, there was certain doubts over availability of MAT credit, meaning of manufacture, possibility of switching from option of 15% to 22% tax rate and so on.

Key changes:

- Section 115JAA will not apply in case of companies availing 22% corporate tax rate
- The reduced rate of 15% MAT will apply from Assessment Year 2021-22
- In case a company becomes disentitled for the 15% rate, on non-fulfilment of conditions of exclusively being engaged in manufacturing, use of used plant and machinery etc, it can opt for 22% rate.
- Explanation inserted stating that certain activities for instance bottling of gas, mining would not constitute manufacture and government is empowered to notify other businesses which would not qualify as manufacture or production.
- Specific provisions to tax income not incidental to or derived from manufacture at 22% where no rate is specified in the Income Tax Act.

Rules and form for deduction of tax on fee paid to professionals under Section 194M notified

By way of Notification No. 98/2019, CBDT has notified rules and Form 16D for tax deducted at source by certain individuals or HUF. Section 194M mandates that in case of payments to resident for professional services in excess of INR 50 lakhs by individuals or HUF who are not covered by the provisions of Section 194C, Section 194H or Section 194J requires deduction under the section if the monetary limits in Section 44AB is exceeded. As per new Rule 30(2C) tax is to be deducted under Section 194M and deposited within 30 days from the end of the month in which it is deducted. Rule 31(3B) prescribes that the certificate of deduction shall be furnished to the payee in Form 16D.

Ratio Decidendi

Order pertaining to buy-back taxable appealable since 'assessee denies liability to tax' under the Act - Writ cannot be entertained

The assessee was aggrieved by the decision of the Delhi High Court which declined to entertain the writ against the demand raised by the department stating that the assessee was liable to pay tax in respect of a buyback of shares. The assessee contended that since the levy under Section 115QA was a separate levy and not assessed under Section 143(3) as part of its total income, it did not have any alternate remedy. The Supreme Court however agreed with the ruling of the High Court and held that the clause 'assessee denies his liability to be assessed under the Act' appearing in Section 246A on appealable order would cover the case of the assessee where liability is denied under particular circumstances. The said clause cannot be confined to liability on total income assessed under Section 143(3). [*Genpact India P Ltd* v. *DCIT* - Civil Appeal 8945/2019, Supreme Court judgement dated 22-11-2019]

'Process' used to define royalty in India-Singapore Treaty cannot be interpreted in terms of domestic law

The revenue department contended that charges paid for provision of bandwidth services would be taxable as royalty under the India-Singapore DTAA by adopting the definition of royalty under Section 9(1)(vi). It was contended that the word process is not defined in the DTAA and in terms of Article 3(2) of the DTAA, meaning as per the domestic law-Income Tax Act, 1961 would apply. The ITAT however, held that the word royalty is defined in the treaty and the definition in the domestic law cannot be used to define a particular word. Also, the definition of the word *process* is not a standalone definition in the domestic act, and it cannot be used to interpret the DTAA. The ITAT also held that the terms 'law in force' in the DTAA cannot be read as permitting unilateral changes in domestic law to override the treaty. Thus, changes in the domestic law, even if retrospective cannot be read into the DTAA. Thus, it was held that charges paid for use of standard facility which did not involve right to use a secret process would not be taxable as royalty. [*Asst. Commissioner* v. *Reliance Jio Infocomm Ltd.* - ITA No. 6331 to 6334/Mum/2018, dated 15-11-2019, ITAT Mumbai]

Deduction of prior period expenditure is allowable in the year of crystallisation of liability

In the course of business, the assessee availed job work service from Kinetic Engineering Ltd. ('Kinetic'). The job work charges levied in earlier assessment years were disputed by the assessee and settled during the impugned Assessment Year (A.Y.) i.e. 2008-09. Pursuant to settlement, Kinetic issued credit notes in respect of reduction of job work charges. Pursuant to settlement, the assessee claimed deduction of job work charges in the return of income for A.Y. 2008-09 and no deduction was claimed in earlier assessment year. In assessment proceedings, the Ld. AO did not disallow the job work charges settled and paid to Kinetic, however, he made an addition in respect of credit note issued by Kinetic. On appeal, the CIT(A) deleted the addition on account of credit note, however enhanced the income of the assessee by disallowing the job work charges settled and paid

to Kinetic on the ground that such charges are prior period expenditure.

On further appeal, the Tribunal held that the liability to pay job work charges did not arise in the earlier assessment year when the invoice was raised by Kinetic but arose in the year under consideration when the dispute was finally settled between the parties. Following the decision in the case of *National Agriculture Co-operative Marketing Federation of India Ltd. vs. CIT* [(2011) 338 ITR 36 (Delhi High Court.)], claim of deduction of job work charges was allowed. [*Klassic Wheels Pvt. Ltd.* v. *DCIT* - ITA No. 2184/PUN/2013, dated 16-9-2019]

Interest on delayed receipt of receivables from AE is a separate international transaction - Debt free structure of AE not a defence

At issue was the addition made to the income of the assessee in terms of the determination by the Transfer Pricing Officer (TPO) that delayed receipt of consideration for the services provided by the assessee to its Associated Enterprise (AE) amounted to provision of loan and interest ought to be imputed on the same. The CIT(A) accepted the argument of the assessee that it was a debt-free company and hence no adjustment on account of interest was called for and directed the AO to verify the same. The assessee relied on the judgement of High Court of Delhi in *Bechtel India P Ltd*. [ITA No 379/2016 dt 21.7.2016]. However, the revenue authorities submitted that the said judgement had been reversed for subsequent years and that adjustment for working capital which includes interest would not adequately address the issue of interest on delayed receipt of variables. The ITAT found force in the ruling of ITAT, Mumbai where in it was stated that the working capital adjustment pertains to rendering of service whereas the debt arising in course of the business which has been specifically included in the definition of international transaction by Finance Act 2012 (w.e.f 1-4-2002) would have be benchmarked as a separate international transaction. Thus, the fact that the assessee is not paying interest is not of consequence. So long as there is a trade receivable which has been realised after the due date, the sum would partake the character of a loan and the assessee ought to receive interest from its AE. [*DCIT* v. *Verizon Data Services* - I.T.A. No. 3090/CHNY/2017, ITAT, Chennai Order dated 22.10.2019]

In absence of specific intimation to Assessing Officer with respect to change in address, notice issued to address in PAN database is valid

The return of income filed by the assessee was selected for scrutiny assessment by issuing notice under Section 143(2) of the Income Tax Act within the prescribed time-limit. The notice was issued at the asssessee's address, available in PAN database. During the assessment proceedings, the assessee objected that the original notices were not served. Further, the subsequent notices were served beyond the statutory time period. However, the AO completed the assessment under Section 143(3). On appeal, the CIT (A) quashed the assessment on the ground that the original notice was not served on the assessee and the subsequent notices were served beyond the prescribed time limit. The order of the CIT(A) was further confirmed by the Tribunal and the High Court.

On revenue's appeal, the Supreme Court held the assessment to be valid on the ground that in absence of any intimation to the AO relating to change in address, the issuance of notice at the address available as per PAN database, is justified. Further, the notice was issued within the prescribed time limit which is sufficient compliance under Section 143(2), irrespective of

service of such notice. It was held that merely mentioning the new address in the return of income without specifically intimating the AO is not sufficient. [*PR. CIT, Mumbai* v. *I-Ven Interactive Ltd.* - Civil Appeal No. 8132 of 2019, decided on 18-10-2019, Supreme Court]

Gains arising from a systematic activity carried out on a land taxable as 'business income'

The assessee was a co-owner of a non-agricultural land along with other four co-owners. The land was sold during the year and gains arising therefrom were offered to tax under the head 'Income from Capital Gain'. In assessment proceedings, the AO held that actions of the assessee involving purchase of plots of different survey numbers, adjoining to each other on different dates and clubbing/merging them in single survey number, conversion of land initially into 'non-agriculture' for residential purpose and then for small business centre purpose and finally for commercial purpose, clearly indicate that purchase and sale was purely business oriented and therefore, profits arising on sale would be taxable as 'business income'. On appeal, the CIT(A) confirmed the action of the AO.

On further appeal, the Tribunal, confirming the action of the AO, held that *firstly,* the action of the assessee of conversion of land into non-agriculture, merger of land, approval of lay out plan from competent authority for plotting then subsequently to build the residential blocks etc., conversion for commercial use, showed that the driving force for purchase of land was to exploit it commercially. Also, since the land was not subjected to wealth tax as applicable to capital assets and the systematic actions of the assessee showed that land was purchased as 'trading asset' with an intention to reap profits commercially. Thus, the actions of the assessee clearly falls within the 'adventure in the nature of trade, commerce', as defined under the definition of 'Business' under Section 2(13) of the Income Tax Act. [*Harshadkumar Amrutlal Patel* v. *DCIT* - ITA No. 361/AHD/2019 decided on 16.09.2019]

Delay in deposit of tax deducted at source is 'failure to deposit'

The petitioners were being proceeded against in their capacity of Principal Officers of the company which had deposited tax deducted at source after a delay of up to 15 months. The petitioners argued that in order to initiate prosecution as per Section 276B of the Income Tax Act, 1961, there has to be failure to deposit TDS and since the amount had been credit to the account of the government, the initiation of prosecution was not valid. The second contention was that the initiation was after a period of three years. The Court was of the opinion that late payment of TDS by the accused attracts Section 276B, and only because the accused deposited the TDS at the credit of Central Government, after the period prescribed under Rule 30, the company and the Principal Officer of the company shall not be absolved from punishment prescribed under Section 276B. [*Sowparnika Projects & Infrastructure* v. *ACIT* - Criminal Revision Petition No. 456/2019, Additional Civil and Sessions Judge, Bangalore City, Order dated 4-9-2019]

Features of electronic form of return of income cannot bar an assessee from making claims which he feels he is allowed under the Act

During the A.Y. 2019-20, the assessee had income under the head 'capital gain' and carried forward 'business losses' from previous years. It was case of the assessee that under the electronic filing of return of income, there are certain columns which are self-populated i.e. on filling of certain entries, the other entries in the return are indicated by the system itself. Due to this self-populated feature of the electronic form,

the assessee was unable to set-off the brought forward business losses against the income under the head 'capital gain' under Section 72 of the IT Act which is otherwise allowable in light of *M.K. Creations v. ITO* [(2017) 6 TMI 821] and *ITO v. Smart Sensors & Transducers Ltd.* [(2019) 104 taxmann.com 129].

On a Writ Petition, the High Court held that the self-populated feature of electronic return is not allowing the assessee to claim set-off of business losses against the capital gain income and if the same is not claimed in return of income, the assessee would not be allowed to claim it before the AO. The purpose and object and procedure of electronic filing of return of income cannot bar an assessee from making a claim under the Act which he feels he is entitled to. The allowability of such a claim can be examined by the Ld. AO. The form prescribed by the CBDT for electronic filing of return of income does not provide for the such a situation i.e. claim of set-off of business loss against the income under the head 'capital gain'. Therefore, the assessee, apart from filing electronic return of income, was allowed to file return of income in paper form which would be accepted by the AO. Further, the assessee was directed to make a representation before the CBDT. Meanwhile, the Income-tax Department was directed not to enforce any recovery proceedings based on electronic return. [*Samir Narain Bhijwani* v. *DCIT* - Writ Petition No.2825 of 2019, decided on 22.10.2019, Bombay High Court]

Funds misappropriated by former director and becoming irrecoverable, allowable as business loss

The former director of the assessee company was found to have misappropriated the funds for his various personal and non-business expenses. Later on, the director was removed. Out of total misappropriated amounts, the assessee could recover only a part amount and the balance amount was written off as irrecoverable. Such write off was claimed as deduction. Further, the assessee had also claimed the deduction of sums payable pursuant to an arbitration award.

In assessment proceedings, the AO disallowed the write off of misappropriation of funds on the ground that it is in the nature of personal expenditure. Further, the deduction of sums payable pursuant to an arbitration award was disallowed as non-business expenditure. On appeal, the CIT(A) confirmed the action of the AO.

On further appeal, as regards deduction of misappropriation of funds by ex-director, the Tribunal held that the ex-director had misused his position and incurred various expenditure from company's funds which were personal in nature. The assesee's claim of writing off the unrecovered amount proves the bonafideness in recovering part of money and writing off balance amount. The unrecovered amount is a loss incurred during the course of business and hence, is a business loss. [*Centrum Broking Ltd.* v. *DCIT* - ITA No. 4120/Mum/2018, dated 06.09.2019]

Expenditure incurred on payment of arbitral award is allowable as business loss

In a dispute involving deduction of sums payable pursuant to an arbitration award, the ITAT Mumbai has held that amount paid for arbitral award is to be allowed as business loss. The Tribunal in this regard relied on the findings of the arbitral tribunal wherein it was recorded that the dispute in arbitration had arisen in the course of business of assessee. [*Centrum Broking Ltd.* v. *DCIT* - ITA No. 4120/Mum/2018, dated 06.09.2019]

Amount received for unauthorised occupation of let out property is not taxable as rent

The assessee argued that the amount received as damages for unauthorised occupation of property let is not taxable as income from house property or other sources. The department however contended that the amount represented unrealised rent and was taxable in terms of Section 25A of the Income Tax Act. The ITAT held that the arbitral award did not partake the character of rent and it was in nature of mesne profit and hence a capital receipt. It also noted that there was no relationship of landlord and tenant between the parties. [*Talwar Bros.* v. *ITO* - 109 taxmann.com 398 (Kol.Trib)]

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