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Case Law Update

Issuance of Letter of Comfort do not constitute an international transaction - ACIT vs. Tata International Limited [ITA No. 4451/Mum/2010]

The Assessee has issued "Letter of Comfort" ('LOC') to the bankers of Associated Enterprises during FY 2004-05 (AY 2005-06). The Assessee had not reported this issuance of LOC as an international transaction. During the course of the TP assessment proceedings, the Transfer Pricing Officer ('TPO') noted this non-disclosure and alleged a commission at the rate of 1.5 percent equating LOC to guarantee, thereby proposing a TP adjustment. Commissioner of Income-tax (Appeals) ['CIT(A)'] after appreciating the contention of the Assessee concluded that Issuance of Letter of Comfort does not constitute an international transaction.

Tax Department preferred an appeal before the Hon'ble Tribunal. Hon'ble Tribunal after considering the arguments of department, the Assessee and judicial precedence observed / upheld as under:

- There is a fundamental difference between guarantee and LOC. Guarantee is a legally enforceable, however, LOC is not;
- Hon'ble Karnataka High Court in United Braveries (Holding) Ltd. vs. Karnataka State Industrial Investment and Development Corporation ((M.F.A. No. 4234 of 2007 (SFC)) held that LOC merely indicates the appellant's assurance that respondent would comply the term of financial transaction without guaranteeing performance in the event of default;
- The issuance of LOC by Assessee has no bearing on the profit, income or loss as the Assessee did not incur any cost or expenditure for issuing such LOC;
- Amendment in Explanation to Section 92B of the Act by Finance Act, effective from 01.04.2002 is to be treated as effective at the best from A.Y. 2013-14. Reliance in this regard was placed on co-ordinate bench in decision in case of SIRO Clinpharm P. Ltd. ([(2017) 88 taxmann.com 338 (Mum. Trib.)].

Accordingly, Hon'ble Tribunal concluded "Thus, in view of the aforesaid discussion, we do not find any illegality or infirmity in the order passed by ld. CIT(A)."

- APA of subsidiary company for subsequent years would have a bearing on the attribution of profits to PE for earlier years if the FAR analysis and overall functions remained unchanged - Celltick Technologies Ltd. vs. DCIT (ITA No.4167/Mum/2017)

The Assessee is a foreign company engaged in the business of developing software and marketing active content for mobile phones. The Assessee has entered into a distribution agreement with its Indian subsidiary i.e. M/s Celltick Mobile Media (India) Pvt. Ltd. wherein the amount realized by the Assessee from the customers was shared between the Assessee and its Indian subsidiary on 50:50 basis.

During the course of proceedings for AY 2014-15, the Assessing Officer ('AO') held that (a) the Indian subsidiary constituted a Dependent Agent and thus determined an income attributable to the Indian PE as "business income" of the Assessee; (b) Further, the AO was of the view that amount received by the Assessee from the provision of software solutions to the telecom operators in India was towards "royalty" as it constituted sale of copyright, and not sale of a copyrighted article. Dispute Resolution Panel ('DRP') upheld the order of the AO.

On appeal, Hon'ble Tribunal adjudicating the attribution of income to the PE in India held as under:

- When the amount remunerated by the Assessee to Indian subsidiary is found to be satisfying the arms-length principle in preceding years and there is no change in facts, no further profits could be attributed to the Assessee in India even if it was to be held that the latter had a PE in India. The Hon'ble Tribunal relies on Assessee's own case for AY 2012-13;
- Further, the Indian subsidiary has entered into an APA for AY 2015-16 to AY 2019-20 wherein, the functions of the Indian subsidiary inter-alia included "marketing and sale of various software solutions" and profit margin to be retained by Indian subsidiary was negotiated.
- Subsequent year's APA would have bearing on earlier years when the FAR analysis and overall functions of the subsidiary company had remained the same during the period covered by the APA and that for the year under consideration. Accordingly, as income disclosed by Indian subsidiary is higher than the price agreed in the APA, no further income attributable to the PE.

- Written down value cannot be a determining factor to decide arm's length price of used machineries - Panasonic Energy India Company Ltd. vs. Addl. Commissioner of Income Tax [ITA No.1892/Ahd/2014]

The Assessee company was mainly engaged in manufacturing of batteries of various types under the brand name Novino. The Assessee has sold old plant and machinery to its associate concern at INR 7.3crs whereas its written down value as per books of account was at INR 8.5 crs. The Assessee has obtained a certificate for net realizable value of the machinery from the independent valuer to substantiate arm's length price. The TPO during the course of the TP assessment proceedings however computed arm's length price of the sale of machinery on the basis of written down value of the asset without taking into consideration any other comparable to determine the uncontrolled price of the sold machine. The ld. CIT(A) dismissed the appeal of the Assessee stating that adoption of written down value by the TPO as arm's length price ('ALP') was quite reasonable.

On appeal, Hon'ble Tribunal rejecting the approach of the TPO and relying on various judicial precedence upheld the following principles:

- The written down value may be one of the factor to be taken into consideration for determining the value of the machinery. However, in view of the specific provision in Rule 10B(1)(a) of the Income-tax Rules, 1962, written down value cannot be a determining factor to decide the ALP;
- The Assessee submitted a report from approved valuer indicating fair market value of machineries. Before rejecting such valuation report, TPO was duty bound to refer valuation of machineries to DVO as per procedure laid down under statute;
- The TPO has not carried out any exercise to determine the ALP but have merely adopted WDV. Thus, the upward adjustment made by the TPO / CIT(A) is unjustified.

- Re-characterization of capital infusion into subsidiary as loan not permissible without specific finding that it was a sham transaction - M/s. Jaypee Capital Services Ltd., vs. DCIT [TS-30-ITAT-2020(DEL)-TP]

The Assessee is into the business of trading of equity, commodity and derivatives of equity and forex market. Assessee. During the year under consideration, the Assessee had made an investment in its AE – Jaypee Singapore Pte Ltd. The AE made final allotment of shares to the Assessee in subsequent year. During the course of TP assessment proceedings, the TPO treated the capital infusion (seems pending allotment) as deemed loan and imputed interest at the rate of 13.5 percent. CIT(A) upheld the adjustment.

On appeal, Hon'ble Tribunal disapproved re-characterization of investment into loan on account of the following reasoning:

- The AO /TPO has no authority to re-characterize a transaction;
- OECD Guidelines also discourage restricting of legitimate business transaction;
- The AO / TPO in his order has not come has not come up with specific finding that the transaction in question is a sham transaction;
- Further, in the absence of any specific finding by the AO that any income has arisen from international transaction, TP provisions contained in Chapter-X of the Act do not apply. Hon'ble Tribunal notes that "Section 92(1) of the act says that income arisen from international transaction is a condition precedent for application of Chapter-X of the Act."

Other Updates

- On 31 January 2020, OECD presented an outline of architecture for the unified approach and a revised programme of work

OECD issued a statement reaffirming its commitment to reach a consensus-based long-term solution to the tax challenges arising from the digitalization of the economy and stating that the Inclusive Framework will continue following a two-pillar approach in working toward an agreement by the end of 2020.

The Statement is accompanied by a revised version of the Unified Approach with respect of Pillar One which will serve as a basis for negotiation by the Inclusive Framework. Some of the important points in the revised outline of architecture pf Pillar One includes – (a) Scope: Unified Approach would not only cover highly digitalized business models but also consumer facing businesses; (b) Nexus: The new nexus rule is proposed to be based on a significant and sustained engagement with market jurisdiction measured based on but not limited to, a minimum amount of Sales Revenue; (c) Profit allocation: Proposes to apply number of thresholds and clarify a number of issues to reduce compliance and administrative burden; (d) Dispute prevention and resolution: Intends to develop new multilateral mechanism (e.g. arbitration) to prevent and resolve disputes.

The statement also takes note of a proposal to implement Pillar One on a "safe harbour" basis, as proposed in a December 2019 letter from the U.S. Treasury Secretary to the OECD Secretary-General. The package published also includes revised progress report on Pillar Two.

Finance Bill 2020 proposes to amend Safe Habour Rule ("SHR")/APA/DRP scope and specifies interest limitation carve-outs

Finance Bill 2020 proposes to amend the Section 92CB/ 92CC of the Income Tax Act to cover determination of attribution of profits to Permanent Establishment ("PE") within the scope of Safe Harbour Rules (w.e.f. AY 2020-21) and Advance Pricing Agreement ("APA") (for APA entered into on/after April 1, 2020). It is noted in the Finance Bill that "In order to provide certainty, the attribution of income in case of a non-resident person to the PE is also required to be clearly covered under the provisions of the SHR and the APA".

It further proposes to amend Section 92B to provide that interest limitation would not apply to interest paid in respect of a debt issued by a lender which is a PE of a non-resident, being a person engaged in the business of banking, in India w.e.f. AY 2021-22.

Finance Bill also proposes amending Section 144C relating to Dispute resolution Panel ("DRP") to include cases where AO proposes to make any variation which is prejudicial to the interest of the assessee within the ambit of Sec 144C and expand the scope of the said section by defining eligible assessee as a non-resident not being a company, or a foreign company w.e.f. April 1, 2020. Existing provision specifies eligible assessee to be a foreign company and any person in whose case Transfer Pricing adjustment was made.