MVDCO Advisory Services

News Letter

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Sudhir Menon (HUF) – Mumbai ITAT

Section 56(2)(vii):

Sec 56(2)(vii) does not apply to **bonus and rights issue of shares** offered on proportionate basis even if the offer price is less than FMV of the shares.

Sec. 56(2)(vii) (c) (ii) provides that where an individual or an HUF receives any property (shares in this case) for a consideration less than its FMV, the difference shall be considered as income of the recipient.

However this does not apply to issue of bonus shares because that is mere capitalization of reserves by the issuing Company and there is no change in the wealth of the shareholder since his percentage holding in the Company remains same.

The same argument applies to the issue of additional shares to the extent it is proportionate to the existing shareholding pattern because the value derived from the additional shares to the extent it is due to the existing shareholding, no additional property can be said to be received by the shareholder. The fall in the value of the existing holding has to be taken into consideration.

As long as there is no disproportionate allotment, ie, the shares are allotted on the basis of their existing holding, there is no property being received by them on the said allotment of shares. There being only apportionment of value of their existing holding over larger number of shares. Therefore Sec. 56(2)(vii) does not get attracted and there can be no income taxable in the hands of the recipient.

Bharati Airtel Limited (ITAT Delhi)

Transfer Pricing: A transaction like corporate **bank guarantee** which has no effect on profit, loss, income or asset of an enterprise is not an "international transaction" under section 92B(1) and not subject to transfer pricing.

Facts: The assessee Company ('a') gave a corporate guarantee to Deutsche Bank for its AE – Bharati Airtel Sri Lanka – to avail working capital facility. The 'a' claimed that since it has not incurred any cost towards giving such guarantee and since the guarantee was issued as a part of the shareholder activity, no transfer pricing adjustment was warranted. The TPO on the other hand took the view that the AE was benefited due to such guarantee and also in view of the retrospective amendment in the Income Tax Act to include guarantee under the defination of international transaction, made transfer pricing adjustment by using CUP method.

The Tribunal held that:

- A transaction between two AE constitutes international transaction u/s. 92B only if it has a bearing on profits, income, loss or asset of such enterprises. Even the transaction referred to in sec. 92B (that includes guarantee) should also be such that has bearing on profits, income, loss or asset of such enterprises;
- The onus is on the revenue to demonstrate that the transaction has a bearing on profits, income, loss or asset of such enterprises.
- The said impact has to be on real basis, even if in present or in future, and not on contingent or hypothetical basis. There has to be some material on record to show that there the intra AE international transaction has some impact on the profits, income, losses or assets;
- When an assessee extends assistance to its AE, which costs nothing to the assessee and particularly the assessee could not have realised money by giving it to someone else in the normal course of business, such an assistance or accommodation does not have any bearing on profits, income, losses or assets and therefore is outside the ambit of international transaction u/s. 92B.

Posco Engineering – Delhi ITAT

Taxability of "composite contract" for supply of offshore and onshore supply & services:

The first question that requires to be answered is whether the contract is composite?

In the present case, all the 4 components of the contract ie offshore and onshore supply and services are distinctly identifiable with separate consideration for each. Simply because the supply of equipment and rendering of services is to one party and for common purpose, it is not necessary that the contract is a composite contract. Therefore the AO was not correct in his position to hold that the contract is devoid of any bifurcation towards onshore and offshore supplies and services.

Title of the good shall be considered to be passed out of India when the delivery was made high sea and the payment was also received out of India. Merely because the risk passed in India cannot be said that the sale took place in India. Therefore, in absence of a PE in India, no income can be said to have arisen in India.

If the seller has to incur the training and repairs cost during the warranty period, then either there is a specific compensation charged for the same or the cost is included in the price of the equipment sold. Ordinarily, when the equipment is sold with warranty period, the price charged for the equipment is higher than when the equipment is sold without warranty. It can therefore be concluded that when the seller has undertaken to bear the training cost at its own, the price of the same is embedded in the price of the equipment sold. In such a case, the price of the equipment is required to be split towards the price of the equipment and compensation for training and other costs.

IBM India Ltd. – Banglore ITAT

Absence of Fees for Technical Services article in DTAA

IBM India Ltd. (ICO) was engaged in the business of providing information technology services. During the year ICO made certain payment to a Philippine Company (FCO) which is in the nature of Fees for Technical services. The ICO made the payment without deducting any tax at source.

The Tax authority contended that in absence of article on Fees for Technical Services in DTAA, the same should be governed by domestic Act by virtue of Article 24 which states that the law of the contracting state should govern the taxation of income except where the provisions to the contrary are made in the DTAA.

The Banglore Tribunal held that:

Article 24 deals only with "Elimination of Double Taxation". It operates only in the field of doubly taxed income and tax thereon and manner in which double taxation is eliminated. It does not confer any right to invoke domestic law for classification of income or taxability of income covered by other articles of the DTAA.

If Article 24 is interpreted as conferring right to tax FTS under the domestic law of contracting state, Article 23 dealing with "Other Income" will become redundant. Even granting of exclusive right of taxation to the country of residence would become redundant. Hence the scope and context of articles have to be understood in its proper perspective.

In this case, the services rendered by FCO are in the course of its business. In absence of article on FTS in the DTAA, the income will be taxed as "Business Profits" under Article 7 and not under "Other Income". Further, in absence of PE of the FCO in India, the income will not be chargeable to tax in India at all.

Even assuming that the payment made is taxable under article 23 on "Other Income", the taxation right will be with country of Residence which is Philippine and therefore not taxable in India.

CORPORATE SOCIAL RESPOSIBILITY – COMPANIES ACT, 2013 to be effected from 1st April, 2014.

1. **Eligibility Criteria:** Section 135 of the Companies Act, 2013 provides that every company having

   a. a net worth of rupees 500 crore or more, or
   b. turnover of rupees 1000 crore or more or
   c. a net profit of rupees 5 crore or more

during any financial year shall constitute a Corporate Social Responsibility (CSR) Committee of the Board consisting of three or more directors, out of which at least one director shall be an independent director.

The Company shall ensure that it needs to spend at least 2% of its average net profit for the immediately preceding three financial years on CSR activities.

However, CSR Rules exempts unlisted public companies and private companies that are not required to appoint an independent director from having an independent director as a part of their CSR Committee and stipulates that the Committee for a private company and a foreign company need have a minimum of only 2 members.

- The provisions apply to any company incorporated in India, regardless of whether it is domestic or a subsidiary of a foreign company.
- The CSR committee is responsible for reviewing, approving, and validating investments in CSR. A report must be submitted prior to the committee's annual meeting that details CSR initiatives undertaken during the previous financial year and justifying any failure to meet the required contribution amount (justifiable reasons have not yet been specified).
- Because the board is composed of independent directors, it is hoped that this will help ensure the credibility of the process.

2. Computation of CSR Amount:

- The net worth, turnover and net profits are to be computed in terms of Section 198 of the 2013 Act as per the profit and loss statement prepared by the company in terms of Section 381(1) (a) and Section 198 of the 2013 Act. While these provisions have not yet been notified, is has been clarified that if net profits are computed under the Companies Act, 1956 they need not be recomputed under the 2013 Act.
- Profits from any overseas branch of the company, including those branches that are operated as a separate company would not be included in the computation of net profits of a company.
- Besides, dividends received from other companies in India which need to comply with the CSR obligations would not be included in the computation of net profits of a company.

3. The Board's report under sub-section (3) of section 134 of the Companies Act, 2013 shall disclose the composition of the CSR Committee.

The Corporate Social Responsibility Committee shall,—

- formulate and recommend to the Board, a CSR Policy which shall indicate the activities to be undertaken by the company as specified in Schedule VII;
- recommend the amount of expenditure to be incurred on the activities referred to in clause (a); and
- monitor the CSR Policy of the company from time to time.

4. The Board of every company referred to in sub-section (1) of Section 134 of the Companies Act, 2013 shall,—

- after taking into account the recommendations made by the CSR Committee, approve the CSR Policy for the company and disclose contents of such Policy in its report and also place it on the company's website, if any, in such manner as may be prescribed; and

- ensure that the activities as are included in Corporate Social Responsibility Policy of the company are undertaken by the company.

5. The Board of every company referred to in sub-section (1) of Section 134 of the Companies Act, 2013, shall ensure that the company spends, in every financial year, at least 2% of the average net profits of the company made during the three immediately preceding financial years, in pursuance of its CSR Policy:

   Provided that the company shall give preference to the local area and areas around it where it operates, for spending the amount earmarked for Corporate Social Responsibility activities:

   Provided further that if the company fails to spend such amount, the Board shall, in its report made under clause (o) of sub-section (3) of section 134, specify the reasons for not spending the amount.

6. The Companies Act 2013 additionally outlines the realm of activities that fall under the umbrella of CSR. These include poverty reduction, health, environmental sustainability, etc. and companies are granted the flexibility to choose which of these areas to invest in or contribute the required amount to central or state government funds earmarked for socioeconomic development. The act does explicitly state, however, that companies "shall give preference to the local area and areas around which it operates."

   Schedule VII of the Companies Act, 2013 provides for list of activities which may be included by companies in their CSR Policies:

   Activities relating to:—

   - eradicating extreme hunger and poverty;
   - promotion of education;
   - promoting gender equality and empowering women;
   - reducing child mortlity and improving maternal health;
   - combating human immunodeficiency virus, acquired immune deficiency syndrome, malaria and other diseases;
   - ensuring environmental sustainability;

- employment enhancing vocational skills;
- social business projects;
- contribution to the Prime Minister's National Relief Fund or any other fund set up by the Central Government or the State Governments for socio-economic development and relief and funds for the welfare of the Scheduled Castes, the Scheduled Tribes, other backward classes, minorities and women; and

Schedule VII states that certain new activities could be classified as CSR activities—protection of national heritage, art and culture, including restoration of buildings and sites for historical importance and works of art, setting up of public libraries, promotion and development of traditional arts and handicrafts, measures for the benefit of the armed forces veterans, war widows and their dependants, rural development projects, training to promote sports, funds to technology incubators, etc. The scope of certain existing activities has been enhanced—the scope of promoting education also includes special education. Further, the schedule elaborates on certain activities. For example, environment sustainability, which includes ecological balance, maintaining quality of air, water and soil, conservation of national resources, etc.

The CSR activities should not be undertaken in the normal course of business and must be with respect to any of the activities mentioned in Schedule VII of the 2013 Act.

Contribution to any political party is not considered to be a CSR activity and only activities in India would be considered for computing CSR expenditure.

7. The CSR Rules appear to widen the ambit for compliance obligations to include the holding and subsidiary companies as well as foreign companies whose branches or project offices in India fulfill the specified criteria. There is a need for clarity with respect to the compliance obligations of a company as well as its holding and subsidiary companies.

8. A company can build CSR capabilities of its personnel or implementation agencies through institutions with established track records of at least three years, provided that the expenditure for such activities does not exceed 5% of the total CSR expenditure of the company in a single financial year.

9. The CSR Rules specify that a company which does not satisfy the specified criteria for a consecutive period of three financial years is not required to comply with the CSR obligations, implying that a company not satisfying any of the specified criteria in a subsequent financial year would still need to undertake CSR activities unless it ceases to satisfy the specified criteria for a continuous period of three years. This could increase the burden on small companies which do not continue to make significant profits.

10. Where a company has a website, the CSR policy of the company would need to be disclosed on such website.

11. Failure to Comply

While a company is not subject to liability for failing to spend on CSR, a company and its officers are subject to liability for not explaining such a failure in the annual report of the board of directors. There is currently no guidance as to what constitutes a sufficient or statutorily valid explanation for failure to spend in the board report. In addition, a company and its directors are liable even if they fail to report on CSR activities that actually were conducted.

Failure to explain is punishable by a fine on the company of not less than 50,000 rupees and up to 25 lakh rupees. Further, officers who default on the reporting provision could be subject to up to three years in prison and/or fines of not less than 50,000 rupees (about U.S. $900) and as high as 5 lakh rupees (about U.S. $9,200).