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INCOME TAX

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GENERAL

Applicability of provisions under Section 194J of Income Tax Act 1961 in the case of transactions by the Third Party Administrators (TPAs) with Hospitals, etc.

The Central Board of Direct Taxes ('CBDT') has issued circular no. 8 dated 24th November 2009 on Applicability of provisions under section 194J of Income Tax Act 1961 in the case of transactions by the Third Party Administrators (TPAs) with Hospitals, etc.

As per Explanation (a) to 194J "professional services" means, services rendered by a person in the course of carrying on legal, medical, engineering or architectural profession, etc.

The CBDT has issued the circular in the context of the following background:

- The services rendered by hospitals to various patients are primarily medical services and, therefore, provisions of 194J are applicable on payments made by TPAs to hospitals, etc.
- Further for invoking provisions of section 194J, there is no stipulation that the professional services have to be necessarily rendered to the person who makes payment to hospital. Therefore, TPAs who are making payment on behalf of insurance companies to hospitals for settlement of medical/insurance claims etc. under various schemes, including cashless schemes, are liable to deduct tax at source under section 194J on all such payments to hospitals, etc.
- In view of this, all such past transactions between TPAs and hospitals fall within provisions of section 194J and consequence of failure to deduct tax or after deducting tax, failure to pay on all such transactions, would make the deductor (TPAs) deemed to be an assessee in default in respect of such tax and also liable for charging of interest under section 201 (1A) and penalty under section 271C.
- A number of representations have been received by the CBDT on applicability of provisions under section 194 J of the Act on payments made by TPAs to hospitals on behalf of insurance companies for settling medical/insurance claims, etc. with the hospitals.

The CBDT has examined the number of representations made by TPAs, insurance companies and Hospitals. On its findings, the CBDT has issued the circular clarifying that

- no proceedings u/s 201 may be initiated after the expiry of six years from the end of financial year in which such payment have been made without deducting tax at source etc. by the TPAs.
- tax demand arising out of section 201 (1) in situations arising above, may not be enforced if the deductor (TPA) satisfies the officer in charge of TDS that the relevant taxes have been paid by the deductee assessee (hospitals etc.). A certificate from the auditor of the deductee assessee stating that the tax and interest due from deductee assessee has been paid for the assessment year concerned would be sufficient compliance for the above purpose. However, this will not alter the liability to charge interest under section 201 (1A) of the Income Tax Act, till payment of taxes by the deductee assessee or liability for penalty under section 271C of the Income Tax Act, as the case may be.

Dispute Resolution Panel Rules notified by Central Board of Direct Taxes

Recently, the CBDT has notified the rules to regulate the procedure of the Dispute Resolution Panel (DRP). This is a very important step in understanding how the DRP would function. One hopes that the constitution of the DRP too would be notified very soon. This will go a long way in guiding tax payers on the way forward in respect of draft orders already received in those cases where the Transfer Pricing Officers have passed orders.

The CBDT will constitute Dispute Resolution Panel (DRP) at the following places:

1. Delhi
2. Mumbai
3. Kolkata
4. Ahmedabad
5. Chennai
6. Hyderabad
7. Bangalore and
8. Pune

The CBDT has notified various key rules to regulate the procedure of the Dispute Resolution Panel. The CBDT has notified rules for Procedure for filing objections, Notice for hearing, call for records, Hearing of objections, No abatement of proceedings, Power to call for or permit additional evidence, Issue of directions, Directions to be communicated to parties, Passing of Assessment Order, Rectification of mistake or error and Appeal against Assessment Order.

CASE LAWS

1. CIT vs. Vandana Verma (Allahabad High Court)

If the search warrant is in joint names, an assessment in individual capacity is void

A search warrant under Section 132(1)(C) of the Income Tax Act, 1961 was issued duly signed by the competent authority in the joint name of Mr. Mudit Verma and Mrs. Vandana Verma to enter and search the residence. Separate warrants under Section 132(1)(C) of the Act were also issued in the name of different persons covering different premises.
During the search operation, the department has also carried out seizure operation, seizing books of accounts, documents, papers and diaries including loose papers and other material of all the entities. Subsequently, proceedings were initiated under Chapter XIV-B of the Act, which prescribes special procedure for assessment of search cases. As the instant case is of search, a notice under Section 158BC of the Act in the name of Mrs. Vandana Verma was issued for computation of undisclosed income of the block period 1.4.1995 to 17.10.2001 to which the assessee tendered her reply but the reply so tendered by the assessee did not find favour with the Assessing Authority, resulting in the computation of total income including undisclosed income at Rs.17,312,432/-.

In appeal before the CIT (A) against such assessment, the assessee raised a preliminary objection that the search warrant having been issued in the joint names of the assessee and her spouse, the assessment on the assessee in the individual capacity was invalid. The legal ground raised by the assessee did not find favour with the CIT(A) and the additions made on the basis of the documents seized from third party were not deleted by the CIT (A). However, CIT (A) deleted certain additions made for ineligible expenditure and allowed the appeal partly.

Decision of the Tribunal

Being aggrieved thereof, assessee preferred second appeal before the Tribunal, where for the first time, a preliminary objection with regard to the framing of assessment in individual capacity has been raised by the assessee as the search warrant was in joint name and this fact was not disputed by the Revenue. The said objection was upheld by the Tribunal and accordingly, appeal of the assessee was allowed on the preliminary point itself.

Decision of the Allahabad High Court

The Allahabad High Court held that the warrant of authorization must be issued individually by the Director/Commissioner at the time of issuing the same. If the same is not issued individually, then assessment cannot be made in an individual capacity as done by the Assessing Officer in the instant case. The warrant was issued jointly, as stated hereinabove, so the assessment will have to be made collectively in the name of both the persons in the status of AOP/BOI. Thus, the Tribunal has rightly held that assessment could not be framed in an individual capacity but it should be framed either as association of persons or as body of individual. However, High Court said that it will be open to the assessing authority to proceed and pass fresh assessment order in accordance with law, if so desire.

2. Liberty India vs. CIT (Supreme Court)

DEPB and Duty Drawback are not eligible for deduction u/s 80 IB

The assessee, a partnership firm, owns a small scale industrial undertaking engaged in manufacturing of fabrics out of yarns and also various textile items such as cushion covers, pillow covers etc. out of fabrics/yarn purchased from the market. The assessee claimed deduction under Section 80-IB as profit of the industrial undertaking on account of DEPB and Duty Drawback credited to the Profit & Loss account. The Assessing Officer denied deduction under Section 80-IB on the ground that the said two benefits constituted export incentives, and that it did not represent profits derived from industrial undertaking.

Aggrieved by the decision of assessing officer, the assessee carried the matter in appeal to CIT(A). CIT (A) concluded that duty drawback received by the assessee was inextricably linked to the production cost of the goods manufactured by the assessee; that, duty drawback was a trading receipt of the industrial undertaking having direct nexus with the activity of the industrial undertaking and consequently, the assessing officer was not justified in denying deduction under Section 80 IB. According to CIT(A), credit under DEPB could be utilized by the exporter himself or it could be transferred to any other party; that such transfer could be made at higher or lower value than mentioned in the Passbook and, therefore, DEPB cannot be equated with the duty drawback, hence, the appellant who had received money on sale of DEPB license, could not claim deduction under Section 80 IB.

Against the decision of CIT(A) allowing deduction on duty drawback, the revenue went in appeal to the Tribunal. The Tribunal held that the amount received by the assessee on account of duty drawback was not an income derived from the business of the industrial undertaking so as to entitle the assessee to deduction under Section 80-IB.

Aggrieved by the decision of the Tribunal, the assessee prayed to the High Court. The High Court held that the assessee had failed to prove the nexus between the receipt by way of duty drawback/DEPB benefit and the industrial undertaking, hence, the assessee was not entitled to deduction under Section 80-IB(3).

Decision of Supreme Court

The assessee preferred an appeal against the order of the High Court. The Supreme Court has rejected the plea of the assessee and held that:

- The Act broadly provides for two types of tax incentives, namely, investment linked incentives and profit linked incentives. Chapter VI-A essentially belongs to the category of "profit linked incentives"
- When Section 80-IA or Section 80-IB refer to profits derived from eligible business, it is not the ownership of that business which attracts the incentives but the generation of profits (operational profits). It is for this reason that Parliament has confined deduction to profits derived from eligible businesses.
- Each of the eligible business in sub-sections (3) to (11A) constitutes a stand-alone item in the matter of computation of profits.
- Section 80-IB allows deduction of profits and gains derived from the eligible business. The words "derived from" are narrower in connotation as compared to the words "attributable to". By using the expression "derived from", Parliament intended to cover sources not beyond the first degree.
- Though the object behind DEPB etc is to neutralize the incidence of customs duty payment on the import content of export product DEPB credit / duty drawback receipt do not come within the first degree source as the said incentives flow from Incentive Schemes enacted by the Government or from Section 75 of the Customs Act. Such incentives profits are not profits derived from the eligible business u/s 80-IB. They are 'ancillary profits' of such undertakings.

3. CIT vs. Bonanza Portfolio (Delhi High Court)

Share broker is eligible to claim "bad debts" u/s 36 (1) (vii) / 36 (2)

The assessee, being a share broker, purchased shares on behalf of its client and paid the consideration for them. The brokerage on the said transaction was offered as income and accordingly was offered to tax. The client did not pay for the shares and hence, the assessee wrote off the amount due and claimed the same as a bad debt u/s 36 (1) (vii). The Assessing Officer rejected the claim on the ground that as the said "debt" had not "been taken into account in computing the income". Therefore, the conditions of section 36 (2) (i) were not satisfied. The CIT (A) has confirmed the order of assessing officer. On appeal, the Tribunal upheld the claim on the ground that Section 36 (2) (i) required "such debt or part thereof" to be taken into account in computing the income and as the brokerage had been taken into account in computing the income and had been offered to tax, Section 36 (2) (i) was satisfied.

Decision of Delhi High Court

Aggrieved by the order of Tribunal, the Revenue preferred an appeal before the High Court. Delhi High Court has dismissed the appeal of the Revenue and held that the assessee being a broker, the fact that it paid for the shares did not make it an "investment" for the assessee. The transaction was one of brokerage on purchase / sale on behalf of the client. The money receivable from the client for the said shares was a "debt" and since it became bad, it was rightly treated as a "bad debt". Thus, the High court concluded that since the brokerage payable by the client was a part of the debt and that debt had been taken into account in computing the income, the conditions of Section 36 (2) (i) read with s. 36 (1) (viii) were satisfied and the entire bad debt was allowable as a deduction.

4. CIT vs. Hero Cycles (P & H High Court)

Even under Rule 8D of S. 14A, disallowance can be made only if there is actual nexus between tax-free income and expenditure

The assessee, being in the business of manufacturing of cycles and parts of two-wheelers in multiple units, has earned dividend income, which is exempted under Section 10 (34) and (35). The Assessing Officer made an inquiry whether any expenditure was incurred for earning this income and as a result of the said inquiry, addition was made by way of disallowance under Section 14A (3), which was partly upheld by the CIT (A).

Decision of the Tribunal

The tribunal held that there was no nexus with the expenditure incurred and the income generated. The tribunal has noted that the entire investments have been made out of the dividend proceeds, sale proceeds, debenture redemption etc. The revenue authority contended that since there is an interest expenditure incurred, it should be presumed that the interest expenditure relates to the funds invested in tax - free investments. The tribunal held that on mere presumption of the assessing officer, disallowance under section 14A is not sustainable.

Decision of Punjab & Haryana High Court

Revenue authority, being aggrieved by the Tribunal's order, had appealed to the Punjab & Haryana High Court. The Court has confirmed the decision of the Tribunal and accordingly held that even if the assessee has made investments in shares out of its own funds, the said own funds were merged with the borrowed funds in a common kitty and, therefore, disallowance u/s 14A can be made is also not justified. It is also held that since the investment in the shares made by the assessee is out of the non-interest bearing funds, disallowance u/s 14A is not sustainable. As per the provisions of the Act, disallowance u/s 14A requires a finding of incurring of expenditure.

INTERNATIONAL TAXATION

CASE LAWS

1. New Skies Satellites vs. ADIT (ITAT Delhi Special Bench)

Fee for use of satellite is "royalty" under Income Tax Act & DTAA

The assessee, a foreign company, is engaged in operating geostationary telecommunication satellites with transponder capacity, which is provided to telecasting companies in India for a fee. The assessee is a company incorporated under the laws of Netherlands and the said company is a tax resident of the Netherlands. It provides transponder's capacity (segment capacity) from the satellite operated by it in the orbit, to enable its customers for transmission of voice/data and programmes to the customers around the world under various contracts. According to this company, all the equipments i.e., satellites as well as the operating facilities (to control, monitor and operate the satellites) are owned and maintained and controlled by it from outside India.

Through transponders installed at satellite, the assessee in the present case is providing transponders capacity of data transmission to their customers, which are telecasting companies/telecom operators. In turn, the telecasting companies/telecom operators provide broadcasting/telecommunication services to their customers. The telecasting companies/telecom operators while relaying the programmes whether live or recorded to their customers uses their earth stations to uplink the data to satellite which is also received by their earth stations in the down linking process from where these telecasting companies/telecom operators provide the telecasting facilities to their customers. These telecasting companies/telecom operators have entered into an agreement with the assessee for obtaining transponder's capacity to enable themselves to up-link and downlink the programmes to be telecasted. For obtaining such transponder's capacity an agreed amount is to be paid periodically as stated in the respective agreements.

The issue arises in the present appeals is regarding taxability or otherwise of such consideration received by the satellite companies from telecasting companies/telecom operators. These receipts have been taxed by the revenue as "royalty" either under the provisions of Income-tax Act, 1961 (Act) or under the provisions of respective Double Taxation Avoidance Agreement (DTAA).

The Assessing Officer has taxed such receipts in India by taking a view that the receipts of the assessee are in the nature of royalty u/s 9(1)(vi) of the Income-tax Act as well as under Article 12.4 of DTAA with Netherlands for the reason that there is a "process" involved in the satellite which has been used by the customers of the assessee." The Ld. CIT (A), by way of consolidated order in respect of three years, has upheld the contention of the Assessing Officer and dismissed the appeal filed. It is the case of the assessee that these receipts cannot be assessed either under Income-tax Act or under Article 12.4 of DTAA as the consideration received by it is not in the nature of 'royalty'.

Decision of the ITAT Delhi Special Bench

The question arose whether the said fee was "consideration for … the use of any … secret formula or process …" so as to constitute "royalty" under Explanation 2 to Section 9 (1)(vi) and corresponding definition under the

DTAA. In Asia Satellite (85 ITD 478), the Tribunal held that the receipts were taxable as 'royalty' having been paid in respect of a "process". However, in the case of PanAmSat (9 SOT 100), it was held that as the term "royalty" in Article 12 of the India-USA DTAA there was a 'comma' after the words "secret formula or process", it was only a 'secret process' which would qualify as royalty and not what was provided by the assessee.

To resolve the conflict, the issue was referred to the Special Bench. The Delhi Special bench has reversed the decision in the case of PanAmSat and held that

- the provision of the transponder through which the telecasting companies are able to uplink the desired images/data and downlink the same in the desired area is a "process". To constitute "royalty", it is not necessary that the process should be a "secret process".
- The fact there is a 'comma' after the words "secret formula or process" in the DTAA does not mean that a different interpretation has to be given to the DTAA as compared to the Act. The argument that there is no "use" of the satellite by the payer as it has no control or possession of the satellite is not acceptable. To constitute "royalty", it is not necessary that the instruments through which the "process" is carried on should be in the control or possession of the payer.
- The context and factual situation has to be kept in mind to determine that whether the process was "used" by the payer. In the case of satellites physical control and possession of the process can neither be with the satellite companies nor with the telecasting companies.
- The fact that the telecasting companies are enabled to telecast their programmes by uplinking and downlinking the same with the help of that process shows that they have "use" of the same. Time of telecast and the nature of programme, all depends upon the telecasting companies and, thus, they are using that process.
- Thus it was held by the Special Bench that the consideration paid by telecasting companies to satellite companies is for the purpose of providing "use of the process" and consequently assessable as "royalty" under the Act and the DTAA.

2. DCIT vs. Vertex Customer Services (ITAT Delhi)

No penalty under Explanation 7 to Section 271 (1) (c) for bona fide transfer pricing adjustments

The assessee company has entered into international transactions with its associated enterprises. The Transfer Pricing Officer (TPO) observed that the assessee company was in the business of running a call centre. The assessee adopted the Transactional Net Margin Method ("TNNM") and showed an operating profit to operating cost at 10.12% on the basis of comparables. The assessee has showed a loss of Rs. 4.27 crs from the international transaction after making adjustment for

(i) cost relating to first year operation,
(ii) cost relating to excess capacity and
(iii) provision for doubtful debts towards sums due from the parent company.

The adjustments were made on the ground that these were extraordinary costs and required to be excluded in computing the arms' length price under Rule 10B (e) (iii) which provides that the net profit margin arising in comparable uncontrolled transactions can be adjusted for differences between the international transaction and the comparable transaction or between the enterprises entering into such transactions which could materially affect the amount of net profit margin in the open market.

The TPO rejected the third adjustment on the ground that it being an ordinary item of expenditure did not qualify for adjustment. On merits, the assessee accepted the addition though it challenged the levy of penalty. The CIT (A) allowed the appeal on the ground that the treatment of the provision for doubtful debts as an extraordinary item and not as operational cost was justified.

Decision of the ITAT Delhi

Aggrieved by the order of CIT(A), the Revenue Authority has filed an appeal before the Tribunal. The Tribunal has dismissed the appeal of the revenue department. The Tribunal held that on facts there was a full disclosure of the relevant facts by the assessee. The conduct of the assessee was not mala fide or contumacious. The computation claiming exclusion of the provision for doubtful debts in arriving at comparable profit margins cannot be said to have been done not in good faith or without due diligence. The Tribunal held that the assessee can not be held liable for penalty u/s 271 (1) (c) of the Income tax Act since his conduct is not malafide or contumacious. The Tribunal did not find any infirmity or illegality in the order of CIT (A). Accordingly the Tribunal held that penalty under Explanation 7 to Section 271 (1) (c) could not be levied.

ACCOUNTS & AUDIT

Institute of Chartered Accountants of India lists companies for IFRS convergence

The Institute of Chartered Accountants of India (ICAI) has brought out a list of over 400 companies that should converge their accounting practices with International Financial Reporting Standards (IFRS) by April 2011. IFRS — issued by International Accounting Standards Board — is acknowledged by 113 countries. This is ICAI's first list and more companies would be added on its next list. The first list comprises 439 companies. It includes BSE-Sensex companies, NSE-Nifty companies, companies that have raised debt of over $50 million abroad, financial sector companies, publicly accountable companies (with total borrowings of over Rs 1,000 crore), Indian subsidiaries of foreign companies that have implemented IFRS at the parent company and companies outside these categories with capital of over $50 million abroad. Significantly, ICAI is mulling including venture capital funds also in the IFRS convergence process.

IFRS convergence will entail a change in the accounting process. IFRS compliance is a huge opportunity for consultants, IT companies and tax experts. Companies will have to train their accounts and finance personnel on IFRS. After IFRS convergence, benchmarking Indian companies with their global peers will be more accurate. ICAI will hold talks on IFRS convergence with SEBI, IRDA, RBI and the Corporate Affairs Ministry on the changes in SEBI guidelines, IRDA rules and regulations, the Banking Regulation Act, Companies Act and National Advisory Committee on Accounting Standards notifications. ICAI will convene talks with companies in oil and gas, aviation, pharma and textiles to evaluate the sectoral impact. It will follow the IASB's programmes on converging IFRS with US Generally Accepted Accounting Principles (US GAAP). ICAI could also evolve separate and simpler IFRS norms for small and medium enterprises as such companies lack the resources to converge with IFRS

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