NANUBHAI DESAI & CO.

March 2010

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Contents

INCOME TAX

DOMESTIC TAXATION

GENERAL

Tax Deduction at Source on payment of interest on time deposits under Section 194A of the Income Tax Act, 1961 by banks following Core-Branch Banking Solutions (CBS) software

As per provisions of section 194A of the Income Tax Act 1961, income tax has to be deducted at source at the time of credit of interest income to the account of the payee or at the time of payment thereof in cash or by issue of a cheque or draft or by any other mode, at the rates in force if such interest amount exceeds specified limit. Further, Explanation to section 194A states that "for the purpose of this section, where any income by way of interest as aforesaid is credited to any account, whether called 'Interest payable account' or 'Suspense Account' or by any other name, in the books of account of the person liable to pay such income, such crediting shall be deemed to be credit of such income to the account of the payee and the provisions of this section shall apply accordingly".

It is clarified that since no constructive credit to the depositor's / payee's account takes place while calculating interest on time deposits on daily or monthly basis in the CBS software used by banks, tax need not be deducted at source on such provisioning of interest by banks for the purposes of macro monitoring only. In such cases, tax shall be deducted at source on accrual of interest at the end of financial year or at periodic intervals as per practice of the bank or as per the depositor's / payee's requirement or on maturity or on encashment of time deposits, whichever event takes place earlier, whenever the aggregate of amounts of interest income credited or paid or likely to be credited or paid during the financial year by the banks exceeds the limits specified in section 194A.

CASE LAWS

CIT vs. Reliance Petroproducts Pvt. Ltd. (Supreme Court)

Section 271 (1) (c) penalty cannot be imposed even for making unsustainable claims

The assessee is a company and the relevant Assessment Year is 2001 - 2002. The return of income was filed declaring loss. The assessee has claimed interest

expenditure on the loans taken by it. From the loan amount, the assessee purchased some shares of an Indian company which was engaged into similar business activity that of the assessee and purchase of such shares was within the business objectives of the assessee. However, the assessee did not earn any income by way of dividend from such shares. The assessee had nevertheless claimed deduction under section 36 (1) (iii) for interest paid on loan taken for purchase of shares. In the assessment order, the assessing officer disallowed the interest expenditure under section 14A on the ground that it was incurred for earning dividend income which is exempt from tax. The assessing officer also levied penalty under section 271 (1) (c) on the ground that the claim was unsustainable. The penalty was deleted by the appellate authorities.

Decision of the Supreme Court

On appeal by the department to the Supreme Court, the court dismissed the appeal. The Supreme Court held that section 271 (1) (c) applies where the assessee "has concealed the particulars of his income or furnished inaccurate particulars of such income". It was held that the present case of the assessee is not a case of concealment of the income. As regard to the furnishing of inaccurate particulars, no information given in the return of income was found to be incorrect or inaccurate. The words "inaccurate particulars" mean that the details supplied in the return of income are not accurate, not exact or correct, not truthful or erroneous. In the absence of a finding by the assessing officer that any details supplied by the assessee in its return of income were found to be incorrect or erroneous or false, there would be no question of inviting penalty under section 271 (1) (c). It was further held that the argument of the revenue that "submitting an incorrect claim for expenditure would amount to giving inaccurate particulars of such income" is not correct. The Supreme Court held that mere making of the claim, which is not sustainable in law, by itself, will not amount to furnishing inaccurate particulars regarding the income of the assessee.

Pik Pen Pvt Ltd vs. ITO (ITAT Mumbai)

Delayed payment of employees' PF contribution allowable under section 43B

The assessee paid the employees' contribution to PF and ESIC after the grace period but before the due date for filing the return of income. The assessing officer made the disallowance under section 36(1)(va) as he was of the opinion that the Employees Contribution to PF/ESIC, even if made before filing of the return of income, is not covered under section 43B. This disallowance was confirmed by the CIT (A).

Decision of Mumbai Tribunal

The Tribunal held that the contribution payable by the employer to the PF / Superannuation Fund or any other Fund of welfare of the employees was allowable if paid before the due date of filing the return of income. Consequently, the issue is covered in favour of the assessee by the decision of Hon'ble Supreme Court in the case of Alom Extrusion Ltd. Accordingly the addition made by the assessing officer has been deleted.

CIT vs. Lokmat Newspapers Pvt Ltd (Bombay High Court)

Speculation loss can be set off against delivery based profits

During the course of assessment year 2003-2004, the assessee declared profit of Rs. 28,37,382/- on the sale of shares and securities held as stock-in-trade. The profit was offered by the assessee as a profit of speculation business and was set off against a speculation loss of Rs.27,61,505/- brought forward from assessment year 1996-1997 to assessment year 1998-1999. After claiming a set off of the speculation loss, which was brought forward, the assessee declared a balance of Rs. 75,877/- as speculation income. The assessing officer did not treat the income which arose from the sale of shares as income from a speculation business on the ground that the assessee had settled its transaction of sale and purchase of shares through physical delivery. Consequently, the assessing officer denied the assessee the benefit of seeing off of the amount of unabsorbed brought forward speculation loss against the amount of profit earned by the assessee during the year from sale of shares and securities held by the assessee as stock in trade.

The CIT (Appeals) confirmed the order of the assessing officer. The Tribunal, following its judgments in the case of Samba Trading and Investment Pvt. Ltd. vs.ACIT and in the case of Sucham Finance and Investments (I) Ltd., held that the profit which has been earned from the sale of shares, fell within the purview of the explanation to Section 73 and to be set off against losses which have been brought forward.

Decision of the Bombay High Court

Aggrieved by the order of Tribunal, the department filed an appeal before the Bombay High Court. The Bombay High Court affirmed the order of Tribunal. The High Court held that the Explanation to section 73 creates a deeming fiction that where the assessee is a company and any part of its business consists of the purchase and sale of shares of other companies, the assessee is deemed to be carrying on a speculation business, to the extent to which the business consists of the purchase and sale of shares. A business postulates a systematic course of activity or dealing. However, once the requirements of the Explanation are satisfied the assessee is deemed to be carrying on a "speculation business".

It was held that the argument of the Revenue that the term "speculative transaction" in section 43(5) must be read into the provisions of section 73 and that a business which involves actual delivery of shares would not constitute a speculation business, cannot be accepted having regard to the deeming fiction created by the Explanation to section 73. There is no justification to exclude a business involving actual delivery of shares. Once an assessee is deemed to be carrying on a speculation business for the purpose of section 73, any loss computed in respect of that speculation business, can be set off only against the profits and gains of another speculation business.

INTERNATIONAL TAXATION

GENERAL

Foreign companies now need to procure PAN

The Finance Act, 2009 had introduced a new section 206AA in the Income tax Act, 1961 ("the Act") making it mandatory for payers to withhold tax at a higher rate if the payee does not provide its Permanent Account Number ("PAN").This provision would be applicable from April 1, 2010.

Implications of the provision

1. With the above amendment, in the absence of PAN, notwithstanding the fact that a lower rate is provided under the ITA or the tax treaty, tax is required to be withheld @ 20% in India. In other words, if the recipient fails to provide the PAN, the withholding tax rate, if applicable, would be higher of the following rates:
   a) Rate specified in the relevant section depending on the nature of payment;
   b) Rates in force (rate specified in the ITA or under the tax treaty);
   c) Rate of 20%.

2. The Revenue Officers are prohibited from issuing any certificate for nil withholding or lower withholding of taxes if the application filed for this purpose does not contain the PAN of the payee. The PAN of the payee must be referred in all correspondence, bills, vouchers and other documents exchanged between the parties.

3. The Central Board of Direct Taxes ("CBDT") has issued a Press Release on January 20, 2010 advising payers to intimate payees to obtain and furnish their PAN in order to avoid tax withholding at a higher rate. The CBDT has clarified that this requirement applies to non-resident payees also.

4. The requirement for PAN should be applicable only when the obligation to withhold tax arises. However, in the recent ruling by the Karnataka High Court, the High Court ruled that all payments which prima facie are in the nature of income are liable to tax withholding. Although an appeal against this Ruling has been admitted by the Supreme Court, this ruling can create additional situations where a PAN may now be required.

Supreme Court stays recovery proceedings in Samsung case

The Supreme Court ("SC") of India has, in a special leave petition filed before it, stayed recovery proceedings in relation to the Karnataka High Court's order in the case of CIT v. Samsung Electronics Co. Ltd. Brief background of this case is reproduced below.

Facts of the case:

The Applicant (Samsung Electronics Co. Ltd) is a branch of Samsung Electronics Co. Limited, Korea, engaged in the development, manufacture and export of software for use by its parent company. The Applicant developed various kinds of software for telecommunication system, for office appliances, for computer systems and for mobile devices, etc. The software developed by the Applicant is for in-house use by the parent company. The Applicant imported software products from Tektronix Inc., USA. Similarly, it imported software product (namely, Telelogic Tau TTCN Suite), which is a readily available software in the market.

Contentions of the Revenue Authority

- The Revenue argued that the buyer of shrink wrapped software (i.e. the Applicant) was obliged to withhold tax under section 195 of the Act at the time of payment to the overseas suppliers. It could not be contended that since the payment was not chargeable to tax in the hands of the overseas suppliers in India, no withholding is required under section 195. The Revenue relied upon the ratio laid down by the Supreme Court in the case of Transmission Corporation Ltd (1999 – 239 ITR 587) & held that the payers will be required to withhold taxes under section 195 unless the Income Tax Authority have specifically reduced such a withholding tax liability under section 195(2) or 195(3) of the Act.

- The payment made by the Applicant is in the nature of "software license fees". There is no transfer of the software as the same remains with the software suppliers. The payment for the right to use such software in the form of license fees falls under the definition of "royalty" in the Act and the DTAA. The Revenue further contended that the ITAT was not right in concluding that the payment was towards the purchase of goods by relying on the case of Tata Consultancy Services as that case was in the context of sales tax and not in the context of income-tax.

Contentions of the Applicant

- An obligation of withholding tax under section 195 of the Act arises only when the payments to the overseas suppliers are "chargeable to tax" in India. Therefore, for the purposes of withholding tax under section 195, the payments have to be "chargeable to tax" in accordance with the Act. In determining the chargeability to tax, as per the provisions of section 90 of the Act, if the provisions of the DTAA are more beneficial than the provisions of the Act, then the provisions of the DTAA would prevail since it is more beneficial.

- In the case of Transmission Corporation Ltd., the Supreme Court's decision does not state that even when there is no income chargeable to tax, there is an obligation to withhold tax under section 195(1) of theAct. The Applicant contended that the ratio laid down in the judgment of Transmission Corporation Ltd. could not be applied to the facts of this case as the payments in that case were prima facie chargeable to tax. Thus the Applicant further contended that the ratio laid down therein must be considered only in light of the factual background and it could not be relied on to say that even when there is no chargeability to tax there was an impending obligation to withhold tax. In fact, this judgment supports the proposition that withholding is required only when the test of chargeability to tax is passed.

Issue:

The main issue before the HC was whether the payment could be treated as "Royalty" under the ITA and whether tax was required to be deducted while remitting the payments?

Conclusion of the decision of the High Court:

- Applicant is liable for withholding tax qua payment made for purchase of software from non-residents.

- The Tribunal was incorrect in holding that since the Applicant had purchased only a right to use the copyright i.e., the software, and not the entire copyright itself, the payment cannot be treated as Royalty as per the Double Taxation Avoidance Agreement

which is beneficial to the Applicant and consequently section 9 of the Act should not be taken into consideration.

- The High Court has not answered the much debated issue of characterization of payment for the import of software.

Aggrieved by the decision of the HC, the Applicant approached the SC with a Special Leave Petition and the SC granted the stay of recovery proceedings.

CASE LAWS

In Re E*Trade Mauritius Ltd (AAR)

India-Mauritius treaty benefits cannot be denied on the ground that assessee is a subsidiary of a USA Corp

The facts before the Advanced Authority Rulings (AAR) were that the Applicant was a company incorporated in the Mauritius and had secured a Tax Residency Certificate from the income tax authorities of Mauritius. The Applicant was a subsidiary of a company incorporated in the United States of America. The Applicant held shares in an Indian company, IL&FS Investsmart Ltd. The Applicant has transferred its shares in the Indian company to another Mauritius company. Under domestic law, the gains from this transfer (gains arising through the transfer of a capital asset situated in India) would be chargeable under Section 9 of the Income Tax Act ('the Act'). In view of the fact that the Applicant had secured Tax Residency Certificate, the Applicant was qualified to take tax treaty benefit. The Applicant had, accordingly availed the benefit of Article 13(4) of the India-Mauritius treaty. The Applicant also relied upon the ratio laid down by H'ble Supreme Court in the case of Azadi Bachao Andolan, 263 ITR 706. The Applicant, therefore, concluded that it would be entitled to the benefits provided under the relevant tax treaty and gains arising from the transfer of shares would be taxable in the country of residence, namely Mauritius.

Contentions of the Revenue and the Applicant

The Revenue, however, contended before the AAR that "there is a scope and sufficient reason to infer that the capital gain from the transaction arises in the hands of the US entity which holds the Applicant company. In other words, the beneficial ownership vests with the US company which, according to the department, has played a crucial role in the entire transaction. Though the legal

ownership ostensibly resides with the Applicant, the real and beneficial owner of the capital gains is the US Company which controls the Applicant and the Applicant company is merely a façade made use of by the US holding Company to avoid capital gains tax in India."

According to the Revenue, considering that the 'real' beneficiary was the US parent of the Mauritius Applicant, the gains must be held to accrue to the US company. Under the relevant provision of the India - USA treaty, the gains would be taxable in India. Contrary to this argument, the Applicant contended that beneficial ownership is irrelevant in the context of Article 13 of the India - Mauritius treaty. Reliance was placed on the decision Azadi Bachao Andolan.

Ruling of AAR

The AAR referred to CBDT Circular No. 789 and upheld the benefits available under the tax treaty. It was held that under Article 13(4) of the tax treaty, capital gains are not liable to tax in India in the hands of Applicant. The AAR also relied on the decision of the Supreme Court of India in the case of Azadi Bachao Andolan. AAR ruled that the effect of decision of Azadi Bachao Andolan is that there is no "legal taboo" against 'treaty shopping'. AAR observed that treaty shopping and the underlying objective of tax avoidance/mitigation are not equated to a colourable device. AAR also stated that if a resident of a third country, in order to take advantage of a tax treaty, sets up a conduit entity, then the legal transactions entered into by that conduit entity cannot be declared invalid. AAR further stated that the motive behind setting up such conduit companies is not material to judge the legality or validity of the transactions. The principle that "every man is entitled to order his affairs so that the tax is less than it otherwise would be" is applicable. The AAR, while dealing with the maintainability of the application, held that there was no existing dispute with the tax authorities. It was observed by the Authority that the proceeding before the High Court has only concerned with the aspect of deposit of tax with the tax authorities. Finally, AAR stated that tax avoidance is not objectionable if it is within the framework of law and not prohibited by law.

However, AAR ruled that a transaction which is 'sham' in the sense that "the documents are not bona fide in order to intend to be acted upon, but are only used as a cloak to conceal a different transaction" stands on a different footing. AAR further stated that for an act to be a 'sham', the parties thereto must have a common intention not to create the legal rights and obligations which they give the appearance of creating.

All the relevant facts, as to the legal formalities for purchase of the shares and their subsequent transfer, had been analyzed by the AAR. It is also noted by the

AAR that the consideration for transfer of shares had been received by the Applicant. AAR ruled that it is difficult to assume that the capital gain has not arisen in the hands of the Applicant but had arisen in the hands of the USA parent company. The AAR observed that while, tax department can make enquiry with the US parent company, the scope of the enquiry should be within the confines of the legal position laid down by the Supreme Court.

Consequently, the AAR ruled that gains made by the Applicant were not chargeable to tax in India.

In Re Laird Technologies India Private Limited (AAR)

If the sum not chargeable to tax in India, then tax not required to be withheld under Section 195 of the Act while making the remittance outside India

Laird Technologies India Private Limited (Laird India or the Applicant), subsidiary of Laird Technologies, Singapore, is a group company of Laird Group Plc, UK.

The Applicant was Laird Group Plc's first manufacturing facility in India, which was located within the Nokia Special Economic zone at Sriperumbedur near Chennai. The Applicant was, inter alia, engaged in the business of designing and manufacturing antenna and battery packs for the mobile phone industry. It had business dealings with leading electronic manufacturers in India such as Nokia, Sony Ericsson, etc..

Laird Technologies Inc, USA with its headquarters in St. Louis (Laird USA), a unit of the Laird Group Plc, UK, was a globally known designer and manufacturer of Antennae, EMI, data communications, etc. Laird USA has manufacturing plants and technical support operations in the US and various other countries. Laird USA was a 'tax resident' of USA. Laird USA had negotiated an agreement and had entered into an Assignment Agreement. A Product Purchase Agreement (PPA) was executed by and between Nokia Corporation, Finland, and its affiliates on the one part and the Laird USA and its affiliates on the other part. The PPA, inter alia, covers the supply of products in relation to Nokia's manufacturing requirements in India. In order to assign its rights and obligations under the PPA in connection with the supplies of its products to Nokia India Pvt. Ltd. (Nokia India) for a period of 5 years, in favour of the Applicant, Laird USA entered into an Assignment Agreement ("the Agreement") with the Applicant.

Under the Agreement, Laird USA irrevocably assigned all its beneficial rights, title, interest, obligations and duties in connection with supply to Nokia India

under the PPA in favour of the Applicant. As per the Agreement, the Applicant would act in an independent status and supply the products to Nokia India at its own risk and obligations. The consideration of USD 5.3 million payable by the Applicant to Laird USA shall be paid within 30 days of from the invoice date outside India.

Issues raised before the Authority for Advance Rulings (AAR):

Whether the amount receivable by Laird USA as per the Assignment Agreement is taxable in India having regard to the provisions of the Income tax Act ("Act") and the Double Taxation Avoidance Agreement between India and USA ("DTAA")?

If the answer to above question is in the affirmative, then, to what extent and in which year(s) would the receipt be taxable in the hands of Laird USA in India having regard to the provisions of the Act and DTAA?

If the answer to above question is negative, i.e., the amount receivable by Laird USA is not taxable in India, then, whether the Applicant is required to withhold tax under section 195 of the Act while making remittance to Laird USA?

Contention of the Applicant:

Laird India, filed an application before AAR, stating that the consideration under the Agreement would be received by Laird USA outside India and the PPA and the Agreement have been executed outside India. Since the capital asset that inheres in PPA is located and transferred outside India, Laird USA does not trigger a business connection in India, under section 9(1)(i) of the Income-tax Act or `Permanent Establishment' (PE) in India within the definition of Article 5 of India-USA DTAA, there is no taxable income either on accrual or receipt basis in India, under the Act or under Article 7 of the DTAA. The payments to Laird USA being not chargeable to tax in India, the Applicant is not required to withhold any tax under section 195 of the Act.

Even if the consideration received by Laird USA under the Agreement is construed as business profits, it would not be taxable in the absence of Laird USA having a business connection or a permanent establishment in India as per the provisions of the Act and the DTAA, respectively. The Applicant is not acting as an agent of Laird USA in any capacity and the Applicant would supply the products to Nokia India on a principal to principal basis and not on behalf of Laird USA.

Ruling of AAR

AAR ruled that the amount of consideration received for assignment of contractual rights by Laird USA from the Laird India is in the nature of business profit that has accrued or arisen in India. However, as the Laird USA has no PE in India, the same is not liable to be taxed under the Act, having regard to Article 7(2) of the DTAA. Further, it also ruled that in the absence of a permanent establishment for the US company, Laird India was also not required to withhold tax under Section 195 of the Act while making the remittance of the fees.

In Re Royal Bank of Canada (AAR)

FIIs not taxable in absence of permanent establishment

Facts of the case

The Royal Bank of Canada (the "Applicant"), registered as an FII with the Securities and Exchange Board of India ("SEBI"), undertakes trading in the derivatives segment of the Indian stock exchanges and intends to trade in equity instruments in near future. The Applicant approached the Authority to ascertain its tax liability with respect to the income earned from the derivative transactions and dealings in shares and securities undertaken in accordance with the provisions of the Income Tax Act, 1961 (the "Act") and the India-Canada Tax Treaty.

Arguments by the Applicant

The Applicant primarily contended that the derivative transactions undertaken were a part of its trading activity with no intention to hold on long term basis and thus the income from such activity was in the nature of business income; not being taxable in India on account of the Applicant not having a permanent establishment in India in accordance with Article 7 of the India-Canada Tax Treaty. The Applicant placed heavy reliance on the case of In Re, Morgan Stanley and Co. International Limited, where the Authority had upheld a similar argument in relation to derivative contracts. Similarly, the Applicant stated that the sale / purchase of shares and other securities were also for the purpose of earning trading profits.

Contentions of the revenue

The Revenue argued that as per the foreign exchange regulations and SEBI regulations, the Applicant being a FII, was only permitted to make 'investments' in capital markets and was not permitted to "trade" in shares, securities and derivative contracts. The Revenue further contended that provisions relating to taxation of FIIs under the Act (Section 115AD) did not

envisage an FII to earn any income other than capital gains on account of transfer of securities.

Ruling of AAR

The Authority undertook detailed and in-depth analysis of the exchange control and SEBI regulations with respect to the permissible activities by FIIs in India, the provisions of Section 115 AD of the Income Tax Act and the earlier rulings of AAR in this regard. They placed reliance on the ruling of AAR in the case of Morgan Stanley, where the Authority had observed that derivatives had a short life of 3 months and they do not yield any income in the nature of dividends; income can be derived only on their purchases and sales and so they are held only as stock-in-trade.

The Authority distinguished the ruling in Fidelity North Star Fund, relied upon by the Revenue, as the income therein did not relate to derivatives. However, the Authority referred to the observations in the ruling to the effect that there is no prohibition for FIIs to deal in exchange traded derivatives.

As regard to the applicability of the provisions of Section 115 AD of the Act, the Authority rejected the arguments of the Revenue and observed that Section 115AD had a wide scope of application and would include in its purview the trading income derived by FIIs from trading in exchange traded derivatives.

In Re HMS Real Estate Pvt. Ltd. (AAR)

Architectural services provided by a limited partnership is liable to tax as "fees for technical / included services" as per the provisions of India-US Double Taxation Avoidance Agreement

Facts of the case:

HMS Real Estate Pvt. Ltd. ('the Applicant) is an Indian company engaged in the business of development and management of commercial real estate. The Applicant proposed to construct an international quality commercial office/hotel complex in Gurgaon. For this purpose, the Applicant has entered into an agreement with Hellmuth, Obata + Kassabaum L.P. (HOK), a limited partnership, which is a resident of USA, for provision of Architectural Design Services.

Pursuant to the said agreement, M/s RSP Architects Planners and Engineers Pvt. Ltd. (RSP) have been appointed as an associate architect. HOK and RSP are to work jointly and on a co-operative basis in order to perform the entire design,

construction documents and construction administration for the Project. Each of them would be responsible for their share of work but jointly responsible for providing the entire design, construction documents and construction administration services necessary to complete the Project.

The scope of work under the agreement can be summarized as follows:

a) Development of program and master plan concept Design;
b) Development of Schematic design concepts;
c) Preparation of Design Development drawings;
d) Coordination and drawing review of documents;
e) Assisting the owner in bidding and contractor selection process;
f) Observing construction progress;
g) Review of cost saving and alternative proposals; and
h) Additional services as may be required.

In respect of the above items of work, HOK will be compensated a fixed fee (net of taxes). It is conceded by the Applicant that payment received for the services rendered in the third stage i.e. during the construction are liable to be taxed as 'fees for technical services' (FTS). In addition to this compensation, a further amount is payable at various stages which is by way of reimbursement of compensation payable to the consultants in USA.

The services except the construction administration, are to be performed outside India. The designs and drawings are transferred electronically to the Applicant and the ownership including the copyrights of the drawings and designs vests in the Applicant. Development of designs will be carried out by means of by-weekly tele-conferencing and video-conferencing. For the purpose of developing the designs, HOK will engage specialist consultant outside India. After the delivery of designs, the preparation of detailed construction documents will take place in India by the Indian Architects in consultation with HOK. HOK will provide advisory for preparation of construction documents. Employees of HOK have come to India for a maximum period of 50 days for providing supervisory services.

The schematic design and design development work has already been completed.

Question before the Authority for Advance Rulings (AAR):

1. Whether the compensation payable to HOK as per the terms of the can be disintegrated in three parts, viz.,
   a) for development and sale of designs;

b) consultancy for construction documents; and
c) for construction administration and additional services?

2. If the answer to the above is affirmative:-
Whether consideration payable for sale of designs is taxable under the India-USA Double Taxation Avoidance Agreement (DTAA) in view of the facts that the US entity does not have any permanent establishment (PE) in India?

3. Whether payment of fees for technical advisory services to HMS / Indian Associate Architects during the Phase-2 of the Project (Construction Document) is taxable under the Article 12(4) of the DTAA even though it is to be excluded from "included services" under Article 12(5) (a)?

4. Whether fees for supervisory/advisory services during the Construction Administration phase is taxable under Article 12(4) of the DTAA and, if so, would such fees attract tax at the rate of ten per cent as prescribed in Section 115A of the Income Tax Act (Act)?

5. Whether reimbursement of expenses actually incurred by HOK without any mark-up is subject to provisions of Section 195 of the Act?

Contentions of the Applicant:

The payments made to HOK (excepting those at the 'construction administration phase') do not fall within the definition of royalty under Article 12(3)(a) of the DTAA;

The payments also do not fall under 'fees for included (technical) services' within the meaning of Article 12(4) of the DTAA. Even if they are treated as 'business profits' accruing or arising in India, the same cannot be subjected to tax under the Act in the absence of a PE , having regard to the provision of Article 7(1) of the DTAA. As the number of days of presence of HOK employees in India will be much less than the prescribed number of days, a service PE cannot be inferred.

On termination of the agreement by the owner or on payment by owner to architect of all sums due, all drawings, specifications, models and work product prepared in connection with the project shall become the property of the owner.

Analysis and Ruling of AAR:

The Applicant's contented that on the basis of terms and conditions of the Agreement in relation to conveying the right, title and interest, which the Architect has in the drawings, specifications, models and work product (which are described as 'products of services'), the transaction has to be regarded as one of sale of designs. This contention of the Applicant has not been accepted by the AAR. The agreement shall be read as a whole. The AAR noted that the approach should be to ascertain what is the true scope and dominant object of the contract. The AAR stated that a holistic view needs to be considered in viewing the agreement without being carried away by the apparent tenor of some of the clauses of the agreement.

The AAR stated that the agreement is in reality nothing different from what is described in the opening sentence i.e. "design and consultancy services". It, further, stated that at every stage starting from the conceptual stage till construction, the Applicant looks for the services and expert advice of HOK. HOK acts in close collaboration with the Applicant, the associate Architect and the Consultant. Bi-weekly meetings through teleconferencing are regularly held. The Applicant's role in the project is all-pervasive.

It is further observed by the AAR that the Applicant does not go out of picture once the so-called sale of drawings and designs take place nor can it be said on a reasonable basis that everything else done or performed by HOK is merely incidental or subordinate to the transfer of plans, drawings and designs. The facts such as the separate specification of price for convenience of payments and adhering to schedules or that a major portion of the amount is payable at the design development stage are not conclusive.

AAR noted that having regard to the scope, objective and predominant features of the Agreement, the HOK must be said to have received payment in the nature of FTS or included services within the meaning of Article 12(4)(b) of the DTAA. AAR stated that it is significant to note that the latter part of clause (b) of para 4 deals with "development and transfer of a technical plan or technical design". On analysis of the facts, AAR stated that the limb of clause (b) is squarely attracted to the present case because technical services rendered by HOK resulted in the development and transfer of technical plan and design to the Applicant. In this connection, AAR stated that if an out-right transfer of a design or plan for consideration has to be treated as an independent transaction unrelated to the services, the scope of latter part of clause (b) will be considerably diluted and the very purpose for which the said words were included in the definition of FTS will be defeated.

Further, it is stated that the architectural services rendered by HOK can also be brought within the fold of the expression 'make available'.

Based on its analysis and facts, the AAR stated that the basic(design) services which include preparation of Master Plan, concept design, schematic design, design development and construction documents, assistance in bidding and contractors' selection process and consultancy during construction phase are all part of architectural services undertaken by HOK as per the Agreement and the payment received by HOK for furnishing all these documents and services to the Applicant fall appropriately within the meaning of 'fees for included services' under Article 12(4)(b) of the DTAA.

The AAR stated that the reliance placed by the Applicant on the decision of Davy Ashmore India Ltd. (190 ITR 626) and International Tyre Engineering Resources (319 ITR 228) are clearly distinguishable from the Applicant's case.

In connection with the payments to consultants, AAR stated that the remittances to HOK for the purpose of making payments to Consultants under the Agreement can also fall under Article 12(4) (b) as they also render architectural services. It is further stated by AAR that since HOK is not the beneficiary of the said payments and the same are to be passed on to the consultant in USA for the services rendered outside India such payments will not attract tax liability under the Act in India. But, it is made clear that the actual payments made to the Consultant can be verified by the Revenue and, if any, adverse material comes to light, appropriate steps according to law can be taken. Thus, AAR stated that the receipts by HOK on account of consultancy fee payable to the Consultant on actual basis will not give rise to taxable income in India and therefore, withholding of tax under Section 195 is not necessary.

As regard to the payment of fees for technical advisory services at the construction documents stage, it cannot be considered as ancillary and subsidiary to the sale of property and therefore, does not get excluded from Para 4 of Article 12 by virtue of clause (a) of Article 12 (5) of the DTAA.

For the applicable rate of taxes, the AAR stated that the rate of 10 per cent as per Section 115A(1)(b)/(BB) is applicable in regard to the taxation of income arising from fees for technical/included services as the said rate is less than the rate specified in the DTAA.

In the result, the questions are answered as follows:

The Agreement is to be viewed as a whole and the three components of the contract (referred to in the question) cannot be considered in water-tight compartments.

The entire consideration receivable by HOK from the Applicant is liable to be taxed in India 'as fees for included services' as per Article 12 (4) of the Tax

Treaty. However, the amount payable as consultancy fees to the consultants in USA has to be excluded while computing the chargeable income. As regard the payment of fees for technical advisory services at the construction document stage, it cannot be considered to be ancillary and subsidiary to the sale of property and therefore, does not get excluded from para 4 of Article 12 by virtue of clause (a) of Article 12 (5) of the Treaty.

As regard payment for "additional services" to HOK, no view is expressed as the details thereof are not available.

The rate of 10 per cent as per Section 115A(1)(b)(BB) is applicable in regard to the taxation of income arising from fees for technical/included services as the said rate is less than the rate specified in the Treaty.

The payment of amounts to the Architect – HOK by way of reimbursement of expenses actually incurred by it does not constitute chargeable income and withholding tax under section 195 is not necessary.

In Re Real Resourcing Limited (AAR)

Treaty between India and United Kingdom – Indian decision on taxability of referral fees, whether virtual office a PE

Facts of the case:

M/s Real Resourcing Limited, (The Applicant) was a company incorporated in UK and was a tax resident of the UK and it was a subsidiary of S-Three Group Plc.

The Applicant intended to render the recruitment services where the Applicant would place a candidate with an Indian company and receive payment for providing such service from the Indian company; and referral services where the Applicant would refer potential Indian clients to a third party based in India for which the payment will be received by the Applicant from the third party in India.

Issue before AAR:

The issue before the AAR was, whether the payments received by the Applicant for the proposed recruitment services and referral services are liable to be taxed in India?

Contentions of the Applicant:

The Applicant that the payments received by it in respect of the services provided by it were not chargeable to tax as it has no Permanent Establishment (PE) in India. Secondly, the office of the Applicant in India is basically a virtual office, i.e. the Applicant has the use of an address and telephone number in New Delhi for the purpose of communication but it does not have actual office space in India, and therefore, it does not have any kind of physical presence in India. Further, the Applicant contended that as per the India – UK Tax Treaty, the provision relating to FTS does not apply. Therefore, when making the payments to the Applicant, the Indian clients are not obliged to withhold tax under Sec. 195 of the Income Tax Act, 1961. The Applicant placed reliance on the decision of the AAR in the case of Cushman & Wakefield (S) Pte Ltd.

Contentions of the Department:

The Tax Authorities contended that the Applicant has not furnished full facts to establish that it has no PE in India while being engaged in recruitment related activities. Further, it was observed that the Applicant has an office at New Delhi which is indicative of the presence of the PE of the Applicant in India. The tax authorities also contended that the services provided by the Applicant are in the nature of FTS as the database maintained by the Applicant for providing information of suitable candidates for recruitment is in the nature of consultancy services, and the Applicant would make available the experience and skills of the candidates who seek recruitment and, therefore, Article 13 of the India – UK Treaty applies. Further, the information downloaded from internet indicates that the Applicant has an office in New Delhi and is indicative of the presence of PE of the Applicant in India.

Ruling of AAR:

The AAR ruled that collecting data and analyzing it, and making a database for providing information on suitable candidates for recruitment, even if they are in the nature of consultancy services, cannot be considered to be ancillary and subsidiary to the application of the right or information. Therefore, Article 13(3) of the India – UK Tax Treaty does not apply. The AAR further ruled that by giving access to the database, it cannot be said that information concerning industrial, commercial or scientific experience will be transmitted by the Applicant to the recruiting agencies. It would amount to unwarranted expansion of the terms FTS and Royalties. The AAR stated that consideration for providing information concerning industrial, commercial or scientific experience, basically involves the sharing of technical know-how and experience, which is not the case here. The AAR also ruled that it would be far-fetched to suggest that the ingredient of "making available technical knowledge, experience, skill, know-how or process" is involved in this case. The AAR stated that taking steps to make available the experience and skill of candidates

available for recruitment does not at all fall within the ambit of making available the technical knowledge and experience of the service provider. The AAR further ruled that the Applicant correctly relied on the earlier decision of AAR in the case of Cushman & Wakefield (S) Pte Ltd. The AAR observed that the function of referring the potential Indian candidate to the Indian based recruitment company, without creating any commitment to recruit them, does not give rise to an inference of a PE in India. For rendering such services, a fixed place of business in India or dependent agent need not necessarily be in existence. The Delhi office of the Applicant is basically a virtual office for the purpose of communication only.

Accordingly, the AAR ruled that the receipts in the nature of referral fee from the Indian based recruitment company cannot be subjected to tax as "business profits" in the absence of a PE in India.

Van Oord ACZ India vs. CIT (Delhi High Court)

The obligation to deduct the tax at source u/s 195 (1) arises only when the payment is chargeable to tax. Karnataka High Court decision in the case of Samsung Electronic Company Ltd. distinguished.

Facts of the case:

The Applicant, a wholly owned Indian subsidiary of Van Oord ACZ Marine Contractors BV, Netherlands, was engaged in the business of dredging, contracting, reclamation and marine activities. The Applicant executed dredging contract for an Indian company. The Applicant reimbursed mobilization and demobilization cost of INR 89.2 million to its parent company for the services provided. The Applicant filed an application with the tax authority for issuing 'NIL' withholding certificate since, there was no income element in the reimbursement of expenditure. The tax authority held that the reimbursement of costs to its parent company were liable to tax in India and directed the taxpayer to deduct tax at source at 11 percent. However, the Applicant filed its return of income without deducting tax on the payments made to its parent company.

The Assessing Officer (AO) disallowed the reimbursement expenditure on the ground that the Applicant had failed to deduct tax under section 195 of the Act, while making payment to its parent company. The Commissioner of Income-tax (Appeals) upheld the disallowance made by the AO. The Income-tax Appellate Tribunal (the Tribunal) observed that under section 195 of the Act, the Applicant is under an obligation to deduct tax at source if the payments are to be made to a non-resident. It is not for the Applicant to decide the taxability of payments in the hand of the non-resident recipient. In case the Applicant feels

that no such deduction is required or deduction is required at a rate lower than the prescribed rate, he is under obligation to file an application before the AO for obtaining a certificate to this effect under section 195(2) of the Act. Accordingly, since in the present case the Applicant did not deduct tax on the payments made to its parent company, such expenditure cannot be allowed under section 40(a)(i) of the Act.

Decision of the High Court:

The High Court observed that the Supreme Court in that case of Transmission Corporation of AP 239 ITR 387, was not confronted with the situation where the amount paid to non-residents was not at all chargeable to tax in India. The Supreme Court dealt with a situation where part of the sum paid to the non-resident was chargeable. In such situation the Supreme Court opined that the tax is to be deducted on the entire amount paid and not on the "pure income profits", as it was not for the Applicant to determine as to how much of the sum paid would be taxable in the hands of the recipient. However, from certain observations of the Supreme Court in the case of Transmission Corporation of AP 239 ITR 387, it is clear that liability to deduct at source arises only when the sum paid to the non-resident is chargeable to tax. Once that is chargeable to tax, it is not for the Applicant to find out how much amount of the receipts is chargeable to tax, but it is the obligation of the Applicant to deduct the tax at source on the entire sum paid by the taxpayer to the recipient. The judgment of the Supreme Court is not to be read as a statute.

The High Court further observed that from the language of the section 195 of the Act it is clear that the obligation to deduct tax is attracted only when the payment is chargeable to tax in India. This position in law further gets strengthened from various judicial pronouncements relied by the Applicant.

As regard to the applicability of the ratio laid down in the decision of the High Court in the case of Samsung Electronics 185 Taxman 313 (Kar), the Court observed that the context was different. In that case the Applicants wanted to show that the amount paid by them was not assessable to tax in the hands of the recipient. The High Court observed that when in the assessment proceedings relating to recipient, it is opined by the income tax authorities itself that the tax is not payable at all on the amounts so received, the provision of section 195 of the Act would not be attracted. Further, as held by the Supreme Court in the case of Transmission Corporation of AP Ltd. the High Court did not agree with some of the observations made by the Karnataka High Court.

ACCOUNTS, AUDIT & INVESTMENT

IFRS convergence: Central Board of Direct Taxes to start talks with CA institute

International Financial Reporting Standards (IFRS) is certainly not off the radar of the taxman, even as the proposed Direct Taxes Code makes no mention of it.

The Central Board of Direct Taxes (CBDT) plans to intensify discussions with the Institute of Chartered Accountants of India (ICAI) to examine the direct tax issues arising out of the proposed convergence of the Indian Generally Accepted Accounting Principles (GAAP) with the IFRS.

The convergence with IFRS is expected to happen in three phases beginning April 1, 2011. It is expected to give rise to significant tax issues, in addition to accounting and other business issues.

With only a year to go before the first phase kicks-in, there are big doubts as to whether the taxman would move away from Indian GAAP (Generally Accepted Accounting Principles) to IFRS for taxation purposes.

The draft Direct Taxes Code, in the present form, is very averse to IFRS and does not recognize fair value measurements or the concept of present values for taxation purposes.

Most Indian companies moving to the IFRS platform are unlikely to get any tax benefits out of this convergence in accounting standards. This is because the taxman is unlikely to fully adopt IFRS for taxation purposes.

It could, however, benefit Indian companies with international presence or even multinationals here as they would be able to support their transfer pricing claims in a better manner through the common IFRS platform now available in many countries.

Currently, the Indian tax authorities largely go by the Indian GAAP. Another important issue is that IFRS based financial statements are consolidated financial statements and there is concept of group tax. But in India, there is no concept of group tax and the Indian Income Tax Department looks at each entity separately.

So when the first phase of IFRS convergence kicks in from April 1, 2011, subsidiaries of Indian companies that prepare accounts through IFRS may have to continue with their financial statements under Indian GAAP.

Meanwhile, the CA institute had recently set up a joint study group comprising CBDT and income tax department officials and that the discussions are expected to intensify in coming days.

Select Limited Liability Partnerships may get 49% FDI

Foreign investors may soon be able to set up Limited Liability Partnerships, or LLPs, in India, as the government is all set to allow foreign direct investment in this new form of business organization.

Initially, FDI up to 49% may be allowed in LLPs in select sectors such as manufacturing. This could help make this form of business organization more popular. So far, only 914 LLPs have been registered in the country. The current thinking within the government is to allow FDI in LLP selectively and cap it at 49% even in sectors where companies can have 100% foreign investment.

LLPs are business entities that are a hybrid between companies and partnership firms. As the name suggests, partners' liability is limited to the extent of their stake in the LLP.

Unlike private limited companies where number of shareholders is limited to 50, an LLP can have unlimited number of partners. Besides, LLPs are not burdened with cumbersome compliance such as meetings and maintenance of statutory records. The DIPP will soon call a joint meeting with other ministries, departments and regulators including the RBI to discuss the paper and finalize the foreign investment regime for LLPs.

Currently, FDI is not permitted in partnerships firms, but is allowed in companies subject to sectoral caps. In a number of manufacturing sectors 100% FDI is allowed through the automatic route.

Sole proprietorship firms can also get non-resident investment on a non-repatriable basis. Many countries allow 100% foreign investment in LLPs though they may not be allowed to undertake certain sectoral activities. The 49% cap on FDI will ensure that control in LLP rests in Indian hands.

RBI had written to the finance ministry and the DIPP that FDI should be allowed in all sectors for LLPs but capped at 49%. It had also favoured mandatory Foreign Investment Promotion Board clearance for any FDI in LLPs.

The government had notified the LLP Act on April 1, 2009. But the taxation of LLPs, which is akin to partnership firms, could be clarified only in the July budget 2009-10. The budget for 2010-11 proposes to exempt capital gains on account of transfer of assets from on conversion of a company into an LLP from tax if the total sales, turnover or gross receipts of the company does not exceed Rs 60 lakh in any three preceding years.

Institute of Chartered Accountant of India to facilitate IFRS implementation

Indian corporates should be ready to comply with International Accounting norms by April 1, 2011, to transit smoothly to the new converged standards while also giving an opportunity to understand its ramifications, both positive and negative, said president, The Institute of Chartered Accountants of India (ICAI). ICAI would act as catalyst and facilitate the implementation of IFRS as per the commitments made by the Central Government.

After deliberating on the various parameters to be applied as the criteria for selection of the companies to be brought under the ambit of IFRS converged standards, it was suggested that the implementation of the IFRS converged standards should take place in a phased manner. The entities that would be required to apply IFRS converged standards from April 1, 2011, are entities like the NSE - Nifty 50, BSE Sensex 30, all Scheduled Banks having subsidiaries, branches or other operations outside India, Insurance entities, Mutual Funds or Venture Capital Funds, as sell as the entities having a net worth in excess of Rs 1000 crore.

However, the SME sector which contributes to the Indian economy significantly would continue with the existing Indian Accounting Standards.

Institute of Chartered Accountants of India wants bar on audit firms with guilty partner

The Indian accounting sector regulator wants the government to bring in a provision to bar tainted firms from taking up any new assignments for a specific period.

The move by the Institute of Chartered Accountants of India (ICAI) is the latest in its undeclared but continuing tiff with the Big Four foreign accounting and audit firms that has escalated after the Satyam fraud. ICAI president told that

RBI, SEBI and the CAG should specify norms "barring such auditing firms for a particular time period whose partner has been found guilty in last three years."

The institute has the power to take action only against the auditor and not the firm. But the institute is of the view that any of the auditors who ceases to be a partner of the firm and has been charged under disciplinary proceedings should not be allowed to undertake fresh work and therefore impose responsibility as if their status as a partner is still continuing. The institute will also be discussing the concept of rotation of auditors in their next council meeting. Currently, only public sector banks are required to rotate auditors, appointed from among RBI-empanelled list of audit firms, but there is no compulsion on private banks and insurance companies to follow the practice.

ICAI has also requested the ministry of corporate affairs that the periodicity of rotation for an audit partner should be once in every three years, while for an audit firm it should be once every six years. At present, there is no such tab on the rotation of audit partner or audit firm under the Companies Act, 1956.

SEBI's new notifications favour small investors

From streamlining the process of declaring dividends to nudging funds to play an active role in corporate governance, Securities and Exchange Board of India (SEBI) ensures more transparency

Small investors won't have to wait forever to get their first account statement and units allotted once they have invested in a new fund offer (NFO) of a mutual fund (MF) scheme. The Securities and Exchange Board of India announced this, along with a few other key rules, in a circular issued recently. Here's what they mean for small investors.

New fund offers' duration

All NFOs, except equity-linked saving schemes, will now be open for a maximum of 15 days, down from 30 days for open-ended funds and 45 days for closed-end schemes. Once the NFO closes, fund will have to allot units and dispatch the account statements within five days, down from 30 days earlier.

ASBA for MF investors

Applications Supported by Blocked Amount (ASBA) is a payment mechanism initiated by SEBI in July 2008 for those investing in initial public offers or rights issue. Under this, the money that you set aside for your application does not leave your bank account till the shares are allotted to you. As a result, your

money keeps earning interest, though the funds are frozen and you can't use them. Also, it negates the need of a refund if shares don't get allotted to you. SEBI has now extended this facility to MF investors.

Though ASBA means little for MF investors because you always get 100% units allotted, it protects your money from market vagaries since SEBI also mandates NFOs to now invest your proceeds only after the NFO closes and allot units within five days after that. Both ASBA and the new NFO time frame will be applicable for NFOs launched after 1 July.

Corporate governance

SEBI now wants MFs to be more active in corporate governance. SEBI feels it is appropriate to allow MFs to voice their opinion as they are vehicles for small investors. SEBI has now made it mandatory for funds to disclose whether they voted for or against moves (suggested by companies in which they have invested) such as mergers, demergers, corporate governance issues, appointment and removal of directors. MFs have to disclose it on their website as well as annual report.

Pay dividends from gains

Typically, when funds pay dividends, they are supposed to pay out of their profits or realized gains. For instance, if you invest in a fund at a net asset value (NAV) of Rs12, Rs10 will go to an account called unit capital, assuming the fund's face value is Rs10. The balance of Rs2 (Rs12 less Rs10) goes into a separate account called unit premium reserve. If this Rs12 goes up to Rs13, the fund can declare a dividend of Re1—its gains.

However, SEBI noted that some fund houses were paying dividends from their unit premium reserve instead of the realized gains. Industry sources claim that some funds used to do this to attract large investors by giving them advance notice in private and then allowing them to book losses (NAV drops after dividend declaration), claim losses and set them off against other gains.

Less commission for FoFs

Life just got tougher for Fund of Funds (FoFs) that invest their entire corpus in international funds. Typically, FoFs charge a maximum of 0.75% per annum. Out of this, the MF pays agent commission and incurs costs on running the scheme and keeps what is left, which fund houses claim is a pittance. To compensate, FoFs enter into a revenue sharing agreement with international funds in which they invest. The international fund pays a small portion,

typically 50-80 basis points, to the Indian FoF, which would then retain this amount as its income.

SEBI has now put a stop to this revenue sharing agreement. Fund houses aren't too happy as they claim it would now be unprofitable to launch and manage FoFs.

Money Matters take

From streamlining the process of declaring dividends to nudging funds to play an active role in corporate governance, SEBI has done well in making MFs more transparent. Cutting down the allotment time to five days, down from 30 days, is bound to pose a challenge to MFs and it remains to be seen how they respond.

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