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DIRECT TAX REVIEW

DECEMBER 2020

Inside this edition

- High Court and ITAT judgements regarding direct tax issues such as deduction under section 24(b) of the Income tax Act, 1961, presumptive taxation under section 44AD of the Act.
- Circular regarding Vivad se Vishwas and TDS on income from salary.
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HIGH COURT RULINGS

Interest and salary received by assessee not carrying independent business but only as partner in a firm not to be construed as business income under section 28(v) for the purpose of section 44AD.

Facts

- The assessee is an individual, a partner in three firms. The assessee showed a total income of Rs. 43,53,066 in his return of income. The case was selected for scrutiny and finalized under section 143(3) by an order dated March 3, 2015, that disallowed the claim of assessee under the applicability of section 44AD.
- The AO held that section 44AD did not apply to the assessee as it is meant for an eligible business and the assessee was only a partner in the firm and was not carrying out any independent business. Furthermore, the AO also opined that the assessee had no turnover and receipt of account of remuneration and that interest from such firms cannot fall as gross receipts under the meaning of section of 44AD.
- Aggrieved the assessee appealed to the CIT-A and later the ITAT, both of which did not favor him and now the case lies with the High Court of Madras.

Ruling

The learned counsel of the department observed that in order to receive the benefit of presumptive taxation, the assessee must fulfill the essential elements of section 44AD. The assessee should be eligible as per clause (a) of the explanation to section 44AD; he should

be engaged in an eligible business as per clause (b) of the explanation to section 44AD. Moreover there needs to be a total turnover or gross receipts to apply the 8% as required by the section. The Court noted that the assessee in such case does not carry on any business and hence the interest received from the partnership firms cannot qualify as turnover of the assessee. It was observed that turnover for such purpose meant the aggregate amount for which either service is rendered or sales are effected. In such case the assessee has done no such sales or rendering of service. The Court agreed with the view of the AO and the CIT-A, in realizing that remuneration and salary received from a firm is eligible only to the extent stated in section 40 (b) of the Act and shall therefore form part of business income to only that extent. The same is indicated in section 28 (v) of the Act. The Court dismissed the appeal of the assessee.

Source: Madras HC in Anandkumar vs. ACIT, 122 Taxmann.com 252 dated December 23, 2020.

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Provisions of section 40(a)(i) and (ia) not applicable to Depreciation as it is an allowance and not an expenditure.

Facts

- Assessee is engaged in the business of software development and sale of software product license, software maintenance and training in software. The assessee filed a return of income in the

Assessment Year 2009-10, after claiming brought forward losses and declaring the income as nil.

- The case was chosen for scrutiny and the AO disallowed a sum of Rs. 6,70,94,074 in regard of depreciation on Intellectual Property Rights. Consequently, the assessee appealed to the CIT-A who allowed the claim as per the evident transfer of capital asset and disregarded the AO's disallowance under section 40(a) (ia).
- Thereafter the revenue appealed to the tribunal which ruled in favor of the assessee. The revenue contended that the assessee had purchased such software from a non-resident and in the nature of royalty and therefore must pay TDS. Due to such non-payment, section 40(a)(ia) must be applied. Hence, the case has now reached the High Court of Karnataka.

Ruling

The Court opined that as per section 40(a)(i), the term 'amount payable' refers to the expenditure incurred for the purpose of the business of the assessee and this expenditure becomes the deductible claim. Depreciation under section 32 is not subject to TDS, as it is an allowance and not an expense. It is a statutory deduction on asset that can be claim as a deduction of depreciation. Section 40(a)(i) and 40(a)(ia) only pertain to expenditure that is revenue in nature and as such does not cover depreciation. The Court further held that the assessee made an outright purchase of the Intellectual Property Rights and not towards royalty and therefore there is no reason that section 40a must be attract in respect of the depreciation. The Court ruled in favor of the assessee.

Source: HC Karnataka in PCIT vs. Tally solutions P. Ltd, 123 Taxmann.com 21 dated December 16 2020.

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ITAT RULINGS

Interest on sum borrowed to repay a loan, utilized for construction of commercial property, deductible under section 24(b).

Facts

- The assessee is company engaged in the business of construction, development of real estate projects and renting of commercial building. The assessee filed a return of income for the Assessment Year 2011-12, where it stated income from house property at

Rs.1,10,64,559. Out of such income it claimed Rs.69,84,167 as deduction under section 24(b) of the Act as interest paid on capital borrowed for the construction of the property.

- The assessee contented that it borrowed money from Corporation Bank for the purpose of letting out a commercial building project 'Indraprastha Equinox'. Later on, it borrowed monies from Mrs. Kaveri Bai to repay the loan borrowed from the bank mentioned above.
- The AO disallowed the entire deduction by virtue of the 3rd proviso introduced to section 24 by way of the Finance Act effective from A.Y. 2003-04, that ensures the presence of a certificate, from the person to whom the interest is payable, 'specifying the amount payable by the assessee for the purpose of such acquisition or construction of the property or the conversion of the whole or part of the capital borrowed which remains to be repaid as a new loan'.
- The assessee appealed to the CIT-A by relying on Circular No. 28 dated August 20, 1969 the CIT-A allowed the claim for the

Corporation Bank but did not consider the borrowings from Mrs. Kaveri Bai as deduction under section 24(b). Therefore, the assessee further appealed to the ITAT.

Ruling

The ITAT ruled in favor of the assessee by the stating that it is clear from Circular No. 28, the CBDT has stated that when a loan is taken to repay loan taken for construction of property, interest payable on such loan also falls as a deduction under the head income from house property. It contended that the CIT-A was incorrect in dismissing such circular. Moreover, the ITAT held that the term property in sec 24(b) is not restricted to merely residential property and does encompass commercial property as well. Therefore irrespective of the property, deduction must be allowed. Furthermore, as for the 3rd proviso to section 24(b), the provisos to section 24(b) are read in the context of section 23(2), which refers to residential property. It is evident that such proviso only curtails the deduction in so far as the use of residential property is concerned and therefore the entire amount of deduction of the assessee was allowed.

Source: Bangalore ITAT in M/s Indraprastha Shelters Pvt. Ltd. vs. DCIT ITA No: 2597/Bang/2019 dated December 16 2020.

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Revenue can record reasons for reassessment on material unearthed in search and seizure.

Facts

- The assessee filed a return of income declaring Rs. 1,30,640 as the income. Thereafter, a search was carried out at the residence of the assessee under section 132 of the Act. Particular documents were seized in the process and the AO recorded the reasons for reopening the assessment under section 147/148 of the Act and as such served the notice of the same to the assessee.
- The assessee challenged the assessment proceedings before the CIT-A. The assessment order passed by the AO under section 143(3) on the basis of the seized material found during the course of the search was quashed by the CIT-A due to non-compliance of section 143(2) by the department.
- The AO thereafter recorded reasons for reopening the assessment as it had escaped assessment due to the order being declared void ab initio by the CIT-A. The assessee contented that no new material found by the AO to initiate new proceedings other than the material found during the search. The AO relied on the case of Krishna Developers & Co. vs. DCIT-II, (2018) 254 Taxman 125 SC and Pooran Mal vs. Director of Inspection (Inv.) [1974] 93 ITR 505 (SC).

Ruling

The ITAT noted that it was clear from the search that the assessee's income had escaped assessment. The tribunal noted that there is no illegality in the AO recording the reasons for reopening the assessment on the basis of the same materials that were seized in the earlier search carried out against the assessee. Given that upon reopening such assessment the AO sent a timely notice under section 148 of the Act, it was justified in its actions of reopening the assessment once again.

The counsel relied on the decision of the Bombay High Court in the case of Metro Auto Corporation and the judgement of the Punjab High Court in the case of Anchi Devi. Therefore, the assessment can be reopened

on the foundation of what was revealed in the course of the search process. In this matter of contention the tribunal ruled in favor of the revenue.

Source: Delhi ITAT in Vijay Kumar Aggarwal vs. ITO.
ITA No. 2338/Del/2017 dated December 21 2020.

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Share Application money to be held as Capital Asset under section 2(14).

Facts

- The assessee as part of its corporate restructuring, decided to transfer shares of certain group entities held by the assessee, to other group entities. Subsequently, the assessee transferred its investments in the form of equity shares, preference shares. It further transferred some share application money. In such process, the assessee incurred long term as well as short term capital losses.
- The AO rejected the assessee the set off of the aforementioned losses. The tribunal in the appeal allowed the setoff against the shares but denied the claim against share application money, it held that share application money does not count as capital asset under section 2(14).
- Therefore, the appeal has been recalled to decide whether share application money transferred by the assessee falls under the meaning of capital asset as per section 2(14) of the Act.

Ruling

The counsel placed heavy emphasis on the case of CIT vs. Siemens Nixdorf Information Systems Gmbh (ITA No. 1366 of 2017), wherein it was held that for the purpose of section 2(14) of the Act, capital asset means any kind of property held by the assessee, irrespective of its involvement in the business barring those which are specifically excluded in the section. The counsel further relied on the cases CIT vs. Vidur V Patel (1995) 215 ITR 30 and Bafna Charitable Trust vs. CIT 230 ITR 846, from which it is evident that share application money forms parts of capital asset. In Bafna it was noted that share application money is nothing but advance and at a later stage converts into share capital. Therefore, the counsel ruled in favor of the assessee by adhering to the ratios of the aforementioned cases.

Source: Mumbai ITAT in DCIT-Circle 7(1) vs. M/s. Morarjee Realties Ltd. ITA No. 2343/Mum/2009 dated December 15 2020.

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Prerequisite for invoking sec 69C is that the source of the expenditure incurred by the assessee must be unexplained or the explanation so given must be unsatisfactory.

Facts

- The assessee filed a return of income on 30th July 2013 and subsequently filed a revised return on February 13, 2014. The case was selected for scrutiny assessment. The assessee is engaged in the business of trading non-ferrous metals.
- The assessment under section 143(3) of the Act was finalized on March 11, 2016. The AO disallowed two separate expenditures being Rs. 8,80,000 as rent expenses and Rs.10,000 as unaccounted expenses towards freight on purchase of machinery from Surendranagar.
- Aggrieved the assessee appealed before the CIT-A, who dismissed the appeal stating that the assessee did not prove the rent

expense was for business purpose and similarly dismissed the appeal for the second disallowance as well.

Ruling

The counsel allowed the expenditure with respect to the rent expenses, it was evident from the documents furnished by the assessee that the guest house rent was used by directors of the company and no personal use of it was made by any director. Furthermore after the erasure of section 37(3) of the Act, guest house expenses are allowable as well. As for the second disallowance, the assessee has clearly stated how the expenditure was incurred and the AO found such explanation unsatisfactory. The assessee has admitted to incurring expense by the use of its own tempo and the paper book shows no evidence of any hired tempo for such purpose. The AO has invoked section 69C without any evidence to corroborate his dissatisfaction with the assessee's explanation. The addition by the AO has been made on a presumption and therefore the use of section 69C does not stand. The Tribunal ruled in the favor of the assessee.

Source: Ahmedabad ITAT in Laxmi Sagar Trade Link Pvt. Ltd. vs. ACIT ITAT No.426/Ahd/2018 dated December 31 2020.

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CIRCULARS & NOTIFICATIONS

Section 192 of Income tax Act- tax deducted at source: Income-tax deduction from the head 'Salaries' for the financial year 2020-21.

The present circular, Circular No. 20/2020, is in reference to Circular No. 4/2020 dated 16 01.2020, whereby the rates of deduction of income tax from the payment of income under the head "Salaries" under section 192 of the Act, during the F.Y. 2019-20, were intimated. The present circular holds the rates of deduction of income tax from the payment of income chargeable under the head "Salaries" for the financial year 2020-21. The present circular is not exhaustive and in case of any ambiguity the aforementioned Act and Rules as well as the Finance Act 2020 (No.12 of 2020), Taxation and other laws (Relaxation and Amendment of certain provisions) and other relevant notification and circulars can be referred to for guidance.

Source: Circular no. 20/2020 [F.NO. 275/192/2020-IT (B)] dated December 3 2020.

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Clarification on provisions of Direct Tax: Vivad se Vishwas Act 2020.

In order to facilitate the taxpayers, the board had issued circular no. 9/2020 dated 22nd April 2020 with the purpose of clarifying certain basic Frequently Asked Questions (FAQ) on issues such as computation of amount payable or eligibility under Vivad se Vishwas. Thereafter frequent representations were made seeking further relaxations and clarifications.

This present circular no.21/2020 has been issued in continuation of the 22nd April 2020 circular, under section 10 and 11 of the Vivad se Vishwas to provide clarification to 34 more FAQs (Q. No. 56-89). Section 10 and section 11 of the Vivad se Vishwas empowers the Board/ Central Government to issue directions or orders in public interest or to eliminate difficulties.

Source: Circular no. 21/2020, IT (A)/1/2020-TPL dated December 4 2020.

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HIGH COURT RULINGS

Once ITAT directed the assessing officer to decide the matter relating to transfer pricing de novo, the assessing officer had to decide the matter in accordance with the elaborate procedure mentioned in section 144C and not dehors it.

Facts

- The respondent-assessee, a wholly owned subsidiary of Headstrong Services LLC, USA, had filed its return of income declaring income of Rs.30,64,480/- for the relevant assessment year. Thereafter, revised return of income was filed on January 30, 2009 that was processed under Section 143(1) of the Income Tax Act, 1961 (for short 'the Act') and subsequently, case of the respondent-assessee was selected for scrutiny assessment.

- Draft assessment order under Section 144C (1) of the Act was passed on December 31, 2010 and the respondent-assessee filed objections before the Dispute Resolution Panel (DRP). Thereafter, assessment under Section 143(3)/144C of the Act was completed in pursuance to directions issued by the DRP, wherein addition was made on account of excess claim of deduction under Section 10A of the Act and transfer pricing adjustment made by the TPO.
- Aggrieved, the respondent-assessee filed an appeal before the ITAT wherein the addition under section 10A was set aside and the AO to frame the assessment de novo.
- Consequently the AO passed the assessment order which was challenged by the respondent assessee before the CIT-A, which partly allowed the appeal.
- Therefore the appeal now lies here due to the non-compliance of section 144C of the Act, by the AO.

Ruling

The Counsel opined that once the ITAT had directed the AO to frame the assessment de novo it meant that a new hearing of the matter had to be conducted, as if the original one had never taken place. Section 144C envisions a change of forum and it leads to complete cessation of the jurisdiction of the Assessing Officer on passing of draft order. As per section 144C the first step to be taken by the Assessing Officer in a series of acts contemplated by the said Section while dealing with the case of an eligible assessee is to give effect to either the direction of the Dispute Resolution Panel or pass an order on acceptance by the assesse. The AO therefore does not have the jurisdiction to pass the assessment order. "Failure to adhere to mandatory procedure prescribed under Section 144C would vitiate entire proceedings and same cannot be treated as an irregularity/ curable defect. There was complete contravention of Section 144C, the Assessing Officer wrongfully assumed jurisdiction and passed final assessment order without passing a draft assessment order and without giving assessee an opportunity to raise objections before Dispute Resolution Panel." The Court ruled in favor of the assessee.

Source: Delhi HC in PCIT vs. Headstrong Services India Pvt. Ltd. 109 CCH 0172 dated December 24 2020.

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ITAT RULINGS

Functionally different companies cannot be selected as comparables.

Facts

- The assessee was previously known as Keane India Limited. The assessee is involved in providing software development solutions to Keane USA and to specific unrelated parties in Europe. The assessee performs the functions of application outsourcing, e-business and total IT management.
- The assessee as well as the TPO applied the TNM method benchmarking transaction. Assessee had selected 29 companies for benchmarking its transactions with Associated Enterprises. The TPO rejected the transfer pricing study of assessee. He selected two companies namely Bodhtree Consulting Ltd. and Tata Elxsi Ltd. Assessee had arrived at average margin (PLI) 12.78% and TPO arrived at average margin of 24.60%. TPO made transfer pricing adjustment. CIT-A modified transfer pricing adjustment made by AO.
- In the appeal before the CIT-A, the assessee furnished detailed submission with regard to various companies. Hence, the CIT-A called for the remand report from TPO, wherein the TPO suggested inclusion of 21 more companies. The CIT-A finalized twelve companies out which the assessee wishes to exclude four companies, namely: Geometric Software Solutions Co. Limited, Bodhtree Consulting Limited, Flextronics Software Systems Limited, Tata Elxsi Limited. These were previously included in the judgement of Sharp Software Development India Pvt. Ltd.
- Consequently, the assessee has appealed before the tribunal.

Ruling

The counsel for the relevant case referred to the judgement of Sharp Software wherein it was discerned that the aforementioned four companies do not make good comparable companies. Similarly in the case of sharp software another judgement was regarded, in the case of ACIT vs. McAfee Software (India) P Ltd. The afore mentioned cases have studied the companies in contention and detailed and by the ratio in those cases it is held that companies that are functionally different in nature cannot be selected as comparables by the authorities. The counsel favored the assessee.

Source: Bangalore ITAT in NTT Data Global Delivery Services Pvt. Ltd. vs. DCIT.IT (TP) A No.2028/Bang/2016 dated December 17 2020.

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Enhanced income under section 92 CA (3) added incorrectly under the Arm's length Price Computation of Income.

Facts

- Assessee is a company stated to be engaged in the business of supplying chain management, logistics and freight forwarding related to movement of goods and cargo within and outside India by road, rail, air and ship.
- The assessee filed its return of income for the Assessment Year 2005-06. The case for selected for scrutiny and notice was served accordingly under section 143(2) of the Act. The AO observed that assessee had entered into International Transactions during the year under consideration which required the determination of Arm's Length Price (ALP). He notified the same to the TPO.

- The TPO under section 92 CA (3) of the Act direct the AO to enhance the assessee's income by the international working computed by him. Aggrieved the assessee appealed before the CIT-A where the additions made by the AO were deleted.
- Consequently the appeal has reached the tribunal at the behest of the revenue.

Ruling

It was noted that the assessee had received the services received from its US parent company to which the royalty was paid by the assessee. The TPO however rejected the explanation of the royalty paid by the assessee. It was further observed that the TPO made no analysis or relied on any evidence through which it was held that the arm's length price for royalty transaction stands subsumed by the gross profit split on revenue received from logistics services on a predetermined basis. Further, TPO has not provided any analysis or evidence to support his findings that no material benefit has been received by the assessee. The that CIT-A has also considered the supplementary TNMM analysis to check the impact of royalty payment on assessee's profit margin that of independent comparable companies to come to a conclusion that the ratio of operating profit to cost at sales of the assessee is comparable to that of uncontrolled entities. The bench is of the view that the CIT-A has done a thorough finding of the case by considering various factors, such as mentioned above, that were not considered by the AO. Therefore the CIT-A order is upheld in favor of the assessee.

Source: Delhi ITAT in DCIT vs. Expeditors International (India) Pvt. Ltd. ITA No.2128/Del/2011 dated December 17 2020.

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***"Specialibus non derogant"*-general provisions do not override the specific provisions. An income already taxed under a provision of the treaty cannot be taxed in the hands of the same assessee in a different provision of the same treaty.**

Facts

- DZ Bank AG, the assessee, is a company incorporated under the laws of Germany and has its principal place of business in Germany, is engaged in the banking business and with the permission of the Reserve Bank, has a representative office in India. In accordance with the RBI's terms the office stood as only a liaison office and therefore was not engaged in the core business of the assessee independently.

- The assessee filed an income tax return in the name of "DZ Bank AG-India Representative Office", disclosing NIL taxable income. In the scrutiny proceedings it was noted that during the relevant previous year "DZ Bank AG provided foreign currency loans to Indian companies' and "these loans were in the nature of external commercial borrowings (ECB) as permitted under the Indian Exchange Control Regulations".
- Article 7 of the Indo German taxable treaty allows the profits of an enterprise to be taxable in India through business being carried out therein by a permanent establishment.
- The assessee contended that such interest income was already taxable in Article 11 of the treaty and the office was not a permanent establishment. The AO rejected such explanations and treated the company as having a permanent establishment in India and proceeded to tax the entirety of the interest along with other amounts

- Aggrieved the assessee appealed to the CIT who dismissed such appeal.

Ruling

It was noted by the counsel that the office earns income only in the form of interest income whose taxability has already been provided for in the treaty. On a plain reading of Article 7 of the treaty it is noted that all profits shall be taxable under such article provided that there is no specific provision for the same. The treaty therefore follows the Latin maxim where specific provision shall override the general ones.

In such case, the interest has already been taxed under article 11 specifically provided for it, there is nothing left to be taxed under article 7. The Counsel further held that The AO was wrong to hold DZ Bank AG- India Representative Office and DZ Bank AG as two distinct entities, as they are one and the same. It cannot justify the taxability of DZ Bank AG under article 11 and DZ Bank AG under article 7 as they the same assessee and therefore cannot be taxed on the same income twice. The appeal of the assessee was allowed.

Source: Mumbai ITAT in DZ Bank AG - India Representative Office vs. DCIT (International taxation). ITA No.1815/Mum/18 dated December 4 2020.

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Foreign exchange Profit or loss to be treated as operating in nature while computation of profit margin of the assessee as well as the comparable companies.

Facts

- The assessee is a company belonging to M/s. Hewlette Packard (HP) group and is engaged in providing ITES services. The assessee undertakes HP's worldwide accounting and transaction processing work, provision of back office operation and customer support services to various associated enterprises.
- The assessee adopted TNMM method to benchmark his transactions and the profit level indicator was taken as operating profit by operating cost (OP/OC). The assessee declared net margin of 19.08%.
- The TPO recomputed the margin of the assessee by excluding interest income and non-operating income and also reducing the expenditure. Further the TPO arrived at 28.17% as the adjusted margin, while computing such he treated the foreign exchange gain as non-operating income.
- The Dispute Resolution Panel provided half the relief to the assessee after which the appeal has reached such tribunal.

Ruling

The Counsel relied on the case of M/s Arctern Consulting Pvt. Ltd (IT (TP) A No.352/Bang/2017) wherein an identical issue regarding the treatment of foreign exchange gain as operating or non-operating in nature has been raised. There the Bangalore tribunal relied on previous judgements of various ITAT rulings wherein such gain or loss was always treated as operating in nature. The Counsel upheld the decision of such case and held that for foreign exchange profit or loss shall always be treated as operating in nature. The appeal of the assessee is allowed.

Source: Bangalore ITAT in Global E Business Operation Pvt. Ltd. vs. ACIT. IT (TP) A No. 725/Bang/2017 dated December 4 2020.

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