Section 32 of the Income-tax Act, 1961 - Depreciation

No depreciation is allowable on the stock exchange membership card acquired either by nomination or directly through stock exchange on or after 1.4.1998

Commissioner of Income Tax *vs.* Techno Shares & Stocks Ltd (BOM)

The expression 'licences' in section 32(1)(ii) has to be construed restrictively so as to apply to licences relating to acquisition/user of intellectual property rights, because, firstly, plain reading of section 32 makes it clear that the depreciation is restricted to the categories of intangible assets specifically enumerated therein and not to all intangible assets. Construing the expression 'licences' widely so as to cover all types of intangible assets acquired under a licence would amount to enlarging the scope of depreciation. Secondly, the categories of intangible assets specifically enumerated in section 32(1)(ii) (barring the expression 'licences') are all relatable to intellectual properties. Since the common thread in almost all the expressions used in section 32(1)(ii) relate to the class of intellectual property rights, it is reasonable to construe that the expression 'licences' in section 32(1)(ii) relates to the class of intellectual property rights. Thirdly, the rule of *noscitur a sociis* would apply to the facts of the present case, because, the expression 'licences' in section 32(1)(ii) is preceded and succeeded by the expressions which are all relatable to intellectual properties and, therefore, the expression 'licences' in section 32(1)(ii) would take colour from those expressions and accordingly apply only to licences relating to intellectual properties.

Construing the expression 'licences' in section 32(1)(ii) widely so as to apply to all types of licences relating to intangible assets would defeat the object of the Act, because, depreciation under section 32 is intended to a limited category of intangible assets and not to a wider category of intangible assets. Therefore, it is reasonable to construe that the expression 'licences' is used in section 32(1)(ii) to apply to licences relatable to intellectual properties only and not to all licences.

Since the stock exchange membership card is not a business or commercial right relating to intellectual property rights, depreciation cannot be allowed on the stock exchange membership card.

Section 37 read with Section 31 of the Income-tax Act, 1961 – Business Expenditure

In textile mills, each separate machine is an independent entity; replacement of such an old machine with a new one would constitute bringing into existence of a new asset in place of old one and not repair of old and existing machine; such replacement expenditure would be capital in nature.

CIT, Madurai *vs.* Sri Mangayarkarasi Mills (P) Ltd., (SC.)

The assessee, engaged in the manufacture and sale of cotton yarn, claimed an amount being expenditure incurred on replacement of machinery, as revenue expenditure. The assessee believed that such expenditure was merely expenditure on replacement of spare parts in the spinning mill system and, therefore, amounted to revenue expenditure. According to the Assessing Officer (AO), each machine in a spinning mill does a different function and all the machines are, not integrally connected. Based on this reasoning, the AO disallowed the above claim of the assessee and held the said expenditure to be of a capital in nature.

The Supreme Court held that in CIT vs. Saravana Spinning Mills (P) Ltd. (2007) 7 SCC 298 it was held that "each machine in a segment of a textile mill has an independent role to play in the mill and the output of each division is different from the other". Further, it is accepted that each machine in a textile mill is part of the integrated process of manufacture of yarn and is integrally connected to the other machines in the mill for production of the final product. However, this inter-connetion does not take away the independent identity and distinct function of each machine. Thus, each machine in a textile mill should be treated independently as such and not as a mere part of an entire composite machinery of the spinning mill. As stated above, it can at best be considered part of an integrated manufacture process employed in a textile mill.

The entire textile mill machinery cannot be regarded as a single asset, replacement of parts of which can be considered to be for mere purpose of `preserving or maintaining' this asset. All machines put together constitute the production process and each separate machine is an independent entity. Replacement of such an old machine with a new one would constitute the bringing into existence of a new asset in place of the old one and not repair of the old and existing machine. Also, a new asset in a textile mill is not only for temporary use. Rather it gives the purchaser an enduring benefit of better

and more efficient production over a period of time. Thus, replacement of assets as in the instant case cannot amount to `current repairs'. The expenditure made by the assessee could not be allowed as a deduction under section 31.

In the instant case, the assessee had not claimed any of the two exceptions - (i) Where old parts are not available in the market (as seen in the case of CIT vs. Mahalakshmi Textile Mills Ltd. (AIR 1968 SC 101), or (ii) Where old parts have worked for 50-60 years. In this case, replacement of machine could at best amount to a repair made to the process of manufacture of yarn and could not be said to be `current repairs'. Repair implies existence of a part of the machine, which has malfunctioned, which is impossible in the case of such replacement.

The expenditure of the assessee in this case is capital in nature as the replacement, in this case, amounted to bringing into existence a new asset and also an enduring benefit for the assessee. The expenditure of the assessee here was not of a revenue nature and thus, could not be claimed as a deduction under section 37.

Section 245Q of the Income-tax Act, 1961, read with Articles 5 and 7 of the DTAA between India and Germany – Application for advance ruling

Indian sub-contractor's workplace cannot be treated as workplace of foreign enterprise and duration of work done by sub-contractor (whether more than sixty days or not) can also not be attributed to such non-resident

Pintsch Bamag, In re, (AAR)

The applicant, a Germany Company, is awarded a contract by Tuticorin Port Trust ('TPT'). The scope of work is "work design, fabrication supply, installation, maintenance, etc. The applicant has sub-contracted most of the work to an Indian sub-contractor. The applicant undertakes the work of study of the technical requirements, designing, supply of official components to sub-contractors supervision of installation to be done by the sub-contractor. According to the applicant it has no PE in India and that the supervisory operations which it will have to carry out at the time of installation and commissioning by the sub-contractor would be only for 2 months and therefore no PE exists nor can be deemed to exist. Further, under the terms of the DTAA between India and Germany, business profits received by the applicant cannot be subjected to tax in India.

The Authority for Advance Rulings held that it is not possible to hold that the place of manufacture of the sub-contractor situated far away from the installation site should notionally be regarded as part of the applicant's permanent establishment. The language of the opening para of Article 5 of the DTAA itself furnishes a key to the correct understanding of the concept of PE. The fixed place of business referred to in para 1 of Article 5 is qualified by the words "through which the business of an enterprise is carried on". The concept of PE conveys the idea that the enterprise's presence has to be "visible" through an establishment in the other country. The objective presence of the foreign enterprise in the other country as reflected in a fixed place of business is the real criterion for determining the existence or otherwise of PE in that country. The entirety of work of fabrication and assembly is carried out by the sub-contractor at the workshop set up by him at a place for away from installation site and run by him independent of any control of the applicant. Such a place of business of sub- contractor cannot be regarded as the PE of applicant. In any case, the language of section 5(1) being clear and as the concept of PE does not take in the establishment of an independent contractor or agent. In the present case, the applicant is not relieved of the liabilities and obligations under the contract by reason of sub-contract. It is difficult to infer that a fixed place of business existed through-out, with the applicant's personnel making use of the same with frequency and regularity. An occasional or brief visit by some of the employees of the applicant right from the beginning does not give rise to inference of the existence of PE.

Taking an overall view, it appears the need for setting up the PE would arise sometime before the installation and commissioning operations begin. Since the duration of the applicant's activities at the site/yard as well as the supervisory activities at the stage of installation and commissioning will not exceed six months, it is not possible to hold that the applicant has or will have a PE in India. Hence, its business profits arising from the periodical payments made by the port trust as a consideration for the contract cannot be subjected to tax under the Income-tax Act, 1961 in view of Article 7.1 of the DTAA.

Section 194-I of the Income-tax Act, 1961 – Deduction of tax at source – Rent

Where assessee shares fees collected from students with franchisee and a part of such share is on account of infrastructure facility provided by franchisee, payment related to infrastructure cannot be treated as rent, and thus assessee was not liable to TDS under section 194-I

Commissioner of Income Tax *vs.* NIIT Ltd (DEL.)

The assessee-company was engaged in the business of providing computer education and training through franchisees. Under the arrangement the assessee was required to provide the courseware and expertise while the franchisees were required to provide the infrastructure facilities like class room facility, equipment, furniture, fixture, administrative set up, etc. The fees collected from the students were deposited in the account of the assessee and then those were shared with the franchisees on account of Marketing and using franchisee infrastructure. The revenue's case was that the assessee was liable to deduct tax under section 194-I in respect of the payment made to the franchisee under the head "Infrastructural claims".

The Delhi High Court held that the relation between the parties in the present case was not of a lessor and lessee. Only a limited license was granted by the assessee-company to the franchisee (i.e., the licencee) for use by the licensee of the trademark and trade name of the assessee company for the education centre. The licensor had right to protect its technical know-how and its trade-mark/trade name. The charges which were payable to the assessee company by the licensee were not fixed and were variable as per the number of students. It was to be noted that (i) the assessee company instead of giving a deposit which it would have done if it was a tenant, in fact receives a security deposit from the licensee, (ii) the assessee never got possession of the premises, and (iii) there was no minimum guarantee in the agreement.

The agreement clearly showed that the agreement was a franchise agreement and it could not be said that by the agreement, rent was in fact being paid by the assessee-company to the licensee. No doubt, the charges had been broken up under two heads viz. that of, marketing claim and infrastructure claim. However, the agreement was an agreement as a whole and such a composite agreement could not be broken up. The provision of section 194-I could not be read to break up composite contracts and when that was not the intention of the parties themselves. Resultantly, the assessee was not liable to deduct tax at source.

Section 80-IB of the Income-tax Act, 1961 – Deductions – In respect of profits and gains from certain industrial undertakings other than infrastructure development undertakings

Duty drawback receipt/DEPB benefits do not form part of the net profits of eligible industrial undertaking for the purposes of Sections 80-I/80-IA/80-IB

Liberty India vs. Commissioner of Income Tax (SC)

The appellant, 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. It claimed deduction under Section 80-IB on the increased profits of Rs. 22,70,056 as profit of the industrial undertaking on account of DEPB and Duty Drawback credited to the Profit & Loss account, which was denied mainly on the ground that the assessee(s) had failed to prove the nexus between the receipt by way of duty drawback/DEPB benefit and the industry.

The Supreme Court held that section 80-IB provides for allowing of deduction in respect of profits and gains derived from the eligible business. The words "derived from" are narrower in connotation as compared to the words "attributable to". In other words, by using the expression "derived from", Parliament intended to cover sources not beyond the first degree.

The devices adopted to reduce or inflate the profits of eligible business has got to be rejected in view of the overriding provisions of sub-section (5) of Section 80-IA, which are also required to be read into Section 80-IB [see Section 80-IB(13)]. Sections 80-I, 80-IA and 80-IB have a common scheme and if so read it is clear that the said sections provide for incentives in the form of deduction(s) which are linked to profits and not to investment. On analysis of Sections 80-IA and 80-IB it becomes clear that any industrial undertaking , which becomes eligible on satisfying sub-section(2), would be entitled to deduction under sub-section (1) only to the extent of profits derived from such industrial undertaking after specified date(s). Hence, apart from eligibility, sub-section (1) purports to restrict the quantum of deduction to a specified percentage of profits. This is the importance of the words "derived from industrial undertaking" as against "profits attributable to industrial undertaking".

DEPB – It is an incentive. It is given under Duty Exemption Remission Scheme. Essentially, it is an export incentive. No doubt, the object behind DEPB is to neutralise the incidence of customs duty payment on the import content of export product. This neutralisation is provided for by credit to customs duty against export product. Under DEPB, an exporter may apply for credit as percentage of FOB value of exports made in freely convertible currency. Credit is available only against the export product and at rates specified by DGFT for import of raw materials, components etc.. DEPB credit under the Scheme has to be calculated by taking into account the deemed import content of the export product as per basic customs

duty and special additional duty payable on such deemed imports. Therefore, in our view, DEPB/Duty Drawback are incentives which flow from the Schemes framed by Central Government or from Section 75 of the Customs Act, 1962, hence, incentives profits are not profits derived from the eligible business under Section 80-IB. They belong to the category of ancillary profits of such Undertakings.

Duty drawback – Section 75 of the Customs Act, 1962 and Section 37 of the Central Excise Act, 1944 empower Government of India to provide for repayment of customs and excise duty paid by an assessee. The refund is of the average amount of duty paid on materials of any particular class or description of goods used in the manufacture of export goods of specified class. The Rules do not envisage a refund of an amount arithmetically equal to customs duty or Central Excise duty actually paid by an individual importer-cum-manufacturer. Sub-section (2) of Section 75 of the Customs Act requires the amount of drawback to be determined on a consideration of all the circumstances prevalent in a particular trade and also based on the facts situation relevant in respect of each of various classes of goods imported. Basically, the source of duty drawback receipt lies in Section 75 of the Customs Act and Section 37 of the Central Excise Act.

Analysing the concept of remission of duty drawback and DEPB, it is clear that the remission of duty is on account of the statutory/policy provisions in the Customs Act/Scheme(s) framed by the Government of India. In the circumstances, we hold that profits derived by way of such incentives do not fall within the expression "profits derived from industrial undertaking" in Section 80-IB.

Analysing AS-2 and relevant Guidance Note issued by the Institute of Chartered Accountants of India (ICAI), it was to be held that duty drawback, DEPB benefits, rebates etc. cannot be credited against the cost of manufacture of goods debited in the Profit & Loss account for purposes of Sections 80-IA/80-IB as such remissions (credits) would constitute independent source of income beyond the first degree nexus between profits and the industrial undertaking.

In the circumstances, it is to be held that Duty drawback receipt/DEPB benefits do not form part of the net profits of eligible industrial undertaking for the purposes of sections 80-I/80-IA/80-IB.

Section 80G of the Income-tax Act, 1961-Deductions-Donations to certain funds , charitable institutions, etc.
Where a trust imparting education is otherwise qualified for exemption under sections 11 and 12, it cannot be denied registration merely on ground that it is charging some fees

Gaur Brahmin Vidya Pracharini Sabha *vs.* Commissioner of Income Tax (Delhi-Trib.)

Where the assessments for earlier assessment years revealed that the assessee trust was eligible for exemption under sections 11 and 12 and the assessee trust was granted registration under section 12AA, it was a testimony to the fact that the trust is established for *charitable purposes.*

Even though the assessee received fee for imparting education and the education being charitable purposes defined in section 2(15) without any condition, such income derived would not be liable to inclusion to the extent to which such income was applied for charitable purposes in India. Education is per se charitable purposes as defined in section 2(15). The same will be charitable purposes irrespective of the fact that for imparting education, the assessee charges fee. There is no condition to hold that to become charitable purposes in respect of imparting education, the same should be imparted free of cost or without charging any fee. So long as imparting education is not for the benefit of any particular religion, community or caste as envisaged in sub-clause (iii) of sub-section (5) of section 80G, the assessee could not be denied exemption.

A trust or fund, which imparts education without charging fee will qualify for exemption under sections 11 and 12 but that does not mean that other trusts which are charging fee for imparting education will not be considered to be charitable purposes. The Act is contemplating exemption being granted to an eligible trust or institution in respect of its income. Thus, it is manifested that only when there will be income, the claim of exemption will arise. In such a situation what the statute envisages is that there are all chances of trust or institution earning income by way of surplus so as to grant them exemption under sections 11 and 12 and subject to condition prescribed under section 11(5) and section 13. If the trust or institution is not expected to earn surplus, there would not have been any question of allowing exemption from tax liability. The Scheme of the act allows exemption from tax liability; and the same can be only when it is envisaged that the trust or institution is likely to earn surplus. Thus, merely because from the activities in the nature of charitable purposes, a trust makes surplus which is within the limitation prescribed under section 11(1)(a), there cannot be any ground to hold that the trust is not carrying on any charitable purposes so as to deny registration under section 8QG(5).

Section 194-H of the Income-tax Act, 1961 - Deduction of tax at source - Commission or brokerage

If cellular telephone service provider allows some margin to distributors in form of discount/ commission on market price of prepaid cellular connection and recharge coupons, such margin cannot be termed as 'commission' attracting deduction of tax at source under section 194H.

Asstt. Commissioner of Income Tax *vs.* Idea Cellular Limited (Hyd. – Trib.)

The definition of expression 'commission or brokerage' as contained in clause (i) of Explanation to section 194-H, is not so wide that it would include any payment receivable, directly or indirectly for services in the course of buying or selling of goods. To fall within the said *Explanation,* the payment received or receivable, directly or indirectly, by a person acting on behalf of another person (i) for services rendered (not being professional), (ii) for any services in the course of buying or selling goods, (iii) in relation to any transaction relating to any asset, valuable article or thing, the element of agency is to be there in case of all services or transactions contemplated by *Explanation (i)* to section 194H.

For application of the provisions of section 194H there should be in existence the relationship of principal and agent in order to bring the discount in the ambit of commission of brokerage. Under the definition of expression 'commission or brokerage' as contained in clause (i) of Explanation to section 194-H, it is not so *wide* that it would include any payment receivable, directly or indirectly for services in the course of buying or selling of goods. Where a cellular telephone service provider, at the time of selling its prepaid cellular connections and recharge coupons to the distributors, allows some margin to its distributors in the form of discount/commission on the market price, discount allowed on transactions resulting in outright purchases cannot be treated as brokerage or commission; more so when the transactions between cellular telephone provider and the distributors were on principal to principal basis and not on principal and agent basis. Hence, it could not be said that the service provider was defaulter in deducting tax at source.

Section 271(1)(c) of the Income-tax Act, 1961 – Penalty –Concealment of income

Penalty spoken of in Section 271(1)(c) is neither criminal nor quasi-criminal but a civil liability; albeit a strict liability; such liability being civil in nature, *mens rea* is not essential

Commissioner of Income-tax, Delhi vs. Atul Mohan Bindal (SC)

During the assessment proceedings, it transpired that assessee worked with Singapore DHL during the previous year and was paid salary and received an amount as retrenchment compensation and also received an interest amount from the Bank in Singapore. The Assessing Officer added all these three receipts to the total income of the assessee and also imposed penalty under Section 271(1)(c). The assessee accepted the order of assessment but challenged the order of penalty in appeal before the CIT (Appeals). The CIT (Appeals) set aside the order of penalty on the ground that the assessee has neither concealed the particulars of his income nor he furnished any inaccurate particulars thereof. The order of CIT (Appeals) was accepted by the Tribunal as well as the High Court.

The Supreme Court held that the penalty spoken of in Section 271(1)(c) is neither criminal nor quasi-criminal but a civil liability; albeit a strict liability. Such liability being civil in nature, mens rea is not essential. In the case of Union of India and Others vs. Dharamendra Textile Processors (2008) 306 ITR 277, this Court held that the Explanation appended to Section 271(1)(c) indicates element of strict liability on the assessee for concealment or for giving inaccurate particulars while filing the return.

Insofar as the present case was concerned, as noticed above, the High Court relied upon its earlier decision in Ram Commercial Enterprises which is said to have been approved by this Court in Dillip N. Shroff. However, Dillip N. Shroff has been held to be not laying down good law in Dharamendra Textiles. Dharamendra Textiles is explained by this Court in Rajasthan Spinning and Weaving Mills. Therefore, the matter was to be reconsidered by the High Court in the light of the decisions of this Court in Dharamendra Textiles and Rajasthan Spinning and Weaving Mills.

Section 194-J of the Income-tax Act, 1961 – Tax deducted at source – Fees for professional or technical services
In field of health insurance, it is Third Party Administrator (TPA), and not insurance company, who pays amounts to hospitals, TPA is required to deduct tax at source under section 194J

The Medi Assist India TPA P. Ltd. -*vs.* DCIT (KAR)

The health insurance companies issue cashless mediclaim policies, which are serviced through the Third Party administrator (TPA). Any policyholder enters into a contract with the insurance company while the insurance company enters into an agreement with the TPAs to service their policies. The insurance company enters into an agreement with the TPAs for the purpose of payment or reimbursing the amount which is spent by the policy holder. The TPAs have a network of hospitals. After the treatment of the policyholder, the hospital sends the bill to the TPA. The TPA processes claim and the payment is released to the hospital directly. The TPA gets reimbursed of all the amount of claim processed. According to the TPA, the payments are made in fulfillment of the contractual obligations between the insurance company and the policy holder and not towards rendering any professional services. So, TPA cannot be held liable to deduct tax at source under section 194J at time of payment to hospitals.

The Karnataka High Court held that a TPA is responsible for making the payment to the hospital for rendering the medical service to the policy holders. The liability of the insurer is only of replenishing of the funds. After the transfer of funds the control of the funds is with the TPA, i.e., when once the amount is deposited in the float fund account. The application of the funds is left to the contracting party, i.e., the insured and the TPA. The ultimate party who pays the amount to the hospital is the TPA. In fact there is no agreement between the insurer and the hospitals. The agreement is essentially between the TPA and the hospitals. In this circumstance, it cannot be said that the TPA who is the authority or the person to pay the amount to the hospital is not required to deduce the tax at source.

Section 10 (22) of the Income-tax Act, 1961 – Educational institutions
State text book corporations are constituted to implement education policy of States and, consequently, should be treated as educational institution

Assam State Text Book Production and Publication Corporation Limited *vs.* Commissioner of Income Tax, (SC)

The assessee state text book corporation was a Government Company. It was controlled by the State of Assam. The aim of the said Corporation was to implement the State's policy on Education. Since Memorandum and Articles of Association only provided a Return on Investment to the State of Assam, the revenue took stand that the assessee's income was not exempt under Section 10(22).

The Supreme Court held that in a similar situation, "CBDT" had granted exemption under Section 10(22) *vide* letter dated 19-8-1975. Further, in the letter of the Central Government dated 9-7-1973, stipulated that all State-controlled Educational Committee(s)/Board(s) have been constituted to implement the Educational policy of the State(s), and consequently, they should be treated as Educational Institution. Therefore, the assessee's income was exempted under section 10 (22).

Section 80-IB of the Income-tax Act, 1961 – Deduction – profits and gains from certain industrial undertakings other than infra-structure development undertakings
Integrated activities of processing, preservation and packaging of fruits or vegetables are embraced within scope of sub-section (11A) of Section 80-IB.

Mrs. Delna Rustum Boyee, In Re, (AAR)

The integrated activities of processing, preservation and packaging of fruits or vegetables are embraced within the scope of sub-section (11A) of Section 80-IB. Notwithstanding the extent of processing and the changes that occur to the original commodity by reason of series of operations, it could still amount to processing of that original commodity.

Processing and preservation are two distinct expressions used side by side. Processing may be for the limited purpose of preservation of fruits without bringing about much change in the form of the fruit. But, 'processing' in the context in which it occurs ought not to be confined only to the operations that would ensure the preservation of fruits as they are, or in the form of slices. In other words, the expression should not be confined to minimal processing that would not change the identity of the fruit. If processing and preservation is to be confined only to fruits as such and not to the derivatives from the fruits, the benefit intended to be given to agro-processing industries will operate in a very limited sphere, thereby defeating the very object of the provision. The extraction of juice and oil from the fruits or further converting the homogenized juice into fruit powder and adding the substances meant for preservation would legitimately fall within the

sweep of the expression 'processing'. The fact that the fruit assumes a different form or that a series of operations are involved in preparing the mixed juices and concentrates which could be preserved for long does not take it out of bounds of processing. Processing in its wider sense would still be aptly applicable. Such activity would be eligible for deduction.

Section 154 of the Income-tax Act, 1961 – Rectification of mistakes

Period of limitation provided under section 154 is to be reckoned from date of fresh order under section 143(3) giving effect to order of appellate authority

Commissioner of Income Tax vs. Tony Electronics Limited (DEL)

Once an appeal against the order passed by an authority is preferred and is decided by the appellate authority, the order of the said authority merges into the order of the appellate authority. With this merger, order of the original authority ceases to exist and the order of the appellate authority prevails, in which the order of the original authority is merged. For all intent and purposes, it is the order of the appellate authority that would be seen.

The original order of assessment ceases to operate on the decision given by the Commissioner (Appeals) and merges with the orders of the appellate authority. Acting upon order of the appellate authority the Assessing Officer passes assessment order, giving appeal effect thereto. Thus, it is the order passed by the Commissioner (Appeals) which remains on record for all intent and purposes as the original order of assessment merges.

When the order is passed during the re-assessment of proceedings, initial order of proceedings does not survive in any manner or to any extent. This principle would be applicable also when the assessment order is challenged in the appeal and appellate authority passes order at variance with the orders passed by the Assessing Officer, on the basis of which fresh order under section 143(3), read with Section 250 is required to be passed by the Assessing Officer giving effect to the order of the Appellate Authority. No doubt, the rectification order passed under section 154 would mean the assessment order as rectified and the assessment order is not obliterated thereby. Once rectification order under section 154 of the Act is passed it would mean that the appeal effect order is rectified. Limitation under section 154(7) is not to be calculated with reference only to the date of original order of assessment, it is to be reckoned from date of fresh order giving effect to order of appellate authority.

Section 172 of the Income-tax Act, 1961 – Shipping business of non-residents

Shipping profits are not covered by DTAA between India and Switzerland and they have to be taxed under domestic Law; freight income received by Swiss ship operator on account of carrying cargo from Indian ports to foreign ports by deploying chartered vessels is liable to be taxed in India under provisions of the Income-tax Act, 1961

Gearbulk AG, In re, (AAR)

According to Article 7.1 of Indo Swiss DTAA, the profits arising from the operation of ships in international traffic stands excluded from the Article dealing with business profits. Article 8 makes a special provision in respect of the profits derived from the operation of aircraft in international traffic. Such profits shall be taxable only in the State to which the enterprise belongs. That means the State of residence can alone tax such profits and the existence or otherwise of a permanent establishment which is an ingredient of Article 7 is not material under Article 8. Then, the Treaty proceeds to deal with various other items of income.

There are unmistakable indications in the Treaty provisions to show that shipping business income earned by a non-resident is not intended to be covered by the Treaty. The language and scheme of the provisions, the possible incongruities that would otherwise arise and a comparative study of other Treaties would lead to the inevitable conclusion that shipping income derived from international operations is outside the purview of the Treaty and it is left to be taxed under the domestic law.

The obvious implication of exclusion the operation of ships in international traffic by virtue of exclusion clause in Article 7 is that such income can be subjected to domestic law discipline. Therefore, such income was liable to be taxed in accordance with and in the manner laid down in Section 172 of the IT Act. Neither a separate article is devoted to it nor is there explicit language in Article 22 to bring shipping income within the coverage of that Article. The shipping income has been dealt with under Article 7. Profits from the international operation of ships are only a species of business profits just as the profits from international air transport. The latter is dealt with separately in Article 8 for the reason that it does not fall in line with the scheme of taxation of business profits under Article 7. Exclusive right is given to the State in which the

enterprise resides. Permanent Establishment test is irrelevant under Article 8. Hence, a separate Article. As far as the profits from international operation of ships are concerned, it is an integral part of business profits; at the same time, they are excluded from the business profits-Article for the obvious reason that it is not intended to be covered by the Treaty. That income has been left to the care of domestic law under which the burden of taxation on such income has been minimized (*vide* Section 172 of IT Act). A particular species of income which is specifically referred to in Article 7 and deliberately left out of its genus, namely business profits, cannot be said to be an item of income not dealt with under Article 7.

The exclusion clause in Article 7 clearly reflects the conscious decision of the authors of the Treaty not to treat the shipping profits at par with the business profits for the purpose of allocating the taxing jurisdiction to the States concerned. In that way, the subject of shipping profits had been dealt with under Article 7. It is not an uncovered or untreated item. Therefore, for the purposes of Article 22, profits arising from the operation of ships in international traffic cannot be treated as a distinct item of income not dealt with in the preceding Articles of the Treaty. No doubt, there appears to be a good reason for vesting the exclusive power of taxation on the country of residence of the business enterprise concerned in the case of both international shipping and air transport. However, in the absence of clear words in the Indo-Swiss Treaty, the shipping profits arising from international operations cannot be placed at par with the profits from the business of international air transport. Whether or not to accord the same treatment to the international shipping business is a matter of policy and it is left to the wisdom and volition of the sovereign representatives at the negotiating table.

Whenever it is intended to cover the shipping income under the provisions of any DTAA, a separate provision has been made therefore. Under Indo-Swiss DTAA, shipping income would be taxed under section 172 of the Income-tax Act, 1961.

Section 195 of the Income-tax Act, 1961, read with Articles 7 and 12 of Indo-US DTAA
Where US company provides centralised assistance to its Indian subsidiary and most of services are managerial in nature and further, US company does not 'make available' to Indian subsidiary technical knowledge, etc., within the meaning of Article 12.4(b) of Treaty, payment to be made by Indian company towards cost allocated by US company will not be taxable in India.

Invensys Systems Inc., In re, (AAR)

The applicant a US based company, is engaged in the business of manufacture of process control instruments, engineering and research and technology based services, co-operative or consortium services, etc. The applicant entered into an Agreement titled as Cost Allocation Agreement with its Indian subsidiary. The Centralised Assistance functions provided by the applicant are (i) Environmental Health & Safety (EHS), (ii) Overall operations assistance, Human Resource ('HR') support, learning & development initiatives, (iii) Assistance on key projects, (iv) Finance, internal audit, treasury and tax, and (v) Corporate secretarial and legal support.

The Authority for Advance Rulings (AAR) held that the term “technical” ought not to be confined only to technology relating to engineering, manufacturing or other applied sciences. Professional service imbued with expertise could be regarded as technical service. Consultancy services could also be regarded as 'technical' in nature and the two expressions “technical” and “consultancy” cannot be placed in water-tight compartments.

Further, many or most of the functions are managerial in nature. The services are not really technical or consultancy services. The expression “technical services” cannot be construed in a narrow sense. Though some of the services required to be performed under the agreement have the trappings of technical or consultancy services, looking at the substance and the predominant nature of the services, they primarily fall under the category of 'managerial'.

Assuming that some of the services/functions can be brought within the definition of technical or consultancy services, yet the other ingredient in clause (b) of Article 12.4 of DTAA viz. “make available” is not satisfied in the instant case. The services even if they are technical, did not 'make available' the technical knowledge, etc. within the meaning of Article 12.4(b) of the treaty. Some services are *prima facie* activities which either help the applicant as a corporate head (co-ordinator) with the necessary inputs or merely represent the normal activities undertaken by the parent company. It is not some remote or indirect benefit that accrues to the group companies. The alleged service must cater to the specific needs of the member of the group. The costs relating to reporting requirements of the parent company including the consolidation of reports will constitute shareholder activities.

Assuming that some of the activities are not really services but they are more in the nature of stewardship/ shareholder activities, the amounts received by the applicant from IIPL in terms of the invoices raised by it cannot be taxed in India in the absence of permanent establishment of the applicant.

Section 273A of the Income-tax Act, 1961 – Power to reduce or waive penalty, etc.
Party applying for reduction/waiver of penalty/interest must make out a case of genuine hardship

Shardadevi P. Jhunjhunwala *vs.* Commissioner Income Tax, (BOM)

In the absence of placing material, petitioners cannot be heard to complain that there was non compliance by the respondent commissioner in considering the case under section 273A(4), particularly where no material been placed before this Court to show hardship that would be occasioned to the assessee. Where the Commissioner has recorded a finding the assessee has not produced any evidence to show that he does not have adequate financial resources, that by itself must have met the test. However, in the absence of the assessee placing any other material on hardship, the findings recorded by the Commissioner cannot be faulted with. Section 273 is an independent power notwithstanding anything contained in the Act. Therefore, even if interest and penalty has been levied in proceedings for adjudication, the respondents have power under section 273A to reduce the penalty or interest under section 273A as it then stood. The test for waiver or reduction for exercise of discretion are different. Under section 273(4) the party applying must make out a case of genuine hardship.

Section 273A of the Income-tax Act, 1961 – Power to reduce or waive penalty, etc. in certain cases
In so far as section 273A(1) is concerned, disclosure must be voluntary; where a diary found during search contained incriminating material based upon which additional income was disclosed, merely because assessee co-operated in deciphering documents would not mean that revenue authorities could not have deciphered same and, thus, it was not a fit case for reduction/waiver of penalty/ interest

Shardadevi P. Jhundhunwala *vs.* Commissioner Income Tax, (BOM)

Search operations were carried out in the premises of the petitioners. Various incriminating documents including one diary was also seized. According to petitioners, the disclosure was made on the clear understanding from the concerned authorities that there would be no penal liability and penal interest, if any would be waived; to avoid litigation and to buy peace of mind, the offer was made at the much higher figure. The notings in a particular diary could not have been deciphered by anyone except one or two persons from petitioner group. Without their initiative, help and assistance nothing could have been found by the department authorities from the said diary. In these circumstances, no penalty and interest could have been levied.

The Bombay High Court held that the diary contained incriminating material based upon which the additional income was disclosed. Merely because petitioners co-operated in deciphering the documents would not mean that the respondent revenue authorities could not have deciphered the same. The test is whether any incriminating material was found. On the petitioner's own statement the diary contained incriminating material. The application was made after that incriminating material was found. In these circumstances, the contention urged on behalf of the petitioners must be rejected.

In so far as section 273A(1) is concerned, the disclosure must be voluntary. The return was based on additional income contained in the incriminating material contained in a particular seized diary. It is obvious if the material had not been seized during search and seizure operations, the income in terms of the diary could never have been disclosed as in the case of the past years. In the circumstances, if the revenue has come to the conclusion that it was not voluntary, and if they had refused to grant relief, it would not be a fit case for the Court to exercise its extraordinary jurisdiction.

Section 9 of the Income-tax Act, 1961 read with Indo-US DTAA
Where US Company granted Indian Company a perpetual irrevocable right to use know-how and transferred ownership in tread and sidewalk designs/patterns (TSD) required for manufacturing radial tyres, consideration for know-how is taxable in India while that for TSD transfer is not taxable; further, consideration received for consultancy, assistance and training is also taxable

International Tire Engineering, In re, (AAR)

Being approached by Indian Company CEAT, the applicant-US company agreed (i) to grant CEAT a perpetual irrevocable right to use the know-how as well as to transfer the ownership in tread and side-wall designs (TSD) and patterns required for the manufacture of radial tyres for a lump sum consideration. The applicant's case was that the sale and transfer of technology know-how took place in USA and the documents were executed in USA and, hence, tax liability in India does not arise. The Authority for Advance Ruling held as follows:

Know-how: The transfer of technical documentation was only a step in aid for making the technical know-how available to the transferee CEAT. The essence and predominant nature of the transaction is the transfer of technical know-how to CEAT in the sense of granting the right to use the know-how which is basically contained in the documents. What is more, the applicant has undertaken to extend all the technical assistance and advice, of course for a consideration, in order to ensure that the know-how is put to effective and proper use. The crux of the transaction is to disseminate and divert the technical know-how, knowledge and informations for the use of the Indian enterprise for the purpose of manufacture of radial tyres. It is worthy to note in this connection that 20 per cent of the consideration for technology transfer is payable only on "successful completion of the outdoor tests of selected products as per the agreed criteria referred in Annexure IIIA". Viewed from any angle, it is inappropriate to say that the consideration is only the price of technical documents allegedly sold in USA.

It must be remembered that the deeming provisions embodied in clauses (vi) & (vii) of section 9 of IT Act were introduced with a view to reach at the income arising to the non-resident by reason of making available to an Indian enterprise the technical know-how, knowledge and informations. With a similar object in view, Article 12 has been included in the Treaty. If in all cases of transfer of know-how documents from the State of residence of transferor, the taxing jurisdiction of the other State is to be ousted, there may hardly be any occasion to apply the royalty or FTS provisions. Those provisions would virtually become ineffective if not otiose.

Secondly, even the assumption or assertion of the applicant that the so-called transaction took place outside India is open to doubt. The Agreement dated 4-9-2008, was executed in India (in Mumbai). There is a declaration that "the transferee shall be entitled to and shall have the right to the know-how documentation immediately on receipt of the same". Obviously, the documents, which are sent through the Courier, are received in India. Moreover, the transferee, i.e., CEAT will derive the rights under the Agreement only on that date. The transfer is not complete till then. The mere entrustment to the Courier for delivery to the transferee is not decisive especially in view of the qualification that the delivery will be effected to the transferee "against invoices and related documents". One thing is clear, that the delivery is not automatic. The delivery seems to be conditional on the transferee/addressee presenting certain documents to the Courier at the time of delivery. Thus, no inference of constructive delivery in US can possibly be drawn. The delivery-schedule ranges between 1 month (from the effective date) and 9 months. It is not, therefore, a case of delivery of technical documentation once and for all, contemporaneous with the signing of Agreement. The delivery-schedule is staggered over a long period of time and none can presume that such deliveries would take place or have taken place in US from time to time. In the absence of any material placed in this behalf, the reasonable presumption to be drawn is that the delivery of various documents, which is an integral part of the Agreement signed in India, would take place in India. The transferee, as already noted, acquires rights only on receipt of the documents in India.

The nature and content of the right transferred is the right to use the technology or the technical know-how supplied by the applicant for setting up the plant for the manufacture of radial tyres and to adopt the know-how in relation to the products that may be developed or manufactured in future in any manufacturing unit of the transferee-CEAT. Not only that, the applicant will provide to CEAT technical service assistance and train CEAT's personnel for making use of the know-how supplied by it on proper lines. Otherwise, the know-how and underlying technology will only remain on paper. In fact, it has been expressly stated that the transferee will not be able to use the know-how unless the applicant trains CEAT's personnel at the plant. Thus, the crux and predominant feature of the transaction involving the transfer of know-how is to equip CEAT with all that is necessary to effectively put the know-how to use. The know-how and technology, which was within the exclusive domain of the applicant, is parted with in favour of CEAT by granting non-exclusive but perpetual right to use the know-how and by putting in place the requisite measures to enable the transferee to effectively utilise and absorb the same. It cannot be doubted that the technology/know-how transfer gets covered by more than one sub-clause of Explanation 2 to section 9(1)(vi), i.e., sub-clauses (i), (ii) and (iv). The services in the form of technical assistance and consultancy connected with those items fall under sub-clause (vi).

Therefore, the consideration received towards technology transfer/ technical know-how and the services connected therewith are clearly liable to be taxed as royalty under section 9(1)(vi) of the Income-tax Act, 1961. The power of taxation in this regard cannot be denied to the Indian Government from the standpoint of territorial nexus.

The technical know-how embodied in various documents is received by the applicant in India from time to time and is put to use in India with the assistance and advice offered by the technical personnel of the applicant deputed to India. The role played by the applicant is perceivable at every stage till the plant is set up and the goods are manufactured. No doubt can possibly arise from the stand point of territorial nexus.

Though there is substantial similarity between Article 12 and section 9(1)(vi) of the Act, the definition of 'royalties' under the Treaty is more restrictive in scope than the definition contained in Explanation 2 to Section 9(1)(vi). In contrast with the wider expression used in Explanation 2 to Section 9(1)(vi), it is seen that para 3(a) of the Treaty uses the expression "consideration for the use of or the right to use". The use or right to use is related to the various items enumerated in clause (a) of para 3. The design, plan and secret formula or process is among the enumerated items. Moreover, the

information concerning industrial, commercial or scientific experience is another item mentioned in para 3(a) of Article 12. Thus, the know-how transfer squarely falls within the definition of 'royalties' in para 3(a). The consideration, which the applicant receives for the right to use the know-how, amounts to 'royalties' within the meaning of clause (a) of para 3 of Article 12. It is not appropriate to describe the transaction as a pure and simple sale of technical documentation. Thus, the payment received by the applicant squarely falls within clause (a) of Article 12.3. The applicant has no better case under the Treaty. Transfer of know-how and the grant of right to use know-how can be subjected to tax in India under the Income-tax Act, 1961, treating the same as deemed income by way of royalty.

TSD Design/Pattern: Having regard to the fact that the ownership in TSD designs/patterns is transferred absolutely to CEAT Limited, the consideration related thereto cannot be brought within the fold of royalty under Article 12.3 of the Treaty for the reason that it is not a case of merely authorising the use of or granting the right to use a design, plan or secret formula or process nor does it amount to furnishing information concerning industrial, commercial or scientific experience. Moreover, this part of the transaction cannot be viewed to be merely incidental to the conferment of right to use the know-how granted under clause 2 of the Agreement. It is, therefore, not liable to be taxed as royalty under the Treaty provisions. If at all, the transfer is deemed to have taken place within India, it amounts to business profits. It can be taxed only in the event of the profits resulting from the transfer of ownership being attributable to the permanent establishment (PE). But, in the present case, PE could possibly come into existence only after the event of transfer of ownership. The PE that may be set up for the purpose of rendering consultancy and technical services in connection with the transfer of know-how has no relation with the transfer contemplated by clause 3 of the Agreement. Hence, viewed from any angle, the amount of consideration related to the transfer of ownership in the tread and side wall designs/ patterns cannot be subjected to tax under the Income-tax Act, 1961. However, the consideration for product development stands on the same footing as transfer of know-how and is liable to be taxed under the Income-tax Act.

Consultancy and Assistance: The consultancy and assistance to be provided by the transferor relate to lay out and set up of the plant and manufacture of the products in the plant with the know-how provided by the transferor, guidance regarding the product quality tests and testing of raw materials, semi finished and finished products, conforming to and fulfilling the Project Master Schedule etc. The supervision services are to be provided at various stages of assembly, installation and commissioning of the machines as well as start up of the plant in conformity with the know-how. It also extends to products quality tests, supervision of
the transferee's personnel in relation to the set up of the plant and know-how implementation. It is stated under the head 'Training Services' that the transferor shall provide to the transferee's designated personnel full, complete knowledge and training of the know-how relating to technology, production process, machines etc. as well as the design, fabrication, assembly, inspection, operation and maintenance etc. of the plant. Moreover, there was obligation to train the transferee's personnel in the production, quality, technical and maintenance departments in the plant in relation to various specified aspects. The payments are to be made to the technical personnel deputed by the applicant according to the rates and mandays specified.

Undoubtedly, these services fall within 'included services' as defined in para 4 of Article 12 of the Treaty. There are two limbs in para 4 of Article 12: (a) the technical or consultancy services which are ancillary and subsidiary to the application or enjoyment of the right, property or information for which the payment described in paragraph 3 is received; and (b) make available technical knowledge, experience, skill, know-how, or processes, or consist of the development and transfer of a technical plan or technical design.

Whether or not the first limb applies, undoubtedly, the second limb is attracted in the instant case. The consultancy, assistance and training services make available to CEAT the technical knowledge, experience, know-how and processes so that the transferee-CEAT will be able to derive full advantage from the know-how supplied by the applicant and to equip itself with the requisite knowledge and expertise so that the transferee will be able to utilise the same even in the future ventures on its own and without reference to the transferor. The importance of consultancy and assistance services is highlighted by an express declaration in the agreement. The “transferor acknowledges that the transferee will not be able to use the know-how unless the transferor trains the transferee's personnel in the plant in order to be capable of designing, developing and manufacturing the products in accordance with the Know-how.” In the MOU concerning fees for included services appended to US-India Treaty, it is clarified: “generally speaking, technology will be considered 'made available' when the person acquiring the service is unable to apply the technology. The fact that the provision of the service does not *per se* mean that technical knowledge, skills etc. are made available to the person purchasing the service, within the meaning of paragraph 4(b)”. This test is satisfied in the instant case. The fee received by the applicant, therefore, falls within the scope of fee for included services as defined in para 4 of the Article 12 of the Treaty. The position in regard to the liability under the Act is equally clear. The definition of fee for technical services in Explanation 2 to clause (vii) of Section 9(1) is even wider in its scope and amplitude that the corresponding provision in the Treaty. The restrictive phrase “make available” is not there in the Act. The fee received constitutes fee for technical services or included services as per the Act and the Treaty.

The essential nature of transaction is not sale of property. It is the conferment of right to use the technical know-how not merely for the plant that is being set up but also for similar plants in the future. Secondly, the plethora of technical services to be rendered by the applicant in the form of consultancy, assistance and training cannot be regarded as merely ancillary and subsidiary to the sale even assuming that the sale of technical documentation is involved. They extend over a long period of time and the consideration payable therefore constitutes the major component of the contractual amount. The consideration received for consultancy, assistance and training is liable to be taxed as fee for included services under the Treaty and as fee for technical services under the Income-tax Act, 1961.

Section 37 of the Income-tax Act, 1961 – Business expenditure
Claim for depreciation on account of enhanced cost due to fluctuation in foreign exchange rate is admissible for deduction under section 37.

Commissioner of Income Tax *vs.* Maruti Udyog Ltd., (SC)

For Updation, visit www.taxpointindia.com regularly

*

* As published in the ICAI magazine – The Chartered Accountant