Income-tax Controversies: A Thought Paper
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While there is no dearth of tax litigation in India, on the sidelines of the Deloitte Tax conference, we thought it is appropriate that we present our thoughts on some of the topical tax issues and controversies that keep the industry occupied.

This thought paper deals with the following subjects:
1. Intangibles and Disallowance of Advertisement Marketing Promotion (AMP) Spends.
2. India Inbound Secondment of Employees: Is it a Case of Rendering Services?
3. Digitalised Businesses: Tax Characterisation Issues
4. Intra Group Charges: Transfer Pricing Considerations
5. Restricting the transfer pricing adjustment only to the value of “international transactions”.
6. Situations in which Income Tax Appellate Tribunal (ITAT) can remand back (Sony and Kodak decisions).
7. Section 14A disallowances
8. Using MAP/APA for non-covered years
9. Profit split method – transfer pricing considerations

Each subject briefly describes the issue, the contrary views, challenges, and our thoughts on the same.

Happy reading!
Intangibles and Disallowance of Advertisement Marketing Promotion (AMP) Spends

Issue in brief
Marketing intangible is developed by marketing activities, which aids in the commercial exploitation of a product or service. Many companies in India are experiencing tax litigation in respect of expenditure incurred on advertisement marketing promotion (“AMP”). These companies are selling products under license to use the trademarks or brands of the foreign group companies, being the legal owners of such trademarks or brands.

In several cases, the Courts/Benches of the Tribunal, analysed important principles and provided guidance on the issues such as “whether the expenses are in the nature of international transaction”, “concept of economic owner”, “rejection of Bright Line Theory (“BLT”), “existence of an arrangement”, etc. The controversy continues as both revenue authorities and taxpayers (which includes distributors and/or manufacturers) have taken the matter to the Supreme Court, and is pending Court’s decision.

Contrary views
Recently, the Courts and the Benches of the Tribunal are rejecting Revenue’s contention that taxpayer’s huge AMP spend leads to brand building for Associated Enterprises (“AEs”). The judiciary is of the view that to make any adjustment on the ground that taxpayer has spent AMP, which is benefitting the brand/trademark of the AE would not be a correct approach.

Earlier, the Delhi High Court in the case of Sony Ericsson Mobile Communications India Pvt. Ltd. vs. CIT (2015) 374 ITR 118 had held in a batch of cases for distributors that AMP incurred by the Indian company is an international transaction and liable for benchmarking.

Post Sony Ericsson (supra), the Courts have held that the alleged excessive AMP spent is not an international transaction per se and not liable for benchmarking, primarily in the cases consisting of manufacturing taxpayers. In the following cases, the Court have laid down the above ratio decidendi:
- Maruti Suzuki India Ltd-[2016] 381 ITR 117 (Del)
- Baush & Lomb Eyecare India Pvt. Ltd.-[2016] 381 ITR 227 (Delhi)
- Whirlpool of India Ltd-[2016] 381 ITR 154 (Delhi)
- Honda Siel Power Product Ltd.- [2016] 283 CTR 322
- Pepsico India Holdings Pvt. Ltd.- [2018] 100 taxmann.com 159 (Delhi-Trib.)
- L.G. Electronics India Pvt. Ltd.-6253/DEL/2012
- Timex Group India Limited-845/Del./2016
- Nikon India Private Limited-6870/Del/2018

The Courts/Benches of the Tribunal have also been remanding the matter back to the file of the Assessing Officer (“AO”)/Transfer Pricing Officer (“TPO”) in the cases mostly involving distributors. This is done to redo assessment considering the recent judicial precedents, both on legal question and benchmarking. In the following cases, the issue has been remanded back:
- Rayban Sun Optics India Ltd-ITA No. 5282/Del/11
- Bose Corporation India (P) Ltd.- [2017] 80 taxmann.com 274 (Delhi-Trib.)
- Daikin-[2017]82taxmann.com150(Delhi-Trib.)
- Louis Vuitton-[2017] 186 TTJ 630 (Delhi-Trib.)
- Canon India-[2018] 97 taxmann.com 624 (Delhi-Trib.)
Historically, too, deduction of AMP expenses has been a debatable issue between taxpayers and tax authorities in India. The tax authorities used to disallow expenses on AMP on an *ad hoc* and *arbitrary* basis alleging that the same directly or indirectly benefitted the brand owner, being a group company (for a brief period law allowed disallowance of a portion of such expenditure, which was later withdrawn). All along, the judiciary disapproved the *ad hoc* approach of the revenue authority, holding that as long as the taxpayers benefit from AMP expenditure incurred by them, no adverse inference is to be drawn even if any direct or indirect benefit has accrued to the parent/ group companies owning the trademark and/or logo.

Reportedly, the revenue authorities also revived the old controversial approach of disallowing AMP expenditure under section 37(1) of the Income-tax Act, 1961 (“Act”). It alleged that the same has not been expended “wholly and exclusively” for the purposes of business and are not capital or personal in nature. Once the initial burden is take off through evidences, etc., then the onus shifts to the revenue to prove the contrary.

Adjustments under sections 92CA and 37(1) of the Act are on a different footing altogether, section 92CA relates to transfer pricing adjustment, whereas, section 37 relates to allowing revenue expenditure, other than certain restricted items. This is because, under section 92CA of the Act, the Transfer Pricing Officer (“TPO”) has to determine the arm’s length price (“ALP”) of an international transaction. In addition, under section 37(1) of the Act, the AO has to test the expenditure basis the commercial expediency, i.e., “wholly and exclusively” for the purposes of business. The Hon’ble Delhi High Court examined this distinction in the case of The Delhi High Court in the case of *Cushman and Wakefield (India) Private Limited*.

The other parameter to be met for allowance of an expenditure is “whether it is capital or personal in nature” under section 37(1) of the Act. As far as personal nature is concerned, it is observed that the revenue authorities do not question the same. In many cases, the revenue authorities have argued the expenses to be capital expenditure in nature.

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1 277 CTR 368 (Del)
India Inbound Secondment of Employees: Is it a case of rendering services?

**Issue in brief**
For many years, foreign multinational corporations operating in India through their subsidiaries or branches have been sending their employees to the Indian office/subsidiaries on a secondment role. While the secondments into India may have come down over the years, but it still continues across various sectors. The tenure of these secondments could range from short term to long term. There is a challenge that these secondments pose in most cases. It is whether the cross charges of costs related to the secondment, that the Indian office/subsidiary receives from the overseas company, is “fees for technical services” and therefore subject to a withholding tax?

**Contrary views**
The initial judicial thinking\(^2\) on this was that the foreign entities of the multinational corporations did not provide services within the secondment arrangements. The rationale was that the seconded employees work under the control and supervision of the Indian company to which they are seconded. They are “economic employees” of the Indian company, despite their “legal employment” that continues with the home countries. The commentaries issued by the Organisation for Economic Co-operation and Development (OECD) also supported this position. India is not a member of the OECD. While the United Nations (UN) commentary seems to endorse the OECD position, it does not have an independent stand on its own on this aspect. The Indian Revenue has been opposing this position. It encourages the secondment to create a service relationship between the foreign company that seconds the resources and the Indian company that hosts the seconded employees. The secondment cross charges have largely been taxed as “fees for technical services” and a withholding tax has been levied on the Indian company remitting the cross charges. In certain cases, the Indian Revenue has also alleged that the secondment creates a “service PE” (permanent establishment) of the foreign company in India.

The Indian Revenue’s position found favour with the Delhi High Court in the case of Centrica India Offshore (P.) Ltd. vs. CIT [2014] 44 taxmann. com 300. Relying on Indian Supreme Court judgment in the case of Morgan Stanley (2007) 292 ITR 416, the Delhi High Court endorsed the position that the “lien over employment” that the seconded employee has over the foreign company cannot be ignored. The Delhi High Court held that the continued lien over the foreign employment that the seconded employee has, implies that the foreign company has provided a service to the Indian company, through the secondment of its employees. Therefore, the Delhi High Court held that the cross charges to the Indian company is nothing but “fees for technical services”. The Supreme Court dismissed an appeal against the Delhi High Court’s decision summarily without giving a detailed judgment. After the Delhi High Court judgment in Centrica, Tribunals in India largely following the same to decide the issue in favour of the Revenue. The Bombay High Court in the *Marks & Spencers*

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\(^2\) DIT v. HCL Infosystems Ltd. (2005) 274 ITR 261 (Del HC), IDS Software Solutions India (P) Ltd. vs ITO (2009) 122 TTJ 0410 (Bangalore ITAT), Abbey Business Services (India) P. Ltd. vs. DCIT [2012] 23 taxmann.com 346 (Bangalore ITAT)
case upheld the proposition laid out by the Mumbai Tribunal (2014) 147 ITD 83. The proposition said that once the Indian companies have subjected the salaries of seconded employees to a salary withholding tax, the same again cannot suffer a withholding tax second time during the remittance by the Indian company to the overseas companies. While the Delhi High Court judgment was not referred to, this proposition came to be upheld. Recently, a couple of Delhi Tribunal judgments have also distinguished the Delhi High Court judgment of Centrica in a secondment context, to hold that secondments are not taxable in India. Therefore, there seems to be a judicial divergence of views that is shaping up.

The Bangalore Tribunal is likely to constitute a Special Bench\(^3\) of the Tribunal soon. This is to hear this question (i.e., whether secondment reimbursements are taxable in India) and to formulate a consistent view that the Tribunals should have.

\(^3\) In the case of IBM India Pvt Ltd

Our comments

The “lien over employment” was one of the key aspects that helped the Delhi High Court to decide the issue in favour of the Revenue. An important aspect that was perhaps missed was the fulfillment of two conditions for a Service PE by Supreme Court in the Morgan Stanley case—one, lien over employment and the second, direction and control of the seconded employees by the foreign home country. In a classic secondment case, the direction and control of the seconded employees lies with the Indian company. The Indian Provident Fund (PF) rules related to “international workers” require remittance of PF by the Indian company in relation to the seconded expatriate employees. When determining tax consequences, the legal employment status should be secondary to the economic employment status. It is hoped that the Special Bench of the Tribunal considers all these aspects in giving an authoritative judgment on the vexed issue.
Digitalised Businesses: Tax characterisation issues

Issue in brief

As businesses run in a more digitalised manner, this also gives rise to tax issues. One issue is the lack of sufficient clarity on some of these aspects of the current income-tax law; the second aspect is that the Government also seeks to garner more tax revenues from this. For example, the new Significant Economic Presence (SEP) tax that was introduced in the Finance Act, 2018.

Contrary views

Bangalore Tribunal decided on the two cases of Google4 that became headlines in the year 2017 and 2018. These cases were related to the payments made by Google India to its overseas affiliate for the purchase of advertisement space (under Google's Adwords programme) for further resale to Indian advertisers. The Revenue had raised a withholding tax demand on the said payments deeming it to be “royalty”. The company’s argument was that the payment was the “business income” of the overseas recipient Google entity and as such, in the absence of a PE in India, the same is not subject to withholding tax. Both the judgments upheld the stand of the revenue authorities that the same is royalty and as such, called for withholding tax. Appeal against the same is pending at the Karnataka High Court.

The Tribunal concluded this by its analysis of Google India’s pre-sale and post-sale services provided by a separate division (the ITES division) alongside the distribution division of ad space. It said that Google India is not a simpliciter distributor, but a distributor offering other services, during the course of which it has access to proprietary IPs of the overseas Google companies. The Tribunal also rejected the company’s reliance on other cases related to purchase of advertisement space (where payments were not held as “royalty”) – ITO v. Right Florists (P.) Ltd., [2013] 32 taxmann.com 99/143 ITD 445 (Kol.-Trib.), Pinstorm Technology Ltd. v. ITO [2012] 24 taxmann.com 345/54 SOT 78 (Mum. Trib.), and Yahoo India (P.) Ltd. v. Dy. CIT [2011] 11 taxmann.com 431/46 SOT 105 (URO) (Mum.). The Tribunal also rejected the argument that had these kind of payments been in the nature of “royalty”, there was no need to try to cover these under the Equalisation Levy, introduced from 2016.

The Government has also now introduced the SEP tax from 2018. The final rules are in the process of being framed and it will be interesting to see how these kind of payments will get characterised, once the SEP tax becomes effective, i.e., whether as royalty or under Equalisation Levy or under the proposed SEP tax.

The other area that is coming under litigation is the taxability of cloud services. Recently, the Pune Tribunal in the case of EPRSS Prepaid Recharge Services India (P) Ltd vs. ITO (2018) 100 taxmann.com 52 held that payments made by the Indian company to Amazon Web Services (AWS) USA towards web hosting charges does not constitute “royalty”. This is one of the few decisions related to web hosting charges. Other cloud service payments to foreign services providers (under various cloud services models such as SaaS, IaaS, PaaS, etc.) are bound to undergo litigation. There is not much clarity on these aspects.
With businesses getting more and more digitalised, it is important that the Government provide adequate clarity on the taxability of payments in digital way of doing business. Else, there is bound to be piling up of litigation at various levels. It is also important that the Government engage with the industry extensively, to provide comprehensive guidance on these aspects.
Intra Group Charges: Transfer Pricing Considerations

Issue in brief
The tax officers while determining arm’s length price of international transactions never leave out testing the payment for intra group services. The tax department is generally less stern in situations where the payment is for reimbursement of a specific expense, and if relevant documentary evidence is maintained regularly. However, it is stern when intra group payments are in the form of allocation of costs, with or without mark-up. It demands concrete evidence as proof for rendition of services and also a scientific benchmarking analysis. Even after providing this information they drag taxpayers in to long drawn litigations.

Tax officers disallow intra group charges on an ad-hoc basis under the garb of making transfer-pricing adjustment. Such ad-hoc adjustments need to be justified on the grounds that the taxpayer has not submitted satisfactory documentary evidences demonstrating rendition of services or that the taxpayer does not need or has not benefitted from the payments made.

Contrary views
There are various cases wherein the Tribunal has accepted the payment of intra group charges as being at arm’s length based on the Transactional Net Margin Method (“TNMM”) analysis undertaken by the taxpayer. One such case is CLSA India Pvt. Ltd. v. DCIT [2019] 101 taxmann.com 388 (Mumbai-Trib.).

However, there are also case laws that do not find merit in testing the arm’s length nature of payment based on TNMM analysis. These case laws insist on a transaction-by-transaction basis of benchmarking, but do not provide any concrete manner to achieve this. Delhi High Court case of CIT v. Cushman and Wakefield (India) (P.) Ltd. [2014] 367 ITR 730 (Delhi) is one such case.

There is also another category of case laws that have taken the most adverse position. In these cases, the Tribunal has cast complete onus on the taxpayer to prove rendition of services and demonstrate that payment adheres to the provisions of section 92C of the Act. If the taxpayer cannot come clean on any point, then the payment should be disallowed in totality. Bangalore Tribunal has taken this position in various cases, one such being Safran Engineering Services India (P.) Ltd. v. ACIT [2018] 89 taxmann.com 77 (Bengaluru – Trib.).

There are case laws that form a favourable view from taxpayers’ perspective. The view being that if the tax officer makes a transfer pricing adjustment in a manner other than by following the provisions of section 92C, such additions should be deleted and no second opportunity should be provided to the tax authorities to rectify their mistake. The Bombay High Court has affirmed this position in various cases, which are discussed by the Tribunal in CLSA India Pvt. Ltd. v. DCIT [2019] 101 taxmann.com 388 (Mumbai-Trib.).
In case the tax officer picks up this issue for audit, based on the variety of positions that have emerged from the case laws, it would be wise to be prepared from all perspectives.

It is best to collate evidences that prove rendition of intra group services on a contemporaneous basis at the time of preparing the transfer pricing study itself. When it is done at that time, one can interview the people who avail these services and can help collate best possible evidences to prove rendition. When collation exercise takes place only at the time of transfer pricing audit, the quality and the quantity of evidence suffers.

It is important to benchmark the transaction based on at least two approaches, say overall TNMM taking service recipient as the tested party and TNMM taking service providers (overseas entity) as tested party.

While justifying arm’s length nature of the international transaction based on overseas entity as tested party, if an agreed procedures report is obtained, it can be of immense help in defending the benchmarking approach as it provides an expert’s view on the issue.

Strong documentation would prove that the taxpayer has discharged its onus of benchmarking the transaction as per provisions of section 92C. This would put the ball in the tax department’s court to dispute the payment of intra group services based on the parameters prescribed in section 92C. This is hardly done by the tax department as they make the transfer pricing adjustments only by challenging need, rendition, and benefit. Once the tax department is not able to dispute the benchmarking of the transaction as per provisions of section 92C, it paves way for direct deletion of the addition made by them.
Restricting the transfer pricing adjustment only to the value of “international transactions”

Issue in brief
Chapter X of the Income-tax Act, 1961 (“the Act”) deals with the computation of income from international transactions with Associated Enterprises (“AEs”) having regard to Arm’s Length Price (“ALP”).

However, there is no specific provision under the Act that deals with the mechanism to compute a Transfer Pricing adjustment, if any, arising on account of the difference in the transaction value and the ALP determined. This has been a major source of dispute between the tax authorities and the taxpayers.

To elucidate, a taxpayer provides services to both AEs and non-AEs or makes payment of costs to both AEs and non-AEs. This leads to computation of margins of the taxpayer at an entity level.

On the basis of the benchmarking carried out, if the tax authorities reach a conclusion that the margins earned by the taxpayer are less than the margins of the comparable company(ies), then an adjustment is made to the profits of the taxpayer that are worked out on a whole entity basis. This happens in a situation where the taxpayer has not maintained or is not able to maintain or has not been able to justify the segmental data clearly working out profits/margins on the AE and non-AE transactions.

As a result, the revenue authorities make a transfer pricing adjustment on the whole margin computation of the taxpayer, thereby making an adjustment even on income/costs vis-à-vis unrelated parties. This clearly is never the intent of transfer pricing legislation across the globe, including India.

Such action of the tax authorities was challenged in appeal and a decision was taken by various High Court(s) across the country and also by the various benches of the Income Tax Appellate Tribunal (“ITAT”). According to this, a transfer pricing adjustment, if any can only be made vis-à-vis transactions with AEs. To give effect to this principle the theory of proportionality has been applied in absence of clearly identifiable/demarcated segmental accounts. This means that in a margin computation the short-fall in margin(s) should be applied only on the proportion of the AE transaction value to the total value of transaction(s).

Contrary views
This issue went to the Apex Court in the case of Hindustan Unilever Ltd.⁴ The Apex Court dismissed the Special Leave Petition (“SLP”) filed by the tax authorities against the Order passed by the Bombay High Court holding that the transfer pricing adjustment, if any, can be made only to the proportion of the AE transactions and no adjustment can be made to 3rd party/ non-AE transactions.

Interestingly, the revenue authorities in certain cases have also interpreted the concept of “restriction of adjustment”, to mean that the amount of transfer pricing adjustment, if any, cannot exceed the value of transaction(s) with AEs. This results in an abnormal/absurd situation, where due to the adjustment, the value of transaction with AE can also work out to NIL.

⁴ Reported in [2018] 259 Taxman 218 (SC)
With the SLP being dismissed by the Supreme Court of India, the issue seems to have been put to rest, i.e., the transfer pricing adjustment ought to be restricted to the value of international transactions. However, to avoid any dispute(s) with the tax authorities, it is advised that segmental accounts should be drawn up clearly and demarcation of the profits/ margins on transactions with AE's and non-AE's is done, thereby avoiding any sort of discussion leading to an adjustment on the non-AE transactions. Needless to say, the segmental(s) should be backed up with sound back-up documents, allocation keys, etc.
Situations in which Tax Tribunal (ITAT) can remand back (Sony and Kodak decisions)

**Issue in brief**
In many cases the Tribunal remands the matter back to the lower authorities for fresh adjudications, even in cases where the Tribunal could itself have solved the issues.

**Contrary views**
Rule 28 of the ITAT Rules, 1963 states that if the Tribunal thinks that the case should be remanded, it may remand it to the authority from whose order the appeal has been preferred or to the Assessing Officer, with directions that the Tribunal thinks fit.

One view is that by restoring back to the lower authorities, no harm is done to both parties, and hence Tribunal in its judicial wisdom can do whatever it requires.

Other view is that Tribunal should itself look deeper into the issue and decide rather that remanding it back to the lower authorities.

The Supreme Court in case of Hukumchand Mills Ltd. vs. CIT (1967) 63 ITR 232 (SC) held that the words “pass such orders as the Tribunal thinks fit” include all the powers (except possibly the power of enhancement), which are conferred upon by the Act. The Tribunal has the authority to direct the lower authorities to hold further enquiry and dispose of the case on the basis of such enquiry, under this section.

The Mysore High Court\(^5\) observed that the power of remand should be used sparingly. The power should be used only in cases where the Tribunal takes the view that it cannot justify the appeal without further evidence or without a clearer finding by the authority from whose order appeal has been presented. This should be done only after examination of the material already placed on record by way of evidence.

“The power of remand is to be exercised judicially. The exact nature of the remand order to be passed in a given case is a matter within the absolute discretion of the Tribunal but the power being judicial must be exercised judiciously according to rule and not humours, must be legal and regular, disciplined as opposed to capricious.” - Jeypore Timber and Veneer Mills (P) Ltd. vs. CIT (1982) 137 ITR 415 (Gauhati)

In United Commercial Bank vs. CIT (1982) 137 ITR 434 (Cal.) (HC) the court observed that while the Tribunal’s power of remanding an appropriate case to investigate fresh facts cannot be disputed, the power must be exercised with proper discretion. It should not be exercised if all the basic facts required for disposal of the matter are already on record and appear from the order of the ITO and the AAC/CIT (A). If on these facts found by the ITO and the AAC, the conclusion for which the Revenue authority was contending before the Tribunal cannot be accepted, then in such circumstances, there cannot be any question of remand. A similar view has been taken in Raja Vikramaditya Singh (Decd) vs. CIT (1988) 169 ITR 55 (M.P.). Also, see Coca Cola India (P) Ltd. Vs ITAT (2007) 290 ITR 464 (Bom).

Though the Tribunal has the power to remand the case, it needs to be exercised judicially. It should not be exercised if all the basic facts required

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\(^5\) Pathikonda Balasubbu Setty vs. CIT (1967) 65 ITR 252 (Mys)
for disposal of the matter are already on record and appear from the orders of lower authorities. It should be exercised only when the Tribunal finds that the order of lower authorities was based on insufficient materials or that some new evidence has to be considered and not otherwise, as it would lead to refusal or evasion of jurisdiction. Recently, the Bombay High Court in case of Sony Pictures Networks India Pvt. Ltd. vs ITAT, WP 3508 of 2018 observed that by not dealing with an issue, which is otherwise ripe for consideration and instead remanding to lower authorities, the Tribunal ensured further litigation and continued uncertainty for both the Revenue authority and the assessee.

At times, Tribunal may realise that there is an underassessment or the lower authorities have not done the assessment correctly. But that does not give Tribunal a power to restore back to lower authorities to rectify their mistakes. The Supreme Court in Mcrop has clearly mentioned that once benefit is granted the Tribunal cannot take it back. The Tribunal does not have power to enhance and should not remand the matter, rather decide the issue itself.

The Madras High Court in case of V. Ramaswamy Iyengar vs. CIT (1960) 40 ITR 377 (Mad) held that under Rule 28, the power of remand is only incidental to its power to hear and dispose of the appeal. However, the power of remand cannot exceed the jurisdiction under section 254(1). Hence, Tribunal cannot exercise the power of remand enhancing the tax.

In Kodak India (P) Ltd. vs ACIT (2013) 37 taxmann.com 233, the TPO held that methods as prescribed by the legislature are mandatory. The Tribunal held that the mandatory provisions are either superseded or ignored and thus, it effects the jurisdiction. The Tribunal held that the TPO has not adhered to prescribed methods, and hence another innings to rectify its mistake cannot be allowed. Bombay High Court has further confirmed this decision.

Our comments

There is a thin line in exercising a power or exercising a duty, and Tribunal should not abdicate its duty by remanding the issues back to lower authorities in situations that do not require so.
Section 14A disallowances

Issue #1: Rule 8D is not automatic and recording of objective satisfaction and finding incurrence of expenditure is necessary

Section 14A (2) of the Act mandates the Assessing Officer (“AO”) to make a determination under the Rules only in a specific situation. This situation is when the AO, having regard to the accounts of the assessee, comes to a conclusion that he is not satisfied with the correctness of the claim of the assessee in respect of expenditure incurred in relation to income not forming part of total income. The satisfaction envisaged under section 14A (2) is an objective satisfaction that has to be achieved by the AO having regard to the accounts of the assessee.

The Apex Court in the case of Maxopp Investment Ltd. v. CIT (402 ITR 640) has held that the AO needs to record satisfaction that having regard to the kind of the assessee, the suo moto disallowance under Section 14A was not correct. It further held that where the AO does not accept the apportionment done by the assessee in his return, he will have to record his satisfaction. The Bombay High Court in the case of Godrej & Boyce Mfg. Co. Ltd. v. DCIT (328 ITR 81) has held that satisfaction of the AO must be arrived at on an objective basis and the AO must consider the working of expenses made by the assessee and when he is not satisfied with the said working and terms it as incorrect, he can then proceed to work out the disallowance under Section 14A as per Rule 8D of the Rules. Further, broad/general reasons given by the AO for allocating expenses attributable to earning tax-free income, that are not with reference to assessee’s facts will constitute a failure by the AO to record his objective satisfaction held by the Delhi High Court in the case of H.T. Media Ltd v. PCIT (399 ITR 576).

Our comments

In view of the decision of the Supreme Court and High Courts, one can take a position that in those cases where the assessee is making a suo moto disallowance under section 14A of the Act in the return, the working/computation of such disallowance must be furnished to the AO. In the event of non-furnishing of these details to the AO, the assessee may not be able to successfully press this ground of objective satisfaction before higher authorities as no details were provided to the AO to enable him to record his non-satisfaction. Disallowances made on general and vague reasoning without reference to facts of assessee’s case can be struck down based on above rulings.
Income-tax Controversies: A Thought Paper
Issue #2: No disallowance of interest where sufficient own funds & non-interest bearing funds are available – Investments made from own funds. Interest attributable to borrowings relatable to taxable income to be excluded

The Bombay High Court in the case of CIT v. Reliance Utilities & Power Ltd. (313 ITR 340) has held that if there are interest free funds available to an assessee sufficient to meet its investments and at the same time the assessee has raised a loan, it can be presumed that the investments were from interest free funds available with it. This principle was again upheld in CIT v. HDFC Bank Ltd 366 ITR 505) which held that disallowance is not warranted if assessee’s own funds and non-interest bearing funds were more than the investments in tax free securities. This decision was subsequently approved by the Bombay High Court in HDFC Bank Ltd v. DCIT (383 ITR 529). The Gujarat High Court in the case of PCIT v. Sintex Industries Ltd (82 taxmann.com 171) held that if the assessee had its own surplus fund against which small investments were made, disallowance of interest and administrative expenses under section 14A was not warranted. The Special Leave Petition filed by the revenue authorities before the Apex Court was also dismissed (Refer 93 taxmann.com 24).

Further, Rule 8D (2)(i) provides for disallowance of expenditure directly relating to tax free income. Though not specifically stated, as a corollary it can be submitted that interest and other expenditure that is directly relatable to earning of taxable income should not be considered for disallowance. Hence interest on loans obtained for specified purposes viz. projects, Capex, working capital etc. ought to be excluded from the amount of interest considered for disallowance. This has been decided by the ITAT Mumbai in Yatish Trading Co P Ltd v ACIT (129 ITD 237)

Issue #3: Net interest to be considered for disallowance under rule 8D

Prior to the amendment of Rule 8D with effect from 2 June 2016, the expression used by the legislature under Rule 8D (2)(ii) is “the amount of expenditure by way of interest” based on the proportion of interest to the ratio of average investments to total assets. One may contend that interest applies only on the net interest income. Where the appellant has net positive interest income (interest income exceeds interest expenditure), no disallowance under rule 8D2(ii) should be made as held by the Gujarat High Court in the case of Nirma Credit & Capital (P) Ltd. (85 taxmann.com 72). This view has been followed by the Tribunal in several of its decisions.

Assessee may not need to provide a one-to-one nexus between borrowings and investments made from such borrowings (as per bank accounts) if the above requirements are satisfied and their own funds exceed investments in tax free securities.

One may also identify borrowings for specific purposes and exclude the interest component thereon for computing disallowance under Rule 8D(2)(ii).
Issue #4: Investments from which no exempt income has been earned should be excluded while computing disallowance as per Rule 8D / Growth funds to be excluded for the purpose of computing disallowance under Rule 8D

Prior to the amendment of Rule 8D with effect from 2 June 2016, under Rule 8D (2)(ii) of the Rules, the expression used by the legislature was “the average value of investments, income from which does not form part of total income.....” Similar wordings have been used in Rule 8D (2)(iii). Therefore for computing the disallowance under Rule 8D (2)(ii) & (iii) the assessee may contend to include only those investments which have actually yielded tax-free income during the year.

Though there have been contrary decisions, the controversy on this aspect was settled by the Special Bench of the Delhi Tribunal in the case of ACIT v. Vireet Investment (P) Ltd (165 ITD 27) which held that only those investments are to be considered for computing average value of investments which yielded exempt income during the year.

Growth funds do not yield any exempt income and the same should therefore be excluded while arriving at the average value of investment for the purpose of Rule 8D (2)(ii) and (iii). There are various Tribunal decisions supporting this view viz., Everest Kanto Cylinder Ltd v. ACIT (167 TTJ 204), Manugraph India Ltd v. DCIT (43 CCH 348), Savita Oil Technologies Ltd v. DCIT (ITA No. 155/Mum/2014) and IDFC Securities Ltd. v. DCIT (ITA No. 7274/ Mum/2016).

Issue #5: No disallowance can be made if no exempt income earned /Disallowance cannot exceed exempt income of the relevant year

The mandate of section 14A is clear. It desires to curb the practice to claim deduction of expenses incurred in relation to exempt income. It clearly relates to the earning of actual income and not notional or anticipated income. Therefore no disallowance can be made under section 14A where the assessee has not earned any exempt income during the year. However, CBDT Circular No. 5/2014 dated 11 February...
2014 stated that the disallowance under sec. 14A is warranted even when the assessee in a particular year has not earned any exempt income.

The controversy on this aspect was settled by the Delhi High Court in the case of Cheminvest Ltd v. CIT (378 ITT 33) which had overruled the Special Bench decision of the Tribunal in the case of Cheminvest Ltd v. ITO (121 ITD 318). Further, the Delhi High Court in the case of PCIT v. IL & FS Energy Development Co Ltd (399 ITR 483) held that CBDT Circular 5/2014 cannot override the express provisions of section 14A read with Rule 8D.

The Madras High Court in the case of CIT v. Chettinad Logistics (P) Ltd (80 taxmann.com 221) also held that Section 14A cannot be invoked where no exempt income was earned by assessee in relevant assessment year. The Special Leave Petition filed by the department before the Apex Court against this decision is also dismissed by the Apex Court (refer 95 taxmann.com 250).

The amount of disallowance computed under Rule 8D cannot exceed the exempt income earned during the year, as held by the Delhi High Court in the case of PCIT v. Caraf Builders & Constructions (P) Ltd (101 taxmann.com 167) and Joint Investments (P) Ltd v. CIT (372 ITR 694).

Our comments

An assessee can take shelter under these rulings to claim that there cannot be any disallowance of expenditure if no exempt income has been earned during the year. In any case the disallowance would be restricted to the amount of exempt income earned.
Using MAP/APA for non-covered years

**Issue in brief**

The Indian government introduced the Advance Pricing Agreement (APA) programme about six years ago with the objective to provide much needed tax certainty to multinational enterprises (MNEs) operating in India, particularly on their intra-group transactions, and in the process, adopt global best practices. Six years down the line, the programme has attracted considerable popularity with foreign investors as indicated by the fact that nearly 1,000 APA applications have been filed and close to 240 APAs signed.

Credibility of a tax administration depends to a large extent upon the efficacy of its dispute resolution mechanism. Dispute prevention has an equally important role in dispute management. In ensuring that avoidable disputes do not occur, APAs have stood out as a model for dispute prevention. Initially the APA programme did not have roll back provisions, but they were added to the programme after tax authorities realized the overall benefit. All these changes have made the APA programme very popular and successful.

Although APAs are entered into with respect to specific covered years, however, it has often been argued by the MNEs that if their functional asset and risk profile for another past year under litigation is similar to the APA covered year, then the APA should have a persuasive value. This was argued by the taxpayer in case of Ranbaxy Laboratories Limited.\(^6\)

**Contrary views**

Arm’s length price is determined during an APA process after a detailed review of the business operations and the FAR of the taxpayer and the AEs. Final price arrived is agreeable to both the taxpayers and the tax administration. Question often arises: whether this price can be used to settle the TP disputes if the FAR of the taxpayer remains same and the transactions are also the same. Different benches of the Income Tax Appellate Tribunals\(^7\) and the High Courts\(^8\) have agreed to use the APA results for the case before them. The CBDT, of late, has been restricting persuasive value of the APA, and have inserted clauses in the APA agreement that would restrict the APA outcomes. They cannot then be used to settle past litigations.

The tax authorities have been of the view that APA has been entered into between the taxpayer and CBDT and is merely a negotiated agreement and cannot be relied upon for another past year into litigation. They have also been of the view that APA cannot be applied retrospectively to any past year under litigation since that year is beyond the roll-back year of the APA.

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\(^6\) Ranbaxy Laboratories Ltd. versus ACIT, Range-15, Delhi, ITA.196/ Del/2013. (ITAT)

\(^7\) Ranbaxy Laboratories Ltd. versus ACIT, Range-15, Delhi, ITA.196/ Del/2013. (ITAT)

\(^8\) Pr. CIT, Delhi-1 versus Ameriprise India Private Ltd., ITA/206/2016. (Delhi High Court)

\(^9\) Ranbaxy Laboratories Ltd. versus ACIT, Range-15, Delhi, ITA.196/ Del/2013. (ITAT)
The Delhi ITAT in the case of Ranbaxy Laboratories Limited⁹ concluded that:

“Para 28…it is not the case of the assessee that APA should be applied for this year (AY 2008-09) but the principles laid down by the highest revenue authority should be accepted by Revenue at least for the purpose of starting the first step of comparability analysis for this year (AY 2008-09) as the nature of international transactions, FAR of the appellant and AEs respectively are similar...

Therefore, the agreement entered into by the CBDT with the assessee, which has considered all the aspects of the manner of determination of ALP which are also similar for this year (AY 2008-09), should be given highest sanctity and therefore mechanism suggests that agreement should be necessarily followed in determining ALP of the transactions for this year (AY 2008-09)”

Persuasive precedent (also persuasive authority) is precedent or other legal writing that is related to the case at hand but is not a binding precedent on the court under common law legal systems such as ours. However, persuasive authority may guide the judge in making the decision.

Similar view has been adopted by the Tribunals with respect to persuasive value of MAP resolutions in cases of Colt Technology¹⁰, Dell International Services¹¹, GKN Driveline¹², JP Morgan¹³ and Virtusa India¹⁴. Thus, one needs to take a pragmatic view on that for the overall objective of dispute management. One can understand the conflict that may be there between negotiated settlements versus strict application of law. But, since the Courts have taken a positive view, it is expected that a positive view on the matter can certainly be in order. Besides, transfer pricing cases are tax avoidance cases and not evasion cases. There is no criminal liability arising in these cases. The outcomes are civil in nature and so, flexibility can be demonstrated by the CBDT to settle these cases, and APA and MAP do provide a good basis for that.

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¹⁰ ITA No. 1853/Del/2014
¹¹ IT(TP)A No. 1302/Bang/2010
¹² ITA No. 5923/Del/2012
¹³ ITA No. 477/Mum/2013
¹⁴ ITA Nos. 267 & 269/Hyd/2011
**Profit split method – transfer pricing considerations**

**Issue in brief**

The taxpayers in India have, as a precedence, hardly adopted Profit Split Method (PSM) as a transfer pricing (TP) tool. In close to 80 per cent of cases, the Transactional Net Margin Method (TNMM) has been the most appropriate TP method.

However, in the current scenario, with greater emphasis being placed on the adoption of the BEPS regime (in Action 8-10), a shift has been witnessed and greater thrust is now being placed on value chain analysis. Due to this, there has been a spurt in adoption of PSM by multinational enterprises (MNEs) in some of their relevant cases.

Information exchange, particularly CbC reporting, has added more to that track change. Recent OECD guidelines on PSM is in line with those aspirations of the tax administrations. Even in India, we have been seeing such movements. Both in TP audits and Advance Pricing Agreements (APAs), tax authorities have started asking for contribution of overseas related parties, moving towards contribution evaluation in the value chain of MNEs. The Central Board of Direct Taxes (CBDT) has not issued any separate guidance/instruction on the subject. Therefore, the position is that all five TP methods can be used, based on their appropriateness.

Revised OECD guidance, issued in June 2018, on application of PSM is in continuation of the BEPS recommendations. OECD has prescribed two approaches for application of PSM-residual approach and contribution approach. These two approaches defined how profit could be split. In the residual approach, profit arising from controlled transactions is split between the two entities, after routine functions’ profit have been allocated. In the contribution approach, the allocation of profit between related entities is as per the contribution made by them in the value chain. The contribution is quantified based on an economic analysis. The United States of America adopts another approach, called comparable approach. This approach, is quite different from the OECD recommended approaches as it compares the operating profit or loss of relevant business activity with uncontrolled taxpayer’s operating profit or loss percentage.

BEPS had laid sufficient emphasis on delineation of each transaction in a value chain of the MNE, and allocating profit based on actual contribution, rather than contractual allocation. The PSM guidance is in line with that. Simply put, value chain analysis assesses the contribution or quantifies value addition made by each entity in an MNE structure. OECD PSM guidance does not undermine other TP methods, such as CUP, RPM, CPM and TNMM, but does bring out business situations where these TP methods do not remain reliable or appropriate.

**Contrary views**

In the Indian context, given that in more than 3 out of 4 cases, TNMM has been applied, the question that needs to be explored is whether there can be a movement towards applying PSM. The OECD is categorical about PSM not becoming the default TP method. It has drawn a boundary to state that lack of suitable comparables should not lead to a profit split.

Some characteristic situations, as mentioned above, could demand application of PSM method, given its appropriateness. TNMM has
its defined space if the functions are routine; cases like cost-plus remuneration model would fall in that category.

Questions before the CBDT and discussions among tax practitioners would thus be on when the PSM could be applied, the methods to apply the weights to analyse the contributions in a value chain of an MNE group, accounting adjustments to bring consistency among taxpayers and external comparables, etc. No doubt, approaches to be adopted would differ between countries, but what is available in the global space would be helpful. Adopting something, which is de hors of international practices, can create its own challenge given the increased global integration.

**Our comments**

India has not issued any specific guidance on PSM, whether earlier or after the OECD’s June 2018 guidance, except for what came through CBDT circular no. 14 of 2001, or in some manner circular no. 6 of 2013, on contract R&D centres. The guidance therefore has to be drawn from some judicial decisions, though they are case specific and contextual. ITAT and HC rulings have accepted15 or rejected16 PSM as the most appropriate method, depending on the nature and facts of the transaction. Key takeaways that could be drawn from these rulings are summarised below.

1. PSM would always be upheld in those cases where it is successfully demonstrated that the transactions are highly integrated and inextricably linked and the relevant entities make significant contributions.

2. Existence of unique intangible is not necessary for application of PSM.

3. PSM was upheld for benchmarking software services, logistic services and freight handling services. But in cases of agency and marketing services, PSM was rejected as the Indian entity did not carry most of the significant functions, and assumed limited risk and employed least capital.

4. Mere existence of loss will not trigger rejection of PSM. Further, once PSM is accepted, determination of split assumes importance wherein key value driver and relative contribution is relevant for splitting residual profits.

Therefore, the takeaways indicate that Indian courts have accepted PSM as the most appropriate method in limited cases involving highly integrated operations and, where both parties make unique and valuable contributions.

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15 MARUBENI INDIA PVT LTD [TS-168-HC2015(DEL)-TP]
Names of authors

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7. Section 14A disallowances – Milin Thakore, Jayesh Desai, Nyrica Trikannad
8. Using MAP/APA for non-covered years – Manoneet Dalal
9. Profit split method–transfer pricing considerations – Manoneet Dalal