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CHARTERED ACCOUNTANTS

Corporate Update

April | 2019

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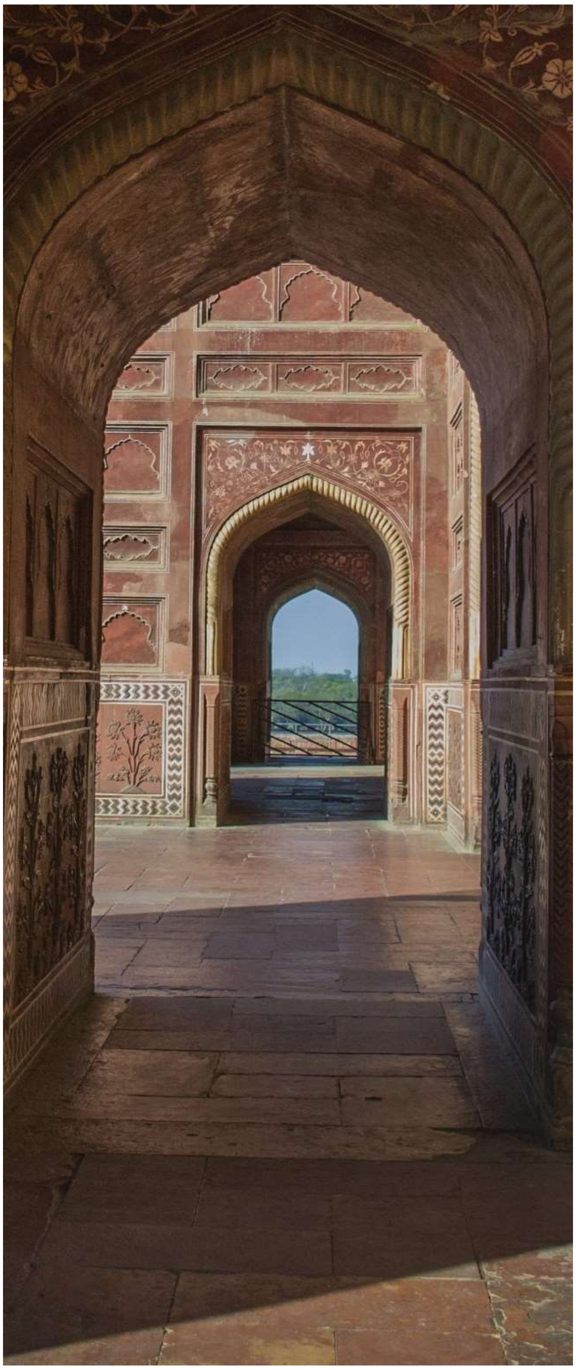

FOREWORD

Dear Reader,

Attribution of taxable profits to a Permanent Establishment ('PE') has always been a contentious aspect. Due to the absence of clear rules on this issue, Indian tax authorities tend to adopt diverging and inconsistent methods for determining attributable profits, which often lead to litigation. Moreover, the Indian Government, as a matter of policy, does not concur with the internationally accepted authorised approach for attribution of profits (which is based on Functions, Assets and Risks), prescribed by the Organisation for Economic Cooperation and Development.

An attempt has been made by the Government to introduce a more uniformed approach, while at the same time, eliminating subjectivity and discretion in attribution methods. To this end, draft rules for determining attributable profits have been issued by the Finance Ministry, for public consultation. Under these draft rules, the Government has proposed a three-factor method for determining the attributable profits. The three factors being sales, manpower and assets, shall be assigned different weightages as prescribed in the rules. The rules are expected to be framed after consideration of the comments of the public and stakeholders.

The Government has also notified revised tax return forms, which are applicable for the Assessment Year 2019-20. In such forms, the disclosure requirements applicable for various class of tax payers have been expanded. For instance, an individual is now required to furnish in the return form, the details of all his /her directorship held in companies. Furthermore, the existing disclosure of Foreign Assets for residents have been expanded to include custodian accounts, insurance assets, equity and debt interests etc.

Such enhanced disclosure requirements shall result in additional compliance burden as well as costs associated with it.

On a separate note, the much-awaited General Elections of the Indian Parliament are underway and various Indian states have already gone to polls this month. The results of the general elections are expected to be announced on May 23, 2019. Post-election of the new Government, the full union budget is likely to be tabled in the Parliament in the month of June or July.

C.S. Mathur
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International Tax

Payment made to professional law firm not having fixed base in India not liable to TDS

Cadila Healthcare Ltd. [(2019) 104 taxmann.com 79 (SC)]

Recently, the Hon'ble Supreme Court dismissed Special Leave Petition filed by the Revenue against the order of Gujarat High Court dealing with the issue of TDS liability on payments made to foreign professional law firms. The High Court had held that taking into account the provisions of Double Taxation Avoidance Agreement (DTAA), no tax was required to be deducted on payments made to foreign professional law firms which did not have fixed base in India and as such, no disallowance could be made in hands of the company making such payments.

Profit attribution to Permanent Establishment - Proposal of Ministry of Finance, Government of India to amend applicable rule

F.No.500/33//2017-FTD.I

The business profits of a non-resident enterprise are subject to income-tax in India only if such enterprise has a business connection in India in terms of the Income -tax Act and PE in India as per Article 5 of the relevant DTAA.

In this case, only those profits which are attributable to PE in India (in case of business connection, to the operations in India) are taxable in India and would include profits that the PE would be expected to make as a separate and independent entity, as typically laid down in Article 7 of tax treaties of PE in India or where they cannot be accurately derived from its accounts, by application of Rule 10 of the Income Tax Rules, 1962, based on global profitability.

Profits attributable to PE can be computed either on the basis of accounts of PE in India or where they cannot be accurately derived from its accounts, by application of Rule 10 of the Income Tax Rules, 1962, based on global profitability.

Rule 10 provides a wide discretion to the tax officer to determine profit attribution including use of apportionment method.

This has resulted in lot of tax uncertainty as well as tax disputes.

Thus, the Central Board of Direct Taxes (CBDT) constituted a Committee to recommend a simple and consistent method of profit attribution under Rule 10, to bring more clarity and predictability and reduce tax disputes and litigation. The Committee submitted its report on April 18, 2019 for comments and suggestions from the stakeholders. Public comments on the report can be sent electronically within 30 days to the CBDT at usfttr-1@gov.in.

The Committee has proposed amendment in Rule 10 or alternatively in the Act itself to incorporate a provision for profit attribution to a PE.

Key observations of the Committee:

Article 7 in most of the Indian tax treaties is either based on pre-2010 OECD Model Tax Convention (OECD MTC) or UN Model Tax Convention (UN MTC). This Article revised in 2010 by the OECD requiring determination of profits attributable to the PE taking into account the functions, assets and risk (FAR). This approach, called as Authorised OECD Approach (AOA) is not followed in India's treaties.

India has made strong reservations on revised Article 7 of OECD MTC as this approach completely ignores the sales receipts derived from the tax jurisdiction and is totally driven by supply side factors.

It is the view of the Government of India that the AOA/ FAR approach can have significant adverse consequences for developing economies like India, which are primarily importers of capital and technology.

The Committee observes that profits are

contributed by both demand and supply side factors. The mixed approach allocating profits partly to the jurisdiction where the consumers are located and partly to the jurisdiction where supply activities are undertaken appears to have been most commonly adopted in international practices and finds favour in Indian court rulings, views and opinions of academicians and experts.

The recommendations of the Committee are as under:

<u>Mixed Approach–Fractional Apportionment Method</u>

Out of various possible options of apportioning profits by a mixed approach, the Committee found considerable merit in the three-factor method based on equal weight accorded to sales (representing demand) and manpower and assets (represent supply including marketing activities).

<u>Profits derived from India</u>

'Profits derived from India' will be the higher of the following amounts:

a. The amount arrived at by multiplying the revenue derived from India x Global operational profit margin (EBIDTA margin), or

b. Two percent of the revenue derived from India.

The Committee is of the view that in case of enterprise having global losses or a global profit margin of less than 2%, continuation of Indian operations justifies presumption of higher profitability of Indian operations. In such cases, global profit margin should be deemed to be 2%.

<u>Profit attribution to PE</u>

Profit attribution to PE shall be determined by apportioning the profits derived from India by a three equally weighted factors of sales, employees (manpower & wages) and assets, as under:

Profits attributable to operations in India = 'Profits derived from India' x [SI/3xST + (NI/6xNT)
+(WI/6xWT) + (AI/3xAT)]
Where, SI = sales revenue derived by Indian operations from sales in India

ST = total sales revenue derived by Indian operations from sales in India and outside India NI =number of employees employed with respect to Indian operations and located in India.

NT = total number of employees employed with respect to Indian operations and located in India and outside India

WI= wages paid to employees employed with respect to Indian operations and located in India

WT = total wages paid to employees employed with respect to Indian operations and located in India and outside India

AI = assets deployed for Indian operations and located in India

AT = total assets deployed for Indian operations and located in India and outside India

<u>Profit Attribution to Business Connection through Significant Economic Presence</u>

Where non-resident enterprise has business connection in India through 'Significant Economic Presence' in terms of the Act, the Committee, considering the role and relevance of users in digital business, concludes that for such enterprises, users should also be taken as the fourth factor for apportionment.

The Committee suggests that the users should be assigned a weight of 10% or 20% in cases of low/medium or high user intensity, while the share of assets and employees would be reduced after keeping the weight of sales as 30% as under:

Profits attributable to operations in India in

cases of low and medium user intensity business models= 'Profits derived from India' x [0.3 x SI/ST + (0.15 x NI/NT) +(0.15 x WI/WT) + (0.3 x AI/3xAT)]
+ 0.1]

Profits attributable to operations in India in cases of high user intensity business models = 'Profits derived from India' x [0.3 x SI/ST + (0.125 x NI/NT) +(0.125 x WI/WT) + (0.25 AI/3xAT)] + 0.2]

<u>Avoidance of double taxation in India where PE is constituted by existence of Indian subsidiary</u>

Where PE is constituted by existence of Indian subsidiary whose profits are separately taxed in its hands in India, the Committee concluded that the profits derived from Indian operations that have already been subjected to tax in India in the hands of a subsidiary should be deducted from the apportioned profits. This recommendation is based on the principle laid down by the Hon'ble Supreme Court in the case of DIT Vs Morgan Stanley [2017] 162 Taxman 165 (SC) and avoids double taxation.

The Committee observes that in a case where no sales takes place in India, and the profits that can be apportioned to the supply activities are already taxed in the hands of an Indian subsidiary, there may be no further taxes payable by the enterprise.

Where the business connection/ PE of the enterprise in India is constituted by the activities of a resident associate enterprise (AE) and such AE has been remunerated by the enterprise at arm's length price,

- Such AE is not in receipt of any payments on accounts of sales or services from any resident person in India [or such payments do not exceed an amount of Rs. 10,00,000]: no further profits will be attributable to the operation of that enterprise in India.

- Where such payments exceed the amount of Rs. 10,00,000: Three factors or four factors apportionment, as the case may be, shall be used for attribution of profits to PE and profits subjected to tax in the hands of AE shall be deducted therefrom.

For this purpose, the employees and assets of AE will be deemed to be employed or deployed in the Indian operations and located in India.

There are certain aspects which require clarification/ modification. As such, multinational enterprises operating in India need to review implications of the aforesaid recommendations on their business models including risk of double taxation.

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Domestic Taxation

Capital reserve created on account of amalgamation scheme to be excluded for MAT calculation

(Priapus Developers P. Ltd. V. ACIT) (TS-121-ITAT-2019(DEL))

Section 115JB of the Income tax Act requires every company to pay minimum alternate tax (MAT) at the rate of 18.5% of the book profits, if the income tax computed as per normal provisions of the Act is less than MAT in respect of any year. For arriving at the book profits, the profit as shown in the statement of profit and loss as per the provisions of Companies Act is to be increased by the items mentioned in clause (a) to (k) to Explanation-1 of Section 115JB {if items (a) to (i) are debited to the statement of profit and loss or if any amount referred to in clause (*j*) is not credited to the statement of profit and loss} and is to be reduced by the items mentioned in clause (i) to (viii) to Explanation-1 of Section 1 15JB of the Act. Explanation 1(j) to such section requires the company to add the amount standing in revaluation reserve related to the asset on its disposal or retirement if the said amount was not credited to the P & L Account.

The Delhi Bench of Hon'ble Tax Tribunal in the case of Priapus Developers P. Ltd ('the Assessee') has held that the amounts transferred to capital reserve, under the scheme of amalgamation, being the difference of fair market value (FMV) and book value of shares shown in the books of amalgamating company cannot be treated as revaluation reserve for the purpose of Explanation 1(j) to Section 115JB of the Act.

In the instant case, the Assessee was engaged in the business of development of infrastructure and real estate. During the AY 2004-05, two of its subsidiary companies were amalgamated into the assessee company i.e. their holding company and the merger scheme was duly approved by the Delhi High Court under the relevant provisions of the Companies Act, 1956. Along with other assets and liabilities, shares of M/s India bulls Housing finance ltd (IHFL), held by the amalgamating companies were also transferred to the Assessee. The Assessee adopted purchase price method as provided in Accounting Standard -14, (AS-14), "Accounting for Amalgamation" for the accounting treatment in case of business amalgamations. In case of amalgamation of companies, two methods, namely, purchase price method and merger method have been prescribed for its accounting treatment. In the given case, as the assessee followed purchase price method, accordingly, assets and liabilities taken over were recorded at the fair market value in the books of accounts and the difference between the fair market value of assets and liabilities taken over viz a viz the business purchase price was transferred to the Capital Reserve account of the assessee.

Subsequently, during relevant AY 2015-16, some of the aforementioned shares were sold by the assessee at a long-term capital loss. The Assessing Officer, however treated the amount transferred to the capital reserve in the nature of revaluation reserve and took the same into account for the determination of book profit under Explanation 1(j) to Section 115JB.

On appeal CIT(A) also upheld the order of the Assessing Officer and held as under:

- that the assessee had not followed AS-13, while preparing its financial statements which requires the difference between sale proceeds and cost of investments (not the FMV) to be recognized in the P & L A/c and that amalgamation has been used as a tool for tax evasion; Here, it may be mentioned that, Accounting Standard 13 (AS-13) on investments lays down the accounting treatment of investments, which are purchased, sold or held by the entity during an accounting year.

- Amount credited to capital reserve is in the nature of revaluation reserve and hence should be added for the purpose of 115JB.

When the matter travelled to the Tax Tribunal, the Tax Tribunal took note of the relevant clauses of the Scheme of Amalgamation wherein it was clearly mentioned that any excess arising on transfer of assets and liabilities would be considered to form part of capital reserve. Further, before the scheme was approved, in pursuance of the circular 1 of 2014 issued by the Ministry of corporate affairs (MCA), notices were sent to various parties including the income tax authorities inviting for comments on the proposed scheme of amalgamation. No comments/objections were however received and thus scheme was approved.

The Tribunal also took note of the decision of the Apex court in the case of J.K. (Bombay) Pvt. Ltd. vs. New Kesar-e-Hind Spinning and Weaving Co. [1971 AIR 1041] wherein it was clearly held that once the scheme is sanctioned by the Court, it becomes binding on all. It also relied on the decision in case of Wood Polymer Ltd. [109 ITR 177] wherein similar views were expressed. Thus, Tax Tribunal held that amalgamation order by Hon'ble Delhi High Court approving the scheme of amalgamation passed is a judicial order and has a statutory force and afterwards the same cannot be termed as a tax avoidance arrangement as alleged by the tax authorities.

It was further held that capital reserve cannot be treated as revaluation reserve since revaluation can be done in respect of assets, existing in the balance sheet. Since, in the present case, shares were acquired by the assessee, the capital reserve created on its acquisition cannot be treated as revaluation reserve as the scheme was duly approved by the Hon'ble High Court.

In view thereof, The Tax Tribunal held that the capital reserve created out of the Amalgamation scheme does not get covered by explanation 1(j) to section 115JB of the Act.

Date of setting up of Business – Deductibility of costs incurred as revenue expenditure

(Indian Railway Stations Development Corporation Ltd. Vs PCIT)
W.P.(C) 6782/2018

In the instant case, Indian Railway Stations Development Corporation Ltd ('the Appellant') was incorporated in FY 2012-13, as a Joint venture company of Indian Railways Construction Company (IRCON) and Rail Land Development Authority (RLDA) for the purpose of development and redevelopment of new and existing railway stations. During the relevant assessment year (AY) 2003-04, it declared a loss and there was no business revenue from its activity. The Assessing Officer disallowed the same in view that the Appellant had not commenced business in AY 2013-14.

The Appellant filed a revision application before Principal Commissioner of Income tax (CIT) under section 264 of the Income-tax Act, claiming that it had set up the business during the relevant assessment year since the preliminary steps had already been taken which included the appointment of key personnel, preparation of draft model Development Agreement and initiation of process to tender financial and advisory services.
The CIT however rejected the appellant's claim for revision affirming the view of the Assessing Officer and held that since something substantial in regard to business plan and development of railway stations was not crystallized, the business cannot be said to have commenced. The CIT also held that granting of certificate of commencement by the Ministry of Corporate Affairs (MCA) is not a criteria for deciding as to whether the business has commenced or not. Furthermore, actual establishment of setting up of business is not a criteria for MCA, for issuance of such certificate.

Aggrieved by the order of CIT, the assessee filed a writ petition before Hon'ble Delhi High Court.

The High court on the basis of various judicial precedence available, held that there is no bright line that can be determinative as to when business commences. In case of the service sector, the relevant factor to be considered is when the entity engages itself in various kinds of steps which are preliminary to setting up of the main substantial commercial venture.

In the present case, on the fact that the Appellant had hired all the key personnel during the relevant year, draft model Development Agreement was finalized and that the first consultant for architectural and technical feasibility studies was appointed clearly indicates that the business had actually set up during the previous year. As such, the High court held that all such expenses incurred were allowable under section 37(1) of the Act in the previous year.

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Income from letting out commercial property as business income of the company, if other services are also provided to the customers

(CIT Vs. Oberon Edifices & Estates (P.) Ltd. [2019] 103 taxmann.com 413 Kerala)

The Hon'ble Kerala High Court has upheld the rental income to be assessed as business income, where the assessee intended to commercially exploit the property.

In this case, the assessee was engaged in the business of developing shopping malls and letting out shops, along with provision of various services and amenities. The assessee reported business income, on letting out shop rooms as well as provision of facilities, during a particular year. The Assessing officer rejected the claim of the assessee and treated the said income as 'Income from House Property'.

While the order of the Assessing officer was upheld by the Commissioner (Appeals), the same was reversed by the Tax Tribunal.

When the matter travelled to the Kerala High Court, the Hon'ble Court examined various judicial pronouncements of the Hon'ble Supreme Court and observed that the issue involved ought to be examined on case to case basis. Thereafter, the High Court considered the 'Memorandum of Association' of the assessee as well as the findings of the Tax Tribunal and observed that the assessee was not involved in earning income from letting out of commercial property simpliciter. Rather the assessee was involved in complex set of activities, necessary for day to day management and conduct of the mall. The Hon'ble court observed that the assessee had primary intention of commercial exploitation of property by way of providing several facilities and amenities to attract the customers and render convenience in their experience of shopping at the mall. Moreover, the substantial income of the assessee was sourced from letting out the shops and provision of facilities only.

Based on such observations, the Hon'ble Court held that the income earned from letting out the property forms part of the business income of the assessee. Against the business income the assessee can claim all expenses incurred in maintaining the property, providing the services, whereas where income is taxed as Income from House Property, claim for costs is restricted to limits as specified under the tax laws.

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Changes in Income Tax Return Forms AY 2019-20

[Notification No. 32/2019 dated April 01, 2019]

The Central Board of Direct Taxes has recently notified the Income Tax Returns ('ITR') forms applicable for Assessment Year 2019-20. Various changes have been made to the return forms as prescribed vis a vis last year, in respect of their applicability as well as disclosure requirements. The major changes made in ITR Forms are as under:

- Persons holding directorship in a Company are specifically required to fill return in ITR 2 or 3.
- Individuals holding equity shares in unlisted company shall not use ITR 1 or ITR 4.
- Additional reporting requirement in relation to foreign assets
- Additional reporting requirements for startups and unlisted companies

A detailed note on the applicability of the ITR Forms and key changes shall be circulated separately.

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Labour Law

Supreme Court defines the expression 'basic wages' for the purpose of Provident Fund Law

Regional Provident Fund Commissioner (II), West Bengal v. Vivekananda Vidyamandir and Ors [2019] 103 taxmann.com 18 (SC)

Under the provisions of Employees' Provident Fund and Miscellaneous Provisions Act, 1952, an employer is required to contribute a specified amount of 'Basic Wages' as defined under the said Act for the benefit of an employee, in addition to the contribution made by the employee.

The term 'basic wages', is defined to include emoluments which are earned by an employee while on duty in accordance with the terms of the contract of employment. Certain specific allowances are, however, exempt.

Certain employers, in terms of the contract of the employment, additionally paid amounts termed as 'Special Allowances' to all the employees, on which Provident Fund was neither contributed by the employer nor paid by the employee. An issue had arisen whether the amounts payable as 'Special Allowance' by an employer is liable to contribution of PF or not.

Supreme Court of India, in a recent case, has held that 'Special Allowance' forming part of the salary structure, essentially and ordinarily paid to all employees under the contract of employment, is to be considered as part of 'Basic Wages' on which the employer & employee are required to contribute specified amount of Provident Fund.

It held that only such amounts which were of the nature of incentive or were variable and not paid across the board to all the employees in a particular category, could be excluded from the definition of 'Basic Wages'.

This judgement would have major impact as additional liability would arise on companies to discharge the same.

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Important dates to remember

Particulars	Date
Deposit of TDS for the month of May 2019	07.06.2019
Filing of GSTR I for the month of May 2019	20.06.2019
Filing of GSTR IIIB for the month of May 2019	11.06.2019

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