Tax News

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INCOME TAX

Reminder For July '10

Action Due	Due Date
Action Due	**Due Date**
TDS / TCS for the month of July 2010	07-08-10
PF for the month of July 2010	15-08-10
ESI for the month of July 2010	21-08-10

SERVICE TAX

Action Due	Due Date
Service Tax for the month of July 2010 in case of company	05-08-2010
Service Tax for the month of July 2010 in case of a company for which e-payment is mandatory.	06-08-2010

INCOME TAX

Vital Notifications / Changes

No circular to be reported in this edition.

SUPREME COURT / HIGH COURT DECISIONS

- **Taxability of fluctuation in foreign exchange rate:**

  In this case the Assessee claimed certain expenses on account of exchange rate fluctuation which were allowed as deduction in earlier year. The assessee made a provision in its accounts vis-à-vis these expenses in this relevant previous year. The AO was of the view that the amount set apart on account of exchange fluctuation should have been considered by the assessee while deducting TDS and since the assessee had not deducted TDS the same provision is not allowable.

  It was held by the Court that, the increase or decrease in the actual payment of the technical know-how fee would ultimately depend upon the foreign exchange fluctuation and that when a provision has been made on the basis of the existing exchange rate, and TDS has been deducted on the said sum, and in the event of there being any higher payment of fee made on account of fluctuation, it would not be necessary to deduct TDS on the said amount again as the same would have to be done when the amount is actually paid at a future date

  Since the Assessee is following the Mercantile System of Accounting, it is only in respect of the provision made in the accounts that the TDS amount would be deducted and the same would have been passed on to the department.

  Also that on account of the fluctuation in the foreign exchange if there would be a reduction of the technical know-how fee, then there is no provision for refund of the TDS which would have already been paid by the Assessee on account of the said fluctuation. *2010-TIOL-488-HC-KAR-IT in Income Tax*.

- **Cash Credits:**

  The assessee had claimed to have received unsecured loans from its erstwhile director and his daughter who was a present director. There was a confirmation letter of the loan amounting Rs. 5 crores but no particulars of bank statement or tax assessment was given. Daughter was a college student without any information of source of such a large deposit. Therefore the amount was added as cash credit in the absence of genuineness. *Toby Consultants P. Ltd. v. CIT (2010) 324 ITR 338.*

- Reporting of reasons in the **judgment:** It was held by the Supreme Court that the court should provide its own grounds and reasons for rejecting any claim of the assessee. Although there is no provision under Income Tax Act or under any constitution which require the recording of any reasons in the judgments but it is established through different judgments of the court that the courts and tribunals are required to pass reasoned judgments or orders. *Shukla & Brothers v. Asstt. Commissioner, Commercial Tax Deptt. Works contract & Leasing (2010)5.*

TRIBUNAL JUDGMENTS

- **Taxability of writing off of cash credit limits:**

  Assessee took some cash credit facility and a term loan from various financial institutions. Term loan was used by the assessee for purchasing capital assets and the cash credit loan was used for meeting day to day expenses.

Subsequently assesee was declared as sick industrial unit - accordingly it restructured its account and credited the amount of loan and interest waived to its P&L.

was observed by the Tribunal that in this case, loans written off in cash-credit account was different as the loans were received for carrying out day-to-day operations of the assessee. The benefit was in the revenue, as the monies had been borrowed for day-to-day operations and not for purchases of machinery. Thus, the loans were for working capital and not for fixed capital. The liability was also contractual in nature. Therefore, it was held that the amount written off by the banks in cash-credit accounts constituted the income of the assessee. *2010-TIOL-379-ITAT-DEL in Income tax.*

- **Whether loss arising on forward contract can be claimed as deduction:**

The assessee was a public limited company and had borrowed foreign currency loans for purchase of plant and machinery. In order to safeguard from the effect of foreign exchange fluctuation, the assessee had entered into forward contracts with authorized dealers. During the previous year relevant to the assessment year under appeal, the assessee had actually settled such forward contracts and thereby incurred a loss. This loss was claimed by the assessee in computing its taxable income. The Assessing Officer disallowed the claim on the grounds that a) the payments were not actually made by the assessee, and b) forward contracts were not covered by sec. 43A.

The tribunal held that, section 43A inserted through Finance Act 2002 made it clear that any adjustment as to increase or decrease in the foreign exchange liability could be made only in the previous year in which the foreign exchange account was settled by an assessee. In case of assessee's appeal, the amended law of sec. 43A was applicable. The foreign exchange contracts were made by the assessee for the purpose of acquiring capital assets and the forward contracts were settled during the previous year relevant to the assessment year under appeal. Therefore, the claim of the assessee to adjust for the loss was allowable.

Other issues which were discussed in this case were:

- Where an assessee is under bonafide belief that income is not chargeable to tax, interest cannot be levied u/s 234B.
- The issue regarding the amount of inter-corporate deposits written off by the assessee was entitled for deduction in computing the taxable income.
- The Debenture Redemption Reserve, even though in the nature of provision for ascertained liabilities, is in the capital account and cannot be deducted in computing book profits u/s 115JB.

For details, please refer to *2010-TIOL-358-ITAT-BANG in Income Tax.*

Taxability of welfare expenses: It was held that expenses incurred on social and welfare schemes for smooth running of business are allowable deduction u/s 37 of the Income Tax Act. *2010-TIOL-341-ITAT-MAD in Income Tax.*

- **Exclusion of exempted capital gain while calculating book profits:**

The issue before the Tribunal was, whether in the absence of any provision for exclusion of exempted capital gain in the computation of book profit u/s 115JB, the assessee can exclude the same from the computation of Book Profit, or not.

The assessee filed return of income showing loss. It prepared its Profit and Loss account as per part II and III of schedule VI of

the Companies Act. Thereafter assessment u/s 143(3) was framed wherein the AO reduced the loss and made certain additions. While scrutinizing the records of the assessment the jurisdictional CIT observed that the assessee had earned capital gain on account of transfer of its assets to its parent company and had not offered the same for taxation under section 115JB. Accordingly, the CIT issued notice to the assessee. While filing reply to the show cause notice, the assessee contended that the capital gain accrued to it was completely exempt in view of the provisions of section 47(iv) and hence the same was not includable in the "book profits".
After hearing the parties at length and referring to the decision of Bombay High Court in the case of CIT Vs Veekaylal Investments Co.P. Ltd, the ITAT held that:

In the referred case, the Court had held that if for computing the total income under the normal provisions, the capital gain computed under sec 45 of the Act had to be taken into account, it was not understood how in computing the book profits under section 115J of the Act, the assessee could exclude capital gain. The assessee is required to take into account income by way of capital gain under sec. 45 of the Act. In the circumstances, while computing the book profits under the Companies Act, the assessee has to include capital gain for computing the book profits under sec. 115J. *2010-TIOL-355-ITAT-HYD-SB in Income Tax*.

SERVICE TAX

- **Important circular/ notification**

➢ **Transmission and distribution of electricity:** The Central Government hereby directs that the service tax payable on taxable services relating to transmission and distribution of electricity provided by the service provider to the service receiver, which was not being levied in accordance with the said practice, shall not be required to be paid in respect of the said taxable services relating to transmission and distribution of electricity during the period up to 26th February, 2010 for all taxable services relating to transmission of electricity, and the period up to 21st June, 2010 for all taxable services relating to distribution of electricity. *Notification No. 45/ 2010dated 20th July 2010.*

- **SC/HC Judgments**

➢ **Taxability of photography services:** The assessee M/s Vahoo Colour Lab, Fountain Chowk, Ludhiana was engaged in rendering service relatable to photography, developing and printing. The issue was whether the assessee was liable to pay the service tax on the value of goods/material consumed, during the course of processing of photography or not?

The assessee explained that the photography films, printing papers, chemical and envelopes are the integral and essential ingredients of their developing/printing job and without the use of the same, photography service cannot be provided. These expenses were stated to constitute a major portion of their expenditure, besides the expenditure of electricity, repair and maintenance of machines directly related to the processing of photography films. According to the assessee, the material bought and sold was chargeable to sales tax and was a State subject and Central Government had no power to tax purchase or sale of goods under the garb of service tax when they were not bought or sold in the course of inter-state trade.

The High Court held that the assessee had already paid the service tax on the value of service, but the claim of the Revenue was that the service tax was also leviable on the cost of material consumed during the course of processing of photography by the assessee. In case of *Bharat Sanchar Nigam Ltd. v. Union of India ,* the SC had held that if the

nature of transaction involved was composite contract of service and sale, and if the components of sale element were discernible, then both the components could not be re-mixed for the purpose of relevant tax.

Since it was not a matter of dispute that processing of photography cannot be completed without the developing and printing process, the photography films, printing papers, chemicals and envelopes are the integral and essential ingredients to complete the process of photography. Hence, the components of sale of photography, developing and printing etc. are clearly distinct and discernible than that of photography service.

As photography is in the nature of works contract and it involves the elements of both sale and service, therefore, as per the circumstances of the present case, the service tax is not leviable on the sale portion. *2010-TIOL-494-HC-P&H-ST in Service Tax.*

- **Taxability of courier services:**

The assessee was engaged in rendering courier service which involved collection of letters, parcels, articles etc from customers and then delivery of the same to the addressees. In this business, the assessee had engaged several agents who were named as Franchisees in the agreement between the assessee and them. These agents collected articles from customers along with service charges at the tariff prescribed by the assessee. These agents called Franchisees were also collecting service tax along with service charges from the customers while accepting articles and were remitting the same in their own name after registering with Central Excise Department in terms of Section 65(33) read with Section 65 (105)(f) of the Act. The entire service charges collected are stated to be passed on to the assessee and from out of the same, the assessee makes payment to the agents/franchisees at the rate fixed in the agreement.

The courier service operation therefore leads to sharing of substantial amount of charges collected from the customers with the franchisees and the assessee gets only the balance amount. The agreement provides for payment of remuneration to the agents/franchisees only for service charges recovered by them for the articles collected by them for delivery at various destinations.

The department wanted to tax net amount retained by appellant from out of the charges collected for courier service after payment to agents/franchisees towards value of 'franchise' service under Section 65(47) read with Section 65(105)(zze) of the Act. In effect, the service charges collected and shared between the appellant and the agents/franchisees got partly taxed twice for service tax under the Act, one under the head 'tax on courier service' and other under the head 'tax on franchise service'.

The question was whether the service charges collected from the customers on which tax was already paid for rendering courier service by the agents/franchisees after registering with the Department, could be subject to a further tax for franchisee service, to the extent of the net amount received by the assessee.

The Department had admitted the liability of the agents/franchisees for payment of service charges on the entire courier service charge recovered from customers and had therefore permitted them to register and remit the tax on regular basis.

High Court found from Section 67 that taxable service is the gross amount in money consideration received from the customers for service provided. In terms of section 67, the entire amount collected from the customers for rendering courier service is subject to tax at the hands of agent/franchisee. If a service falls under two heads, there is no provision in the Finance Act, 1994 to tax the very same service charges twice under two heads.

In this case, in fact, the agent/franchisee was not doing independent business but was only acting as agent for collection and delivery of parcel as agent in the courier service. Apart from appointing the agent/ franchisees, the assessee was not rendering any service to the franchisees. The franchisees also did not make any payment to the assessee which alone could be subjected to tax.

The High Court therefore held that the assessment and demand of tax from the appellant under Franchisee would not be allowed. *2010-TIOL-493-HC-KERALA-ST in Service Tax.*

- **CESTAT Judgments**

➢ **Taxability of space selling service:** With effect from 1-5-2006, any service to any person by any other person, in relation to sale of space or time for advertisement in any manner is taxable but it does not include sale of space for advertisement in print media and sale of time slots by broadcasting agency or organization.

It was held that as this service became effective only from 1st May 2006, therefore said activity could not be taxed by authorities prior to that date. *Margadarsi Marketing (P) Ltd. v. CCE (2010)5 Taxmann.com 84*.

➢ **Cenvat Credit:**

It was held that the scheme of Modvat or cenvat which provides for the facility of availing credit in respect of duty incurred on raw materials to be utilized in the manufacture of the dutiable final product clearly requires proper utilization of such credit in accordance with the provision of law, otherwise availment of such credit would be rendered unlawful. To avail the credit lawfully the raw material on which the same is sought to be availed must be utilized in the manufacture of final dutiable product, and credit earned thereon, should also be utilized for payment of duty on the final product. Till both the credit earned and the product on which credit is earned are lawfully utilized, it can not be said that credit has been lawfully and completely utilized. Of course, the utilization of credit and utilization of input may not necessarily be utilized in relation to one and the same final product. *Ranbaxy Laboratories Ltd. v. CCE (2010) 5 Taxman .com 94 (Breaking News) 27 STT 4.*

INTERNATIONAL LAW

➢ **Taxability of off-the-shelf shrink-wrapped software sale:**

The assessee company was a company registered in Mauritius. The manufacturing company was a company registered in USA. The assessee was involved in supply of the software purchased from the manufacturer to the clients located in India. During the relevant previous year assessee had supplied off the shelf shrink wrapped software to Infosys Technologies Ltd. in India.

Assessee submitted that software sold by the company to Indian entities was shrink-wrapped off-the-shelf software and hence consideration was for sale of copyrighted article which should be characterized as business income. So according to assessee it was not a payment in the nature of royalty. Also since there was no PE so business income was not taxable under article 7 of DTAA.

Assessing officer and commissioner were of the view that sale of software to Indian entities was liable to be taxed as royalty.

Tribunal referred the decision of Supreme court in case of Tata Consultancy Services v. State of Andhra Pradesh (2004)271 ITR 401/141 Taxman 132, in which court said that software programme may consist of various commands which enable the computer to perform designated tasks. The copyright may remain with the originator of the programme but when copies are made and marketed it becomes goods which are assessable to sales tax.

Thus, Tribunal held that in the facts and circumstances of the case and in the light of judgments referred by it, sale of software cannot be treated as income from royalty either under Income Tax Act or under the terms of DTAA. *Velenkani Mauritius Ltd. v. DY. DIT (ILT) (July 2010 addition) (International Taxation) 390*.

➢ **Taxability of Licensing of software:**

The assessee, TTI Team Telecom International Ltd., was a company incorporated in Israel and was a tax resident of Israel. Assessee entered into a contract with Reliance Infocomm Ltd. for supplying software license for the wireless network of Reliance in India. The salient features of the agreement were :

- It did not allow Reliance to transfer, assign, sub-licence or use the software by outsourcing it.
- It did not allow Reliance to decompile, reverse-engineer,

disassemble or decode the software.
- It provided that all the copies of software shall be returned to assessee upon termination or cancellation of the agreement.

Assessee submitted that agreement was for purchase of software product and the licensee i.e. Reliance had not acquired any copyright for the use of the product. It said that consideration was for the sale of copies of copyrighted articles (without transfer of copyright), which should be in the nature of business income and in the absence of a PE in India, it should not be taxable in India as per Article 7 of DTAA between India and Israel.

The assessing officer did not agree to it and held that payment made for supply of software was royalty within the meaning of the terms of Article 12 of the DTAA and also section 9(1) of the Income Tax Act.

Commissioner (Appeal) was of a different opinion and was in favour of the assessee, and held that :
- Agreement did not give any title to the software or any trademark or copyright to the Reliance.
- Reliance was not allowed to reverse engineer, decompile or disassemble, or could not remove, obscure or deface any property legend relating to the software.
- Software could not be sold, transferred, assigned, sub-licensed or used by any outsource of Reliance without the consent of the assessee.
- As per the Copyright Act, copyright shall subsist only in respect of original literary, dramatic, musical and artistic work, films and sound recording. It is therefore different from the work. Copyright is a copy property in a work.

Commissioner relied upon many decisions e.g. in case of Lucent Technologies Hindustan Ltd., assessee purchased from US company an integrated equipment which consisted of both hardware and software as one can not function without another. Software supplied by Lucent was customer specific and could not be re-used and duplicated in any other exchange where identical orders were placed by DOT. Therefore, Tribunal held in this case that purchase of software could not be considered as payment of royalty and therefore there was no obligation of TDS. Other cases it relied upon were Samsung Electronics Co. Ltd., Motorola Inc., and Hewlett Packard India (P) Ltd.

Tribunal held that in the facts and circumstances of the case and in the light of legal decisions relied upon by Commissioner (Appeals), purchase of software product accompanying end user license without transfer of right of copyright of the software was not taxable as royalty under the Income Tax Act and under the India-Israel Treaty. *TTI Team Telecom International Ltd. v. DY. DIT (ILT) (July 2010 edition) (International Taxation) 393*.

- **CUP method of transfer pricing:** The assessee was engaged in the business of processing and export of chemicals. It had transactions with associated enterprises as well as with non associated enterprises. The method of computation of arm's length used was CUP method. Under CUP method the price of the goods or services is directly compared with the price in uncontrolled transactions under similar conditions. During the transfer pricing assessment proceedings, the assessee was asked to furnish the invoices made to multinational end user by AE, sales register as well as comparative rates at which it had been supplying the products to other concerns in India as well as abroad. Assessee submitted that:
  - AE came into existence because European customers felt comfortable with America based firm rather than Indian firm.
  - On pricing transaction with AE, assessee provided 1% industry discount and 20% discount on quantitative and qualitative basis.
  - The P& L a/c of USA AE was shown to assessing officer to show that AE did not have any other interest with the assessee.

Assessing officer made an addition saying that assessee was selling goods to AE at a discount of 5% as compared to goods sold to non AEs.

Commissioner (Appeals) held that in case of assessee, the AE was in USA where the marginal tax rates were higher than that of India. USA is known to follow a very strict transfer price regime. Also the assessee enjoyed benefit of 30% deduction that year under 80HHC. Further AE at

USA had shown to have suffered a loss. All these factors showed that there was no saving or avoidance of tax by assessee by shifting profits to USA. From the Risk Matrix point of view, it was a very low risk case.

CIT (A) further observed that 97.5% of the assessee's turnover was to AEs in USA and Europe and only 2.5 % to non AEs , therefore to maximize its profits it had to depend upon the market of Europe and USA. So as volume sold was a significant factor in fixing the price therefore AE would be given preference while deciding the price and while calculating simple average there was hardly any profit to assessee.

Tribunal upheld the decision of the CIT(A) and held that:

- In case of Ranbaxy Lab Ltd., it has been held that it could have been appreciated if both the entities which were compared were in same country because geographical situation influence transfer pricing in many ways.
- The transaction with high profile clients was different when compared to small scale or small players in South East Asian business.
- For survival and to maximize its profits it had to depend upon its AEs only.
- If overheads to run the AEs were reduced then there was hardly any profits

Thus, the Tribunal held that transactions with AE were at Arm's Length and there was no case for making transfer pricing adjustment to the arm's length declared by the assessee. *Dufon Laboratories v. ACIT (2010) 39 SOT 59 reported in (July 2010 addition) (International Taxation) 401.*

- **Withholding Tax & Sec. 195:** In this case, the key issues were:

  - Whether the ITAT could decide on whether the payment made by the assessee was chargeable to tax in the hands of the recipient as Royalty or as payment for use of a Copyrighted material.
  - Whether ITAT was competent to decide that the recipient of payment was entitled to the benefit of the DTAA and ignore sec.9 of the Act.
  - Whether withholding tax is a mere procedural provision to recover tax from the payee and not an assessment of the payee's income.
  - Whether assessee, after accepting the liability of TDS and deducting it, can file an appeal against application of such withholding tax.

  Facts of the case were:
  - The assessee company, an Indian tax resident, who purchased software from a non resident had to pay a sum for it.
  - The nature of payment was not clear.
  - Therefore, the assessee, on safest side, deducted TDS on the payment of software and deposited it.
  - Afterwards, the assessee was convinced that payment was not for royalty but for the sale of copyrighted product and filed an appeal to advice whether TDS was wrongly deducted.
  - CIT dismissed the appeal and then the assessee went to ITAT (Tribunal). The Tribunal held that there was no liability of TDS as payment was in nature of sale of copyrighted product.
  - Then Revenue went in appeal before the High Court.

  The High Court held that:
  - Tribunal was not right in holding that there was no liability of deducting TDS, because this power of deciding in this matter was confined to Assessing Officer under sec 195(2) and reconfirmed in the Transmission Corporation's case. The Court held that ITAT had not referred this case in deciding whether payment was liable to TDS u/s 195 or not, therefore it was not within the competence of ITAT to decide the nature of payment.
  - The question whether the recipient was entitled to the benefit of DTAA vs. sec. 9 did not arise before the ITAT, therefore it was not competent to decide on this matter.
  - It was not within the competence of the ITAT to decide the nature of payment in an appeal of this nature because it has not followed the case of Transmission Corporation.
  - Court decided that withholding tax was a procedural requirement and in no way amounts to an assessment of the recipient income in hands of the payer.

It was also decided that resident payer may also avail section 248 of the Act to prefer an appeal against the order passed u/s 195(2) of the Income Tax Act. *Sonata Information Technology Ltd. v. CIT (2010) 5 Taxmann.com 64 reported in (July 2010 addition) (International Taxation) 405*.

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