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Dr. Ikramul Haq
Editor
Mrs. Huzaima Bukhari

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Kind regards

Mrs. Huzaima Bukhari
Editor

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For Lahore
Office No. 14, 2nd Floor,
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Few Places to Hide as Taxes Trend Higher Worldwide

by
Conrad De Aenlle

Death and taxes are the only certainties in life, if you believe Benjamin Franklin. Had he been around today, he might have observed that taxes also have become a great uncertainty in life.

Taxes on earnings, investment income, sales and a few other things have gone up already in many countries, and further increases are possible, including a huge one in the United States.

Another source of unease and doubt for taxpayers is a trend toward increases of other sorts: in scrutiny by revenue authorities, reporting requirements for individuals and businesses, and legislation to close tax code loopholes.

International taxpayers — expatriates and others whose personal or professional lives extend across borders — may find conditions particularly challenging. Dealing with a changing tax regime is tough; dealing with more than one even more so. Not only that, but some authorities are focusing more keenly on foreigners or on their own citizens living elsewhere. On the bright side, certain countries still treat foreigners better than their own citizens.

Navigating a landscape that may have been familiar but is suddenly a treacherous terra incognita is not easy, tax advisers warn, but it can be done as long as taxpayers are well prepared, take care to avoid mistakes and resign themselves not to go too far.

"There is no magic solution, no one structure that will work," said Gavin Leckie, a wealth adviser and specialist in expatriate financial issues for J.P. Morgan Private Bank. "A lot of this is a defensive exercise. Make sure to organize yourself so that you've anticipated problems and taken steps to protect yourself."

There is much, existing and potential, to protect yourself from. The biggest tax-related question mark — several hundred billion dollars big — concerns the fiscal cliff. That is the term coined by another famous Ben — Bernanke, the U.S. Federal Reserve chairman — to describe the anticipated destination of the American economy if an extensive mix of tax increases and government spending cuts goes ahead as scheduled next month.

Numerous increases are on the books or heading there in Europe, including on income and/or value-added taxes in Spain, Finland, Italy, the Netherlands and France, where a 75 percent income tax rate on income exceeding €1 million, or $1.28 million, is coming in 2013. Bucking the trend, Britain is about to lower its top income tax rate to 45 percent from 50 percent — after having raised it from 40 percent.

The European Commission has proposed, and 11 euro zone members support, a tax on financial transactions. Ireland introduced a tax on

insurance premiums this year, the Dutch plan to raise their tax on premiums in 2013, and France hopes to raise taxes on rental income and capital gains from vacation homes of domestic or foreign owners.

If the expanding tax bite around the region makes you want to cry in your beer, being in France could cost you more on that score, too. The beer tax is due to rise 160 percent.

Conditions in Asia are comparatively placid, but that region has not been immune from the trend. Attempts to raise the value-added tax in Japan have failed in the past, along with governments that made them, but a doubling of the V.A.T., called the Japan Consumption Tax, was approved in August.

"Quite a few countries are trying to increase tax revenue," said Kevin Cornelius, a partner in Geneva for the Human Capital Practice at Ernst & Young. "The question is who's raising taxes the slowest. I can't remember as much tax legislation going through as we've seen in the last 24 months."

Americans would welcome at least one more piece of legislation. At press time, negotiations were continuing in Congress on a compromise to avoid going over the fiscal cliff. The consensus among pundits in Washington and on Wall Street is that one will be reached that preserves present rates on middle-class taxpayers and perhaps raises them on high earners.

If no deal emerges, tax rates will increase on income, capital gains and dividends.Employee payroll taxes are also scheduled to rise, and surcharges are due to be introduced on earned income and investment income of well-off individuals to defray the costs of thehealth care overhaul. "*Courtesy: International Herald Tribune*"

Saving Arm' s Length Pricing: From Economists' Myths of Tax Avoidance by Taxpayers, to the Reality of Uncertain Application of Rules

by

Andrea Musselli and Alberto Musselli[*]

In this article, the authors affirm that while some economic studies conclude that there is a breach of the arm' s length standard by corporations, the reality is not clear. It is uncertain how tax authorities in different countries apply the arm' s length standard and whether it is applied in a consistent manner throughout various

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[*] Partners, Studio Musselli, Milan. The authors are grateful to dr Deloris Wright and to prof. Giampaolo Arachi, Econpubblica Bocconi Milan, as well as dr Fabio Comelli of the IMF, for their comments on the portion of this article concerning economic studies of actual transfer pricing by taxpayers. Any errors are solely those of the authors. This article was written before the publication of the OECD interim draft on intangibles (June 2012).

countries. The real problem is whether the arm' s length standard, as laid down in the OECD Guidelines (and in countries' legislation), allows firms and tax authorities to anticipate which is the right rule to apply in concrete cases. This article presents some reasons and circumstances why and when this does and does not occur, and proposes some solutions.

1. Introduction

There is a great discrepancy between the conclusions of the studies of some economists on transfer pricing, and what happens in reality. In the transfer pricing arena there are currently conflicting interests between businesses and tax authorities, as well as between different countries[1] involved in the taxation of multinationals.

All of these factors create much confusion in the analysis of the taxation of multinational enterprises, and may give rise to actual situations that are precisely the opposite of what national legislators and international organizations (including the OECD, in its role as "legislator") have endeavoured to promote in agreeing on the arm' s length principle as the basic standard for allocating profits arising from multinational groups.

The final result, in the authors' opinion, is that the arm' s length principle is applied in practice in an unsatisfactory manner, and that the asserted positive aspects of the arm' s length principle are clearly offset by the uncertainty arising from its actual application. However, actual and current data about specific application of the arm' s length principle would be available to firms, tax authorities, scholars and interested parties only if an "independent" study about that application were to have access to detailed information on corporations. This last point will be considered further.

2. Economics of Multinational Enterprises

Under the economic system of capitalism, corporations have an incentive to do business in different countries; therefore real economic reasons other than tax optimization are the basis for the globalization of enterprises, and this way of explaining the globalization of enterprises is accepted even by those who think that capitalism is not the best way to organize the production and exchange of goods and services in human societies.[2]

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[1] Affected now by large sovereign debts and budget deficits. What once seemed impossible is now reality. See extract from the Bloomberg website, U.S. Loses AAA Credit Rating As S&P Slams Debt Levels, Political Process, available at www.bloomberg.com/news/2011-08-06/u-s-credit-ratingcut- by-s-p-for-first-time-on-deficit-reduction-accord.html (6 Aug. 2011) ("S&P lowered the U.S. debt one level, from AAA, to AA+ while keeping the outlook at negative; the rating may be cut to AA within two years").

[2] The globalization of enterprises is a concept even developed in Marxian theory and with reference to the twentieth century in Marxian studies. See e.g. P. Sweezy and P. Baran, Monopoly Capital: An Essay on the American Economic and Social Order (Monthly Review

Some multinational enterprises aim to expand their area of sales by exploring new markets after originally doing business only in their home country. Under another profile, domestic businesses aim to find the best price for various aspects of production as compared to the current price in the home country (i.e. the lower price of labour in developing countries is a well known reason for the shifting of manufacturing centres to those jurisdictions). In conclusion: the obtaining of tax savings is not historically the predominant goal of businesses operating in the form a multinational enterprise.

To prevent tax arbitrage (which is a possible, but historically not the main driver of the globalization of enterprises), countries (now via the OECD) have agreed as regards the arm' s length principle for group transactions. As such, the conditions agreed between parties which are part of a unitary business but which are located in different countries (i.e. a multinational group of associated companies) must be those that would have been agreed by independent parties under similar conditions.

3. Empirical Studies on Transfer Pricing Manipulation

Many economic studies that are focused on group taxation conclude that transfer pricing constitutes an important means of tax planning which is perceived as an illegal way to skirt anti-avoidance legislation and the arm' s length principle despite audits by tax authorities. This leads to the question of how these conclusions are reached.

Non-compliance with the arm' s length standard is proclaimed when affiliates that are lightly taxed increase their share of the consolidated profits. Data, focused on US multinationals, show that profits of affiliates located in 18 tax havens soared from USD 88 billion in 1999 to USD 149 billion in 2002.[1]

Other studies relate the increase of one percentage point in the host country tax rate with the decrease of earnings before interest and taxes (EBIT) of US affiliates of 3%,[2] while more recently the profitability of German affiliates is positively correlated with the current tax rate in the foreign parent country.[3] The implied conclusion is that transfer prices are used simply to shift integrated profits to group companies that are subject to a lower tax rate (or a rate not increased by more than the growth experienced by the other affiliate).[4]

4. Lack in Economic Studies Proving a Breach by Corporations of the Arm' s Length Principle When Based on Database Data

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Press, 1966),where imperialism and military expenses are considered a remedy against surplus productive capacity.

1 M.A. Sullivan, Data Show Dramatic Shift of Profit to Tax Havens, Tax Notes (13 Sept. 2004).

2 J. Hines and E. Rice, Fiscal Paradise: Foreign Tax Havens and American Business, 109 Q.J. Econ. 1 (1994), at 149.

3 A. Weichenrieder, Profit Shifting in the EU: Evidence from Germany, 16 Int'l Tax & Pub. Fin. 3 (June 2009), at 281.

4 See also M. Overesch, Transfer Pricing of Intrafirm Sales as a Profit Shifting Channel – Evidence from German Firm Data (2006), ZEW Discussion Paper 06-08.

Economic studies that are based on database data are incapable of giving convincing evidence of transfer pricing manipulation. [1] The actual situation is significantly more complicated than that depicted in such studies, such that general conclusions cannot be drawn.

Most economic studies are based on publicly available data, such as data extracted from databases including balance sheets and financial results of companies, or the prices of imported or exported goods. Such data are generally not sufficient to verify a company' s compliance with the arm' s length principle. To verify whether transfer prices truly comply with the arm' s length principle, due to the nature of the principle and to how this economic principle has become a legal standard, data are required regarding how a group of companies has "individually" organized its proper business in terms of risks assumed and assets employed by its units in various countries. These data are not recorded in publicly available databases (e.g. Bureau van Dijk, Standard & Poor' s and other software compiling financial results of companies) or semi-publicly available databases (e.g. the MIDI database of the German Bundesbank, which includes financial data on German companies). Using publicly available data, the economic studies mentioned above are unable to allocate intangible assets of the integrated business which are the logical, and economically arm' s length, consequence of successful investments' assuming business risks related to a specific group. Public databases eventually include only what are classified as intangibles on the balance sheet of a company, but such assets are usually the result of payments made for those intangibles. Indeed, no database provides a means to determine which enterprise assumed in the past those risks connected with the development of intangibles of the tested business.[2]

5. Compliance with the Arm' s Length Principle Is Verified Only with Information of Particular Groups about Their Own Individual Allocations of Business Risks

Only when information is available on the allocation to group units of business risks by individual groups, is it possible to make a well founded judgment as to whether transfer prices comply with the arm' s length principle. All other ways to reach conclusions about compliance with the arm' s length principle ultimately provide only circumstantial evidence of such compliance (or non-compliance) and cannot be used as the basis for drawing conclusions.

Detailed information regarding intra-group business is held, first, by those enterprises[3] and, then, by tax authorities that audit compliance

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[1] This does not mean that some enterprises now and/or in the past have not shifted profits to low-tax jurisdictions through illegal transfer pricing.

[2] I.e. data on marketing investments or on how an associated enterprise has assumed risks related to those investments are hardly extractable from public databases.

[3] Currently, the legislation of nearly all countries (as well as internationally accepted recommendations, such as the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (2010), International Organizations' Legislation IBFD,

with the arm' s length principle as part of the process of verification of whether taxpayers have complied with their tax obligations. It is often the case that all this information becomes publicly available only when litigation commences between companies and tax authorities as the result of a proposed income adjustment that is contested by the taxpayer.

Only in this latter case are scholars (including economists, if they are accustomed to studying judicial pronouncements and rulings) and, more generally, the public able to make a well-founded judgment about tax evasion or avoidance by the companies under analysis; they are also able to understand how tax authorities carry out tax audits to verify taxpayers' compliance with the arm' s length principle. But even in the case of litigation, the revealed information is limited to a sample of companies which is not representative of the universe of enterprises and which cannot be relied upon to support any general conclusions.

6. Studies on the Application of the Arm' s Length Principle by Tax Authorities: Same Deficiencies as Studies of Companies

One of the duties of the OECD, after having issued guidelines to harmonize the legal standard of the arm' s length principle,[1] should be to monitor how companies and tax authorities of various countries apply that principle, in order to verify that the internationally agreed principle is applied consistently in all countries that proclaim to refer to it.

The OECD report, Dealing Effectively with the Challenges of Transfer Pricing, was released in early 2012 and provides some circumstantial evidence of how audits by tax authorities are carried out and on how companies are (or are not) in compliance with the arm' s length principle.[2] The Report states:

> Although the survey of the results achieved by the transfer pricing programmes of various countries was not designed for publication in full, a brief overview of the results helps to illuminate some of the practical challenges facing tax administrations in this area of work:
>
> – [...]

(OECD Guidelines), chapter V, incentivize or mandate a report from taxpayers in which the taxpayer proves that its transfer prices comply with the arm' s length principle, and in which taxpayers disclose information to verify such compliance (e.g. risk allocation among entities, any comparable transactions, intra-group contracts, reasons why a method has been considered the best method to comply with the arm' s length principle).

1 OECD Guidelines (2010).

2 OECD, Dealing Effectively with the Challenges of Transfer Pricing (OECD Publishing, 2012), at 3, available at http://dx.doi. org/10.1787/9789264169463-en (the "report is the result of work that was commissioned by the Forum on Tax Administration (FTA) and undertaken by a study group led by the United Kingdom. This study commenced with a written survey of FTA member countries designed to capture a broad overview of current performance in the management of transfer pricing issues and the scope for improvement").

– Some countries recover very little tax from their transfer pricing audits or enquiries whereas others recover very large amounts from almost all their audits.[1]

The statement above is not conclusive (as economic studies of companies mentioned above) because in fact it would be possible (but not probable) that all associated companies in (first) countries where tax authorities have made upward adjustments of 100% of the audited income have breached tax law, while all associated companies in (second) countries where tax authorities adjusted 0% of audited income have complied with tax law.

The focus of the report is on audits by the tax authorities because corporate behaviour is dealt with only indirectly. However, the probable fact surrounding the abovequoted portion of the report is (as circumstantial evidence, rather than definite proof) a different approach by the tax authorities of different countries in applying the arm' s length principle.

There are no data to indicate whether groups that have received an upward income adjustment to an associate company (in those countries where all audits by the tax authorities end in upward adjustments) have also received a downward income adjustment to the group company in the other country involved in the intercompany transaction.

The tax authorities of two different countries do not consistently apply the arm' s length principle[2] when:

– the text of the regulation specifying the arm' s length principle in a legal provision is not sufficiently clear to be applied as a solely consistent approach by (at least) both countries' tax authorities involved in the audit of a single taxpayer (group); or

– the rules are clear but the behaviour of at least one of two tax authorities involved in the audit of a single multinational enterprise is aimed at increasing its own tax revenue, disregarding the arm' s length principle.

Two different answers should follow from countries in their role of legislators, as well from the OECD (which is nothing but a – very authoritative – association of countries), in the same role of legislator, as regards each of the above-mentioned situations:

– in the first case, the text of OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD Guidelines) (which has inspired and will inspire legislation in Member countries) might be improved so as to leave less doubt regarding their practical and actual application. This is the

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1 Id. at 16.

2 This is the case when one tax authority increases the income of a group member and the other tax authority (involved in the intercompany transaction) does not adjust in a corresponding manner the income of the company under its jurisdiction.

focus of the current project of the OECD working party on intangibles and chapter VI of the 2010 OECD Guidelines; and

- in the second case, a judicial system might be instituted that is more efficient than the one that would normally have jurisdiction to rule on appeals by taxpayers under each country' s domestic legislation. A ruling regarding compliance with the arm' s length principle would be obtained efficiently if it were actually mandatory to enter arbitration to resolve issues of double taxation as mandated under certain circumstances by tax treaties based on the OECD Model Convention (new article 25) or by the 90/436/ EEC Convention in European Countries. The aim is to have one single transfer price in each individual audited transaction for both auditing tax authorities (and companies).

7. Effects of Uncertainty Surrounding Application of the Arm' s Length Principle in Practice

Uncertainty surrounding the proper tax rule to apply is detrimental to all business activity because the immunity of property from arbitrary expropriation by governmental authorities is one of most important conditions for economic growth.[1] Unclear tax rules expose taxpayers to the risk of upward income adjustments based on an interpretation of tax law by tax authorities that is different from the interpretation followed by the taxpayer.

Although uncertainty as regards tax rules may initially seem to be an advantage for companies that would have the opportunity of tax "optimization",[2] this circumstance may turn into a serious drawback for the same companies when one considers that given a transfer price calculated by a company, the tax authorities of each country involved in an intercompany transaction, may adjust that price so as to increase taxable income in their jurisdiction, simply when and because it is not clear which is the true (legal) transfer price.[3]

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[1] W.J. Baumol, The Free-Market Innovation Machine: Analyzing the Growth Miracle of Capitalism (Princeton University Press, 2002). See chapter 1. The limitation of state authority is historically significant: "The century after Magna Charta inaugurated the process of conceding the sanctity of property, including immunity from taxation without representation, a process carried to its conclusion in England in the struggle between Charles I and his parliaments", at 69 (emphasis added).

[2] See Overesch, supra n. 6 (some economists emphasize that "since economies of integration are special characteristics of affiliated companies, it is often impossible to calculate a true intercompany transfer price. Hence, multinationals should have a range of opportunities to set tax-optimal transfer prices "). See also J. Hines, Tax Havens, working paper 3/2007 (Michigan University, Office of Tax Policy Research, 2007) ("in practice the indeterminacy of appropriate arm' s length prices for many goods and services, particularly those that are intangible, or for which comparable unrelated transactions are difficult to find, leaves room for considerable discretion").

[3] The disadvantage becomes less serious when at least two tax authorities (in different countries) involved in auditing a taxpayer' s transfer prices are obliged to eventually resolve differing views regarding transfer pricing through mandatory arbitration, as their conflicting

8. Saving the Arm' s Length Principle

8.1. The economic concept of the arm' s length principle as set forth in tax law

Although economic analysis of transfer pricing is a broad subject, the focus here is on only one of the theories aimed at determining the terms to which independent parties would have agreed under similar conditions (the arm' s length principle).[1]

The arm' s length principle is generally aimed at allocating the results of a multinational business carried on by different units. Each economic unit is located in a different country, and they all manufacture intermediate inputs for each other. The arm' s length principle, which is the focus here, is complied with by assigning:

- anything more than a "normal" economic return[2] to those affiliates that do not participate in risks (also referred to as entrepreneurial risks) that generate potential extra profit or loss; and
- any extra profit or loss (that remains from the global result of the whole group after having assigned normal returns as above) must be allocatedto location base costs (and to related affiliates) that share in assuming entrepreneurial risks.[3]

The arm' s length principle has basic features that are different to a formulary (unitary) rule (i.e. based on the local share of assets, sales and salary in respect of the global group assets, sales and salary) aimed at

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interests constitute a safeguard also for taxpayers, that the legal rules and a single transfer price are effectively applied by the tax authorities as well.

[1] The focus is on the economic principle of the arm' s length principle in the form that has become the tax standard in the OECD Guidelines.

[2] A typical economic return may be considered the remuneration present on the free market, in light of similar risks assumed and assets employed. See Andrea Musselli, Arm' s Length Intragroup Intangible Transfers: Economics, Regulations and Actual Behaviors (January 2006), Econpubblica Bocconi University, Milan, Working Paper 108, available at http://ssrn.com/abstract=878443,or http://dx.doi.org/10.2139/ssrn.878443, at 2.

[3] J. Hines, The Transfer Pricing Problem: Where the Profits Are, NBER Working Paper w3538 (December 1990), at 26, available at http://ssrn.com/abstract=226838. When intangibles are developed not simultaneously but rather in sequence, the rule is not appropriate because connected costs, when they have been invested at different times, would not allow an appropriate consideration of the different degrees of their risks. Entrepreneurial risk is the risk that when all inputs are combined together by the global firm, the final result of the same firm is a profit or a loss. For a summaryof the Hines model in diagram form, see A. Musselli and A.C. Musselli, The Arm' s Length Standard in Multinationals' Taxation, Tax Plan. Int'l Transfer Pricing, BNA International (October 2007), at 5. Chapter IX of the OECD Guidelines seeks a further requirement that tax administrations accept a risk allocation as it is decided by group entities ("In the absence of comparables evidencing the consistency with the arm' s length principle of the risk allocation in a controlled transaction, the examination of which party has greater control over the risk can be a relevant factor to assist in the determination of whether a similar risk allocation would have been agreed between independent parties in comparable circumstances. In such situations, if risks are allocated to the party to the controlled transaction that has relatively less control over them, the tax administration may decide to challenge the arm' s length nature of such risk allocation").

allocating the result of a multinational integrated business in a clear and predictable manner.

Being related to risk assumption and the reward of each unit' s investments, the arm' s length principle promotes corporate efficiency and is equitable for countries because the reward of companies under their tax jurisdiction is linked to activities performed locally as if such activities were performed by an independent enterprise.[1]

The OECD Guidelines and US regulations specify transfer pricing methods which would allow, but only when fairly interpreted and implemented, taxpayers to assess arm' s length conditions in compliance with the model mentioned above, and would also allow tax authorities to audit taxpayer compliance with those conditions.[2]

8.2. Basic concepts to assess compliance with the arm' s length principle: the "economic model" implicitly included in tax law

Groups must determine at the moment of intercompany transactions if part of the total investment has already been borne and any further investments are to be developed at the time when the results of the whole business are already known. The alternative is seen where the results of the whole business are not already known (perhaps at a point of commencement of a business) and the same group must decide how to allocate entrepreneurial risks of the entire investment process among associated enterprises before the uncertainty is resolved as regards actual results.[3]

Economic parties, in planning their investments, know or should know the risk conditions and projected results of their business.

Governments, through their tax authorities, must conduct tax audits to verify corporate compliance, but in practice, tax authorities are at an informational disadvantage vis-àvis group managers when it comes to the degree of business risk. First and foremost, tax officers may only observe, during audits often arranged years after the transactions in question, the actual results of the business and they also might not know the distribution (of the stochastic variable) of possible (projected ex ante)

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[1] This judgement is also included in the OECD Guidelines, supra n. 10. For more aspects of the model, see Hines, supra n. 19.

[2] See e.g. arguments developed in Musselli, supra n. 19. The model is well suited for markets included in the definition of monopolistic competition; in the authors' opinion, the concepts of the economics of contracts may be of significant help in projecting rules to be applied as a coherent model for transfer pricing law. See i.e. articles quoted at infra n. 35.

[3] See again with more detail Musselli, supra n. 19. The UK tax authorities (HMRC) makes reference to similar concepts, observing that it is necessary to investigate the implied model in the OECD Guidelines. See HMRC Manual on transfer pricing and bargaining power, available at www.hmrc.gov.uk/manuals/intmanual/INTM467085.htm ("Although the term 'bargaining power' is not used in the OECD Transfer Pricing Guidelines the concept is implicit in references to relative bargaining and competitive positions, for example at 1.30 and 3.19") (emphasis added).

results from which that actual result is drawn.[1] In other words, tax officers are not informed about risk conditions of the business like managers are, and must rely on a mix of information collected by firms and other sources.

8.3. Issues indicating a need to clarify the application of the arm' s length principle

The analysis below considers some issues that could give rise to litigation between corporate taxpayers and tax authorities, as well as between tax authorities of different countries. Some possible solutions for dealing with and limiting the uncertainty surrounding the application of the arm' s length principle are also presented.

8.3.1. Comparable data from public databases as benchmark for profits of associated parties

Practitioners (including corporate taxpayers, tax authorities and advisers) are very familiar with the fact that most arm' s length prices are currently reached by benchmarking the operating profit of at least one associated enterprise not bearing entrepreneurial risks (in the meaning as described in 8.1.) to the operating profit achieved by independent enterprises bearing similar (low) risks and carrying out similar economic functions (e.g. distribution and production) as the tested associated enterprise.

The 1995 OECD Guidelines allow (strengthening the choice in 2010 in avoiding a prejudicial preference of transaction methods over profit methods) such a means of determining an arm' s length price, recognizing that often it is not possible to find similar prices of goods or services agreed in similar independent transactions because such independent transactions simply do not occur and intermediate inputs[2] are unique.

The lack of this type of analysis from an economic perspective is also well known, as databases containing financial results of independent enterprises used as a benchmark do not include contracts related to those results and, in any case, do not contain complete information regarding the business of each enterprise (e.g. risks, conditions) so as to allow a perfect comparison with the activity of associated enterprises.

Many concerns are suggested in the OECD Guidelines regarding the application of net profit comparison methods (so-called transactional net margin methods). The profit comparison is ultimately allowed by the OECD, but a clear conclusion as regards its use is included in paragraph 2.74 of the Guidelines: "The transactional net margin method may afford a practical solution to otherwise insoluble transfer pricing problems if it

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[1] For this reason one must not forget what Hines emphasizes, supra n. 19, at 3 ("assets earning what appear to be ex post pure rents may in fact have been produced by firms that ex ante gained only normal return").

[2] Intermediate inputs are inputs in the production of other goods – produced by and sold to associate firms.

is used sensibly and with appropriate adjustments to account for differences of the type referred to above [...]".

The bulk of analysis in setting transfer prices in such a way in actual cases is to determine that at least one associated enterprise is not engaged in investing in assets bearing entrepreneurial risks (assets the remuneration of which is linked to the results of the global business), and so it is possible to find independent economic parties that could be an alternative to the activity of the associated enterprise and the results of which, obtained in the free market, are the sought benchmark for the associated enterprise.

The basic economics of the arm' s length principle in such circumstances simply involve the assessment that the group' s global business is at a starting point in a way that entrepreneurial risks may be freely allocated to group members because facts that will resolve uncertainties producing global profit or loss have still not occurred,[1] or the group global business is at a point where its results are known and the units that will perform the residual activity are not allowed to obtain those specific (known) results (extra profit or extra loss).

This is an assessment that the managers of enterprises must perform before they execute intercompany transactions and which will be audited, perhaps years later, by tax officers. These tax officers must use information that was available to the same managers of the enterprises at the time of transactions (and not information available only at the time of an audit, i.e. using hindsight).

Although some legal concepts about the mentioned economic approach are beyond the scope of this article, the authors will emphasize issues that constitute the bulk of the approach.

In these cases the "perfect" comparable transaction does not exist, and the OECD Guidelines explicitly allow more than one result in such circumstances (i.e. they allow a set of comparable transactions and thus a transfer price included in an allowed range). The OECD Guidelines are intended to be implemented into domestic legislation by Member countries, and these Guidelines must be flexible in order to be implemented by the legislature of each country. In addition and in any case, the legislation of almost all countries allows the use of a set of comparables when comparables are sought through database searches.

Clear decisions regarding legislative policy are needed in this regard in order to avoid litigation due to misunderstandings about the legal rule to be applied in a single actual case. *De jure condendo* it is possible to think of a more strict legal procedure for setting transfer prices in such a way, but there are many drawbacks to doing so.

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[1] From a stochastic perspective, more than one result (associated with a degree of probability) is possible, and it is not known which one will become true.

Therefore, when more than one result may constitute a legal transfer price, an enterprise really may choose an "optimal" transfer price, but only from among a limited set which is determined using allowed methods specified under the OECD Guidelines (which indeed restricts much free discretion by enterprises).

This conclusion must not be interpreted as saying that "it is often impossible to calculate a true intercompany transfer price" like some economists do, because this a reasonable approach to resolve cases where a lack of legislation (which is closed by methods found in the OECD Guidelines) would really produce the opportunity to shift profits at the will of enterprises; what one must understand is that the bulk of compliance under the legal proceeding is the assessment of the fact that the tested group entity (which is compared to the set of comparables) is not involved in bearing entrepreneurial risks of the whole business under analysis, such that it is not allowed to split part of the global business results. This must be complied with consistently, as it is not acceptable to apply the rule differently from one tax period to the next, i.e. one year the group unit is not allowed to split combined group results, while in other years it is in connection with different results recorded by the whole business and not due to a change of a different risk allocation.

The bulk of reasoning here is that the tested associated companies are lower-tier economic units benchmarked with similar independent ones and their economic results; those tested associated parties are not allowed to participate in the results of the whole business group, be they profits or losses.

If a different legislative approach is considered a better option to further limit the remaining discretionary power of enterprises in complying with the legal proceeding, it must be implemented in a clear manner by specifying, using clear language, what is asked more of enterprises as a specific behaviour (in a way that is auditable by tax authorities, and as a last resort by judicial authorities) to assess the "correct" benchmark.

It is unacceptable to leave what may seem to be a discretionary authority to the taxpayer (and which indeed, when fairly implemented, is the more logical solution to resolve a problem which, without that solution, would be much worse) and then to blame the taxpayer for choosing the purported most advantageous transfer price (from among the limited set of allowed results) from its own perspective. It is also unacceptable to allow the tax authorities (at least the authorities of one country) to choose the purported best price from their perspective in order to amend the taxpayer' s choice (perhaps years after that choice) and to extract more tax revenue from that taxpayer which selected, years before, one of the allowed and possible prices.

Currently, an actual problem is that public opinion (scholars, economists and also players of the transfer pricing game, such as businesses and tax authorities) do not have updated data concerning the application of the arm' s length principle. As such, the authors' conclusions are not

supported by numbers from actual cases. Indeed, with actual numbers and cases it would become easier to distinguish when it would be suitable to reformulate the text of the OECD Guidelines (or the legislation of Member countries) to achieve a clearer text to prevent any misunderstanding as to what is asked of taxpayers, and when it would be a suitable intervention to improve arbitration proceedings, because the text is clear but in the individual case the two countries' tax authorities that are involved do not have the same approach in auditing the same transaction.

Currently, conclusions on the actual state of art of transfer pricing are based on groundless data, without any reference to particular groups' allocation of business risks. As such, this state of art is asserted on the basis of ideological beliefs as to who will make those conclusions.

Indeed it would be important to know by a review/study of audited taxpayers by tax authorities and, perhaps, at the OECD level, also on a no-name basis (with regard to both tax authorities and taxpayers):[1]

- How much current litigation between taxpayers and tax authorities involves comparables extracted from public databases (set 1)?
- Among this pool of litigation (set 1), which cases involve the basic assessment of setting the arm' s length price in such a way that the tax authorities have asserted that the associated tested party was not comparable to the taxpayer' s database set because it was the owner of intangibles, or bearer of entrepreneurial risks for the group business (set 1a)?
- Under the pool of litigation remaining from set 1 after the litigation from set 1a is removed (and so where the challenge is not the categorization of the associated enterprise as an enterprise not involved in entrepreneurial risks that may be compared to independent enterprises in a database), which litigation involves situations where the two involved tax authorities do not agree on same transfer price (set 1b)?

When and if this information could be publicly available, also on a no-name basis, one would have reasonable tools to aid in understanding actual problems, and with a strict relationship between the actual state of art and proposals on possible legislative amendments to improve the application of the arm' s length principle.

8.3.2. Hidden permanent establishments and the paradox of a high level of income assessed in the hands of low-risk enterprises

Often group businesses, regardless of activity and sector, reorganize their structure to provide more centralized management of manufacturing, distribution or other functions, in search of increased efficiency. From the

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[1] This may be anticipated i.e. as a peer-to-peer review by OECD Member countries in monitoring the application of the OECD Guidelines.

perspective of the tax authorities of the host country, they generally have seen reduced average profits being generated in their jurisdiction as a result of the changes in the business models with a necessarily consequent decreased volatility of these results.[1]

Economic theory of the arm' s length principle is not in contrast with such a result, as the lower the assumed risk by an economic party (and so variances between expected values – the average – and all possible values), the lower its expected return must be. Obviously there must be coherence between past and future activity, such that if a positive intangible has been developed for the reason of a past activity, at the moment the enterprise is stripped of functions, it must be compensated for the intangible development.

In some cases when an enterprise is stripped of functions, there are organizations that do not obtain the status of a permanent establishment of a foreign entity that is the internationally agreed (minimal) form of enterprise allowed to produce taxable profits in the host country.

Tax authorities of host countries often classify independent or associated companies performing some very limited "services" for foreign entities as permanent establishments of non-resident associated principal companies, and as a result of those classifications the same tax authorities seek to have a huge amount of income allocated to those establishments. The allocated income is not related to limited activity performed locally. In these cases administrative matters often prevail over economic principles surrounding the arm' s length principle; problems arise because when a permanent establishment of a foreign entity is deemed to exist according to tax authorities of the host country, the same establishment has not filed a tax return for the involved company, nor has it created separate accounting for the establishment. Often, tax authorities will adjust income to the value of sales (without cost deduction) of the foreign entity in the host country and not at the limited amount in compliance with limited risks and functions locally assumed and performed.

The OECD' s authorized permanent establishment approach (the 2008 Report) allows tax authorities to assess the presence of a (hidden) permanent establishment in the host country, but suggests limiting the income adjustment to this entity to only that income related to the (limited) actual economic functions and risks performed and assumed.

In the real world, tax authorities often begin their challenge with huge amounts of upward adjustments linked to sales of the foreign entity; then litigation may end in a compromise with the challenged taxpayer. As such, the enterprises would accept the challenge about the recurrence of requirements to consider a permanent establishment as being in

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[1] Chapter IX of the OECD Guidelines deals with issues arising from reorganizations, e.g. the value of eventual intangibles which were developed as a consequence of activity prior to the reorganization and which are deemed to be sold upon reorganization.

operation and in exchange the tax authorities would limit any income adjustment to the true income linked to activities actually performed.

It would be important to know, through actual data, simply with the aim of improving the legal standard:

- How much current litigation involves a hidden permanent establishment that is challenged by tax authorities such that at the outset the tax authorities of one country have imposed a massive income increase related not to activities performed locally but to sales in a host country (set 2)?
- How much litigation included in set 2 has concluded with the assessment of limited income in the hands of the hidden permanent establishment related to the actual activity performed where the tax authorities have waived an assessment of income from sales in exchange for a waiver by the taxpayer of its right to appeal against a recurrence of circumstances that trigger the deemed existence of the permanent establishment (set 2a)?

When this information is available, one could form a well founded opinion about (1) how, in practice, the recurrence of circumstances that trigger the deemed existence of the permanent establishment is determined and (2) whether the existence of such circumstances is determined through fair interactions between taxpayers and tax authorities or whether the tax authorities have the competence (and threaten) to impose massive income increases on an enterprise in order to make it easier to assess the actual existence of circumstances that allow taxation in their country.

8.3.3. Intangibles not developed simultaneously: the marketing problem

Under the model of the arm' s length principle referred to above, only costs and investments bearing entrepreneurial risk are allowed to share part of the global integrated results.

Another important problem arises in cases where more than one enterprise is involved in bearing entrepreneurial risks and it is necessary to estimate the relative contribution of each party to the overall value. A simple way to do this would be to connect each other' s costs and investments bearing those risks. However, this is not appropriate when expenses have been incurred in different periods and the information about global integrated business is different at the time each party made its proper investments (i.e. intangibles developed not simultaneously but in sequence).[1]

Consider a simple example involving marketing costs: A company plans to offer a product for sale, and the manufacturing entity is located in one country while the distributing entity is located in another. Looking at past activity, there have been research investments by the manufacturing

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[1] Hines, supra n. 19, at 26.

enterprise to develop (and produce) goods that will be offered for sale, by the distribution entity, under an (until now) unknown[1] commercial name. At this stage the marketing activity is merely projected for the future, to let consumers know of the favourable features of the product.

Future marketing expenses may be much greater than past investment expenses related to the conception and discovery of the product, but such marketing expenses normally are incurred in the final step of the overall investment process aimed at manufacturing and selling goods or services. Marketing expenses are borne at the time the product is offered for sale, and may be incurred much later than the initial investment activity. Therefore, past expenses of a manufacturer may serve to limit the free entry of new enterprises and may have already created a positive value at the time the marketing activities are performed.[2]

Briefly, the manufacturer may become, before any marketing is performed, the owner of a bottleneck input (sometimes also with legal protection for the invention, as in the case of a registered patent) for the whole integrated business (including the future activity of offering the product and marketing activities for sale).

The first step in finding a practical solution (under the legal pattern of the arm' s length principle mentioned above) to the problem of the eventual allocation of the income of an integrated business to the manufacturer and distributor, is simply to separate the situations where this problem is present from those where it is not.

In fact, the distributor is not the developer of a marketing intangible:

(1) at the time when marketing investments will be borne by the integrated activity (production and research have already taken place, and marketing will be developed), this is no longer a zero-return activity and the results of the integrated business are already known. In this case the manufacturer does not agree at arm' s length that projected positive income is earned by the distributor, while, similarly at arm' s length, the distributor would not accept for itself projected losses, and therefore the sole arm' s length agreement is that which provides for a normal return to the distributor for similar (no-risk) distribution activities and gains or losses attributed to the manufacturer; or

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[1] Obviously, the fact that the name has no value is a particular hypothesis to be proved as a matter of fact.

[2] This is another hypothesis because the opposite case may occur, in reality, when marketing expenses are the first phase of the investment process aimed at creating a need for the product (or when the name already has a value at the moment of developing new markets). See C. Bogan and D. Wang, Launching a Blockbuster, 20 Pharmaceutical Executive 8 (2000), at 96; "Blockbusters are not discovered, they are built!", quoted in C. Roberge, Transfer Pricing in the Pharmaceutical Industry: The Remuneration of Marketing Intangibles (HEC Montréal Université de Montréal, 2010), at paragraph 4.1, available at www.oecd.org/dataoecd/41/44/46019470.pdf.).

(2) at the time when the projected activity is still expected to have zero projected return (integrated business results are not known and free entry in the market is allowed to new parties), but by a choice of group managers, supported with adequate intra-group agreements, the distribution activity is benchmarked with the activity of independent parties active in the market. The normal return to the group distributor is reached by granting, through appropriate transfer prices and contractual clauses, a priority claim on future sales income to the distributor, covering distribution costs but limiting income when costs are covered to the independent return on a similar function.[1]

The rule sought by the authors is simple to apply also from an ex post perspective, at the moment of audit by the tax authorities, perhaps even years after marketing investments and when global results are known, with the sole determination concerning the fact that marketing expenses have not been incurred at the distributor' s risk.

With regard to ex post transactions, during a tax audit carried out years after the commencement of distribution activities, the tax authorities may determine that a normal return has been left in the hands of the distributor for each audited period. This is an incontrovertible determination because whether marketing expenses have been borne not at the risk of the distributor is a (historical) question of fact. In this case, the actual conduct of the parties prevails over any (even written) agreement, and the sole difference between independent parties and group members is that independent parties would have bargained to obtain a contract for the future activity and remuneration, before carrying out transactions (making marketing investments). The tax authorities may not challenge transfer prices because the normal return on activity under a distribution contract was appropriate in any case, i.e. in both cases mentioned above – in case (1), because it was the only allowed arm' s length conduct, and in case (2) because it was due to an (also implied) choice of group managers.

This is a very simple rule that could be specified in tax law with appropriate examples related to audits by the tax authorities with regard

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[1] A. Barbera, Considering Risk in Trademark Royalty Arrangements, 12 Transfer Pricing Rep. 71 (28 May 2003) (contractual arrangements are "the key method for the allocation of risk between entities"). See also OECD Guidelines (2010), chapter IX (when comparables on risk splitting cannot be found, the contractually agreed risk allocation is accepted when certain conditions are met). See OECD Guidelines, paragraph 9.20 ("One relevant, although not determinative factor that can assist in this determination is the examination of which party(ies) has (have) relatively more control over the risk, as discussed in paragraphs 9.22-9.28 below. In arm' s length transactions, another factor that may influence an independent party' s willingness to take on a risk is its financial capacity to assume that risk, as discussed in paragraphs 9.29-9.32").

to distribution activities and which could be used to resolve many actual transfer pricing cases.[1]

The rule should be recorded (perhaps it is better to say "restated", in order to reflect the opinion that the rule is already implicitly included in the OECD Guidelines) in the OECD project on intangibles, so as to prevent misunderstandings with regard to a point which is so important for the actual application of the arm' s length principle (such as the distinction between enterprises bearing entrepreneurial risk and those that do not in the marketing field).

Examples of when there is compliance with the rule are essential, and they should be aimed at explaining that when the transfer price of a product (in situations as mentioned above) is determined so as to leave a "normal" return in advance to the distributor (with appropriate contractual clauses allowing this normal return with low volatility in nearly every state of the future world), no challenge may be made by the tax authorities, regardless of whether the normal return is determined through a price comparison (CUP method) or by a gross (resale price method) or net (transactional net margin method or comparable profit method) margin comparison.[2]

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[1] The largest ever tax litigation (in terms of the size of the proposed income increase) began under similar circumstances, namely in the US Glaxo case. Thus, the need for clear language in tax law is truly essential. In 2006, the litigation between the US IRS and the US Glaxo distributor ended by means of a settlement accounting of USD 3.4 billion of increased taxes and penalties. For the years from 1989 to 1996, the US Glaxo distributor agreed (before commencing distribution activity in the United States, and assuming tremendous marketing expense) with associated companies to a transfer price, basically at the level of a gross margin guarantee, related to the royalties to be paid to the foreign patent owner or related to the price of the drug to be resold on the US market. The US tax authorities challenged the development by the US distributor of a valuable marketing intangible, consequently adjusting its taxable income. In the authors' opinion, that adjustment was not at arm' s length; in evaluating intra-group transactions assessing intangible assets in the hands of both the foreign manufacturer (assuming research expense risk) and the US distributor (assuming marketing expense risk), the US tax authorities had to prove two conditions, at least one of which was impossible to prove. The first condition to prove should be the existence of a highly risky integrated business at the moment of distribution before incurring marketing expenses. In the authors' opinion, their case is just the opposite, because at the moment the US distributor was going to sell Glaxo products in the United States, Glaxo foreign entities were already the owners of a valuable bottleneck input, developed outside the United States, with projected low-risk distributing activity. But also if the US tax authorities could prove that at the moment of commencing sales in the United States the business was a high-risk activity with zero expected return, they could not prove that the central management decision was, at that point, to share those purported risks between Glaxo foreign entities and the US affiliated distributor. This is a historical fact and also with hindsight and information available only at the time of the audit, years after the transactions, there are doubts that the US distributor gained a positive (limited) profit for each period of its distribution activity. See A. Musselli and D. Marchetti Hunter, Glaxo Transfer Pricing Case: Economic Rationale, Legal Framework and International Issues, 14 Int'l Transfer Pricing J. 3 (2007), at 165, Journals IBFD.

[2] See Roberge, supra n. 30 ("only a net margin pricing structure, ex post by nature could clearly be relied upon as equivalent to an indirect reimbursement of expenses "). It is interesting to note in this regard that Barbera, supra n. 31, whose approach to the notion of risk rests primarily on the way pricing is structured, argues that if the price of a product sold by a

Having focused on a special case involving a simple rule to be applied, it is now possible to return to more general problems related to marketing costs.

It is beyond the scope of this article to submit some reasonable solutions to the problem of marketing intangibles based on updated economic models (e.g. as could be suggested by economics of contracts). As such, the authors simply present some concepts, also because the majority of problems concern not economic concepts but rather how tax legislation deals with those concepts.

The marketing intangible must not be considered the same as an intangible which is developed under different principles governing the development of intangibles in other business sectors.

It is necessary to refer the eventual development of any intangible to an economic model included in the tax rules concerning factors (drivers) of profits under an integrated economic activity.[1] The model is that already mentioned above and which is included in the OECD Guidelines, which provides for an extra profit/loss attribution (intangible development) based on an ex ante transactional risk assumption. Under this line of reasoning, the concept of an intangible may also be broadened to reflect concepts extracted from the economics of contract. For instance, the particular position where one associated enterprise has a strong bargaining position and is the owner of a bottleneck input under the integrated activity, could come from contractual clauses that the same company would have requested of the counterparty when and if both were not associated but rather independent enterprises. For example, the part of the OECD Guidelines dealing with business restructuring is not comprehensible unless one supposes (as is the case in economics of

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manufacturer is set using an operating margin, then the manufacturer effectively bears all market risk. Further, "[t]he profit split and the transactional net margin method are both ex-post pricing methods, implicitly calling for year-end adjustment mechanisms". Roberge has doubts that if the distributor is "permitted to earn a very substantial gross profit margin … [it] should be regarded as having been indirectly reimbursed" even for extraordinary marketing expenses. As ex ante pricing based on gross margins is necessarily based on forecasts, the argument assumes the commercial success of the product on the local market. As anticipated sales may not materialize and, accordingly, critical mass may not be achieved, such an ex ante pricing structure cannot guarantee a low and stable level of remuneration. See Roberge, supra n. 30, at paragraphs 5.1.3.1 and 5.2. In the authors' opinion, in the US Glaxo case two facts were present: (1) marketing was developed with fragmented investments for each period such that for each period the amount of possible losses for the distributor (sales were nearly contemporaneous to marketing investments) was very small and (2) some years later it was possible to verify that in each period the distributor never recorded a loss (before putting at risk new marketing investments). Based on these two facts, the authors conclude that the distribution activity was a no-risk activity for the same distributor. Noting that gross profit pricing (as under the Glaxo structure) cannot guarantee a low and stable remuneration to the distributor, (per Roberge) it is not proven that the distributor is a marketing developer but, if anything, it is proven that the distributor, when the associated enterprise' s profit is higher than that achieved by the independent distributor using a net profit comparison, may have been overcompensated in relation to assumed risks. All these concepts are developed in A. Musselli and D. Marchetti Hunter, supra n. 32.

[1] See supra n. 22.

contracts) the behaviour of a company willing to invest in a trading relationship with another economic party when the investment has a value only for (or increases the value of) the integrated business of those parties. The first company might agree before investing as regards its remuneration under all predictable future scenarios, because in the opposite case, if the bargaining regarding remuneration were to occur after the investment is completed, the first company would have lost its ability to obtain its best remuneration because there is only a single sale market (the counterparty of the integrated business).[1]

When actual cases are examined more closely using the tools of the above model, it is imperative to bear in mind the moment when investments are made because at different points in time information about the profitability of the integrated business is notably different. As such, the degree of risk of investments is also different. When marketing costs are borne at the final moment of the business,[2] perhaps when enterprises have previously invested in research and as further protection (so as to strengthen barriers to free entry in the market) have patented a product or a manufacturing process,[3] marketing investments have lower degrees of risk as compared to when they are borne at the starting moment of a business, perhaps when no product has yet been developed and when it will be developed only when and if consumer demand will be successfully driven by those marketing investments.

Concepts included in examples from the Australian Taxation Office (ATO), in NAT 14586-11.2005, serve to supplement discussions already undertaken in the past by the OECD working party on taxation of multinationals, and may be a starting point to be developed in the OECD Guidelines. The authors' considerations in this article are aimed at refining the hypothesis of examples in order to render them consistent with constraints related to data limitations usually faced by those who must actually set transfer prices, and to include both real cases and theory. The ATO examples are based on a foreign manufacturer that developed a product with a well known name abroad (where related products are already sold) and which will enter a new geographic market to sell the same product through a related distributor. The name is not known in the new market and it belongs to the manufacturer. The first

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1 See A. Musselli and A.C. Musselli, Stripping the Functions of Affiliated Distributors, 15 Int'l Transfer Pricing J. 6 (2008), at 262, Journals IBFD; A. Musselli and A.C. Musselli, Stripping the Functions of Producing Affiliates of a Multinational Group: Addressing Tax Implications via Economics of Contracts, 15 Int'l Transfer Pricing J. 1 (2008), at 15, Journals IBFD.

2 The authors propose to use the concepts of "time of investment" and "information available at that time about profitability of same investment" to link the abstract model of transfer pricing with the overly specific features seen in practice with regard to real transfer pricing cases. Consider, for example, pharmaceutical sector investments where information about business is so different at the moment of commencing research on an active ingredient as compared to the moment where the ingredient is proven to have a positive effect (or to have no effect when the research has failed) on human diseases. Obviously the risk of investment at those different times is massively different, too.

3 In the pharmaceutical sector, one may think of an active ingredient.

aim of the examples should be to specify that when marketing costs are not borne by the distributor, the problem of the development of a marketing intangible is irrelevant for resolving transfer pricing cases as analysed above. In fact, if any marketing intangible will be developed in those cases, it will be developed by the manufacturer, such that the arm's length transfer price is determined based on the "normal" remuneration of comparable distributors.

Indeed, the next problem in creating tax rules is to understand when it is useful to distinguish between the normal versus abnormal marketer role of the distributor. In this regard, the general context of marketing expenses borne by distributors not owning trade names is presented: consider that an (independent) distributor may hesitate to invest in marketing or advertising of products when that distributor is not the owner of the brand or commercial name of such products. This hesitation is due to the eventual moral hazard of the manufacturer, which could (after the distributor has invested in publicizing the name of the manufacturer so as to increase income from the resold products) (1) terminate the contract, denying the distributor of benefits arising from marketing investments or (2) have all contractual leverage to obtain the best price for itself.[1]

A clear solution for transfer pricing cases is seen when it is possible to find an independent contract[2] concerning distribution activity to be applied also in the relationship among affiliated enterprises. The contract specifies the duration of the relationship, obligations of the parties (regarding e.g. marketing, size of transactions, target geographic market) and prices (whether prices of goods to be resold or royalties on income from the resale of products). Here it is not necessary to discuss the role of the marketer (normal versus abnormal) because regardless of the role of the affiliated marketer, that role corresponds to the independent role as identified in the independent contract. Also, if there is a different comparison to be done, i.e. where that affiliated distributor performs a more risky activity than the independent distributor, an adjustment can be projected to account for the different behaviour expected from the affiliated distributor.

When independent (internal) comparable contracts are deficient such that there is only information about remuneration of independent distributors extracted from databases containing financial information on enterprises, it may be useful to contemplate the marketer role in relation to assumed risks. Here, the concept of normal versus abnormal marketer is a useful one. The most reliable results to be extracted from databases are those involving low-risk (distribution) activities because it is not possible to obtain, from databases, information about contracts for the

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[1] See reference at supra n. 35.

[2] When it is possible to find entirely comparable contracts, they are usually for internal comparables, i.e. for sales of affiliated manufacturers with independent distributors, given the fact that the goods to be resold are the same as those to be resold in affiliated transactions.

pool of comparables; it is only possible to obtain information about actual data and not about possible remuneration in each possible scenario; it is not feasible to see the contract provisions concerning the marketing activity and it is nearly impossible to obtain information from balance sheet entries on marketing costs (which are generally included in operating expenses).

The model of the arm' s length principle included in tax rules is well suited to work with the economics of multinationals where price competition is superseded by innovation as a prime competitive weapon of enterprises, and any integrated business aims to market different products differently from those of its competitors; any marketing intangible is developed in connection to a specific activity of the manufacturing entity and therefore any such marketing intangible is linked, as an economic result, to specific integrated business results realized in connection with integrated activities of the manufacturer and distributor.

Once remuneration has been determined using a profit method (TNMM or comparable profit method) for low-risk, normal distributors, the role of an abnormal marketer is considered in assessing that the net profit for the projected abnormal marketer affiliated distributor, when marketing investments are made by the same distributor, will initially be lower (and may also become a loss) than the net profit determined from the pool of comparables, given a set transfer price for the resold product. The profit of the affiliated distributor, if and only if the marketing proves to be successful, will have to be greater in a second period than the period covered by the pool of comparables, given a set transfer price for resold products. The duration of the intercompany contract and eventual transfer pricing adjustments must be projected to reach these targets. More than one method may provide an arm' s length result.[1]

A further step (perhaps with a new example) is foreseeable where it is not appropriate to refer only to the distributor' s activity when determining an appropriate transfer price. Here, given an assessment of risks assumed by a distributor related to risks already assumed by the manufacturer (or, with same results, the total risks of the integrated

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[1] Roberge (supra n. 30, quoted) makes a proposal related to the case when a marketer is not the risk taker with regard to marketing expenses ("in cases where the excess marketing expenditures are clearly documented in the intra-Multinational enterprise arrangements, or where third-party data allows for an identification and quantification of such expenses (if not directly, at least through an inquiry into the comparative level of assistance provided by the manufacturer or Marketing Intangible owner to the related and arm' s length- independent n.d.r- distributors), provided also that the differential in operating expenses is found not to amount to a higher level of risk for the related distributor, the application of the Resale Price method supplemented with a Cost plus on additional marketing expenses can provide an Arm' s Length remuneration for the local distributor".). The authors do not fully understand the above concept because when a cost-plus is applied (so that costs are covered in each possible future scenario) to additional marketing expenses, it is certainly true that the differential of marketing costs is not related to a higher level of risk.

business), one is faced with an eventual marketing intangible that must be connected to the intangibles developed on the production side. It is necessary to agree to a rule providing for a split of combined profits resulting from the integrated business, and both sides of the transaction must be analysed (the view of the manufacturer and the view of the distributor),[1] developing a key factor to relate the risks and the intangible already developed by the manufacturer to the risks and the eventual marketing intangible development by distributor. As noted at the beginning of this article, it is usually not appropriate to relate the amount of costs of research and development affiliates to the amount of costs of marketing intangibles because at the time when marketing will be carried out, the integrated business may already have a value which is not connected to past costs. Here more than one economic pattern may permit the assessment of arm' s length conditions and time of investments (time of investment on the production side versus time of making a marketing investment), and this is an important factor when evaluating the different degrees of investment risk.

Another point to bear in mind concerns the possibility of incurring marketing expenses in fragmented amounts so as to limit the amount at risk connected to these marketing expenses, allowing the resolution[2] of uncertainties related to demand before making the relevant marketing investments. This would resolve the well known problem under US Treasury Regulation section 1.482 regarding so-called periodic adjustments, as well as described in chapter VI, section C.4 of the OECD Guidelines, "Arm' s length pricing when valuation is highly uncertain at the time of the transaction". For example, one may consider that when a pharmaceutical active ingredient has become a patented drug, the degree of risk for the business is drastically changed from the time when there was no conception of that active ingredient and some research expenses were incurred just to discover that ingredient.[3] In this case, the value of the patented drug is not related to the discovery costs, but to the profit arising from future business. Also when there is uncertainty surrounding

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[1] The authors' opinion is consistent with Roberge (supra n. 30, quoted), who proposes at the conclusion of her work some specific ways to split combined profits. In the opinion of the present authors, economics of contracts and game theory may provide the best model to be applied.

[2] This behaviour is confirmed by empirical studies on the economics of actual multinational enterprises. See thesis of I. Horstmann and J. Markusen, Exploring New Markets: Direct Investment, Contractual Relationships, and the Multinational Enterprise, 37 Int'l Econ. Rev. 1 (1996) (companies which will enter foreign markets in the presence of uncertain demand might prefer to explore the new market through "independent" licensees rather than affiliates, in order to avoid fixed set-up expenditures; an incentive remuneration must be granted to that licensee for inducing a truthful revelation regarding the state of the demand in the particular market).

[3] J. Hejazi, Transfer Pricing within the North American Pharmaceutical Industry: Has There Been a Structural Shift in Risk?, 13 Int'l Transfer Pricing J. 1 (2006), at 8 (observing that in recent years with the explosion of generic drugs, one sees the "erosion of patent protection [that] increases the level of risk bearing on the R&D function").

the integrated business results (including distribution and marketing activities), that uncertainty may be resolved in the future with marketing costs at risk in fragmented amounts so as to be recovered over time and ultimately permitting an understanding (without assuming new relevant risks) of the actual value of the drug.[1]

Cases in which more than one intangible has been developed in the integrated business remain the true problem of the economic concept of the arm' s length principle, when those intangibles have been developed in sequence. Where one intangible is already developed and another is going to be developed, it is not permissible to use shared costs of developing both intangibles to split integrated results, as it is necessary to assign a value to the former related to the latter, based on market values and not on development costs. In any case, no uncertainty is acceptable with regard to the arm' s length principle from a legislative perspective; more clear rules need to be promulgated by legislators regarding behaviour requested of taxpayers. Otherwise, the discretionary authority of taxpayers cannot be blamed and considered a breach of the arm' s length principle, as determined in the legal standard.

9. Conclusion

The theoretical supremacy of the arm' s length principle in respect of a unitary formula (i.e. based on costs, assets and sales) to allocate the income of a multinational business to group members is well known and proclaimed by governments and economic scholars, because the arm' s length principle promotes efficiency of enterprises and an equitable division of tax revenue among countries where the multinational business is carried out.

However, the theoretical supremacy must also be proven with regard to the effectiveness of the principle (not as it is in an ideal formulation, but in its practical application) when it comes to the possibility of enterprises to anticipate the tax consequences of their cross-border transactions. This effectiveness is the highest for the unitary methods, but varies in the case of the arm' s length principle because the arm' s length principle is a general rule that must be applied to real cases. The less the possibility of enterprises to anticipate how tax authorities (of at least two sovereign countries involved in a single crossborder transaction) and, eventually, judicial authorities will apply the arm' s length principle (i.e. in practice) to real cases that are audited and adjudicated, the higher the degree of uncertainty for taxpayers.

Economists emphasize that uncertainty surrounding the proper tax rule to apply is detrimental for business because the immunity of property from arbitrary expropriation by governmental authorities is one of most important conditions for growth.[2] Uncertainty as to tax consequences (but

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[1] This type of analysis was applied to the US Glaxo case in Musselli and Marchetti Hunter, supra n. 32.

[2] W.J. Baumol, supra n. 14, see chapter 1.

also regarding administrative, labour law and other aspects of corporate existence) of cross-border transactions serves to discourage worldwide trade and investment, and worsens current difficulties related to growth. This is a significant negative consequence in terms of the lack of growth (not immediately and fully observable, but present nevertheless).

In this period of recession, these negative consequences must be carefully evaluated by judicious legislators. A first signal is also observable in some countries where multinational enterprises protest their lack of certainty as regards rules of law and threaten to under-invest in those countries.[1]

Regarding actual behaviours of taxpayers and tax authorities involving the arm' s length principle, there are no clear conclusions but there is only circumstantial evidence. Indeed, clear conclusions as to what is really going on as regards application of the arm' s length principle would be an important factor when determining necessary improvements to transfer pricing legislation.

Some economic studies conclude that enterprises shift profit to low-tax countries despite the legal standard of the arm' s length principle and consequent audits by tax authorities, but there is no real evidence of this. Indeed, a very recent (2012) OECD report on audits by tax authorities reveals that some countries recover little tax revenue from transfer pricing challenges, while others recover a great amount in nearly 100% of the audited cases. This last fact proves nothing with full evidence, but gives circumstantial evidence that the arm' s length principle, agreed in nearly all countries as the standard identified in the OECD Guidelines, is, in practice, applied in an inconsistent manner by tax authorities in different jurisdictions.

Empirical studies on the application of the arm' s length principle, in reaching a well-founded conclusion, might be based on information concerning how single groups share risks of their proper integrated business with affiliated enterprises. This information is in the hands of the same corporate taxpayers and then in the hands of the tax authorities when they audit compliance by taxpayers. Such information is generally not available in public databases.

An "independent" study could be carried out by governments or the OECD as part of the monitoring of the application of the OECD Guidelines, perhaps on a no-name basis (to respect the confidentiality of data of the tax authorities and taxpayers), with the focus of the study

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[1] Newspapers in many countries are full of interviews with corporate managers seeking increased certainty as regards the tax consequences of business decisions – and not only with regard to transfer pricing (which, in any case, remains a field where great problems, like those mentioned in this article, are experienced). Taxpayers have a similar desire for certainty of law as a reaction to challenges by tax authorities based on the so-called theory of corporate tax abuse. See J. Blank and N. Staudt, Corporate Shams, Working Paper 12-09 (New York University of School of Law) or aggressive tax planning; see OECD Ctr. for Tax Policy and Adm., Report on Corporate Loss Utilization through Aggressive Tax Planning (2011). In both cases, taxpayers seek to know in advance with more precision what is prohibited by tax law and what is not.

clearly aimed at improving future rules about the arm' s length principle, rather than at constituting a further appeal for resolving current litigation between businesses and tax authorities. This would allow a fine-tuning of the application of the arm' s length principle and a proposal of solutions to those problems. The OECD, with its highly skilled professionals, and in light of the organization' s authoritativeness, would certainly be the best body to carry out this proposed study.[1]

Some recurring cases of litigation involving the application of the arm' s length principle have been considered in which, in the authors' experience, the need for certainty regarding the rules to apply is very relevant. Some pragmatic solutions have been proposed to improve existing guidance so as to avoid litigation regarding the benchmarking by databases, hidden permanent establishments and marketing intangibles. Now litigation regarding the application of the arm' s length principle arises:

(1) as regards the requirement where the intangibles of the integrated business are located (which associated enterprise is the owner of the intangibles); and/or

(2) where there is agreement of taxpayers and also of the two or more involved tax authorities with regard to matters mentioned in (1), as regards how to calculate the remuneration of parties not owning intangibles (low-risk enterprises) or how to calculate the split ting of the integrated business result when at least two intangibles are owned by different units.

As a general conclusion, the OECD and the legislators of its Member countries are faced with an acute problem of legislative policy where it is necessary to take a clear decision between two stances that create the premise for cases under (1) and (2), mentioned immediately above. The alternative is that:

- tax regulations provide more detail regarding the behaviour asked of enterprises in order to comply with the arm' s length principle; or
- where more than one option is allowed by law because different methods comply with and are deemed to be consistent with the arm' s length principle, tax regulations must confirm that taxpayers are free to choose (in the limited meaning described above) from among permitted options, without any possibility that the tax authorities will challenge the transaction, perhaps years later.

The fuel on litigation classifiable under both cases (1) and (2) is to be switched off by clearly choosing one of the above two options, or a combination thereof.

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[1] If a real collective political will were to be present, based on an agreement of Member countries.

Regarding the cases described under (1) above, the OECD Guidelines must do a better job (as compared to the current state of affairs) of specifying the rules for allocating eventual intangibles to group members, and must better refine the notion of marketing intangibles, i.e. using concepts examined above (or other concepts of course, provided that they ultimately, truly clarify the questions). Once the text of the Guidelines is so improved, eventual residual litigation between taxpayers and tax authorities must really be left to be decided by the courts (through a mandatory ruling with one single transfer price that is applicable for both tax authorities involved in a single transaction).[1] Such litigation would be based on a disagreement on a question of fact about the fundamental assessment (consistent with the assumption of entrepreneurial risk and the related reward) determining the arm' s length pricing in an actual case.

Regarding the cases described under (2) above, namely concerning the way to measure the value of intangibles when more than one intangible is used by different associated enterprises, or concerning the way to measure the remuneration of parties not owning intangibles, the OECD Guidelines must decide whether to provide more detail on the quantitative process aimed at that measurement (and so to better specify demands that taxpayers are requested to comply with). As such, this would limit the permissible options.

Conversely the OECD Guidelines could decide to leave more flexibility for taxpayers to choose the mentioned measurements of remuneration, clearly allowing for more results to be regarded as legally acceptable arm' s length pricing.

Also in this case, a clear decision on the text of the international regulations is to be taken as a matter of legislative policy so that eventual residual litigation, concerning only facts and circumstances, will be left to judicial authorities.

Much litigation, in fairly interpreting the OECD Guidelines as an economic model, should not exist, but the authors are aware that there is in fact much litigation regarding which behaviours really comply with the law, and so now is the time to provide more details regarding the application of the arm' s length principle, specifically with the OECD work with regard to intangibles. The risk in providing more detail on the arm' s length principle is that there may also be some inaccuracies in respect of pronouncements of economics handbooks, and that it may not be possible to cover all possible cases that could arise in reality. However, this is a small risk when compared to leaving the situation as it is now, specifically where it is extremely difficult to apply the arm' s length principle so as to obtain any predictable result in practice. Currently,

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[1] The path of arbitration when two tax administrations do not agree on a unique transfer price in a single intercompany transaction (see article 25 of the OECD Model Tax Convention on Income and on Capital (15 July 2005), Models IBFD) is the best way to achieve actual compliance.

application of the rule is often ex post,[1] because when predictable results are not possible in advance, the actual rule that will be applied is left to courts to determine. This is unacceptable in any legal system where the supremacy of law is proclaimed as a guarantee against abuse of power by a governmental authority.

There is currently an ideological contrast between those who think that companies shift profits through illegal transfer pricing and those who think that tax authorities do not apply the agreed arm' s length principle in a consistent manner. However, neither opinion is based on incontrovertible data to support well founded conclusions, and in any case neither is useful in the efforts to improve the arm' s length principle.

It is no longer acceptable for companies and tax authorities to quote the OECD Guidelines regarding the assertion that "transfer pricing is not an exact science"[2] in order to justify "everything and its opposite" as regards arm' s length pricing. Indeed, this state of affairs could even exist in the field of economic theory surrounding the arm' s length principle, but must not exist in the field of tax regulations because it has a worse economic effect in the latter case (because of the uncertainty it creates for investors). Uncertainty surrounding the legal application of the arm' s length principle cannot be the aim of prudent legislators (and the OECD is certainly one of them)[3] because a law must regu late a matter so as to encourage logical behaviour in economic parties that seek to comply with that law, and in a way that such behaviour can be audited by tax authorities (and judicial authorities).

If the arm' s length principle is applied so as to create uncertainty for businesses (and for tax authorities in auditing the activities of businesses), the supremacy under unitary rules is certainly lost.

In the authors' opinion, the OECD, given its strong authoritativeness, has the influence, expertise and skill to (attempt to) improve the system.[4]

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[1] A system like this, based on ex post decisions of tax authorities, absolutely requires that both (at least two) tax authorities involved in auditing a single transaction (the tax authorities of the seller and the tax authorities of the purchaser) come to the conclusion of a single transfer price but without any negative consequence arising from an adjustment to the taxpayer' s transfer price (in term of penalties, interest, correlative or secondary adjustments, etc.).

[2] The requirement is found four times in the OECD Guidelines (2010) at paragraphs 1.13, 3.55, 4.8 and 8.3, to always allow more than one result as the arm' s length price.

[3] The difficulties involved in OECD work are well known, as before the OECD can have its own position there must be consent of Member countries (and this is often not a simple affair).

[4] Worldwide uncertainty regarding basic conditions for business is currently as bad as it has been since the 1930s. This takes the form of e.g. uncertainty about the solvency of sovereign debt and financial institutions, as well as the existence and future of widely used currencies (e.g. the euro). The need for certainty as regards desired behaviours in tax matters is necessary not (only) for equitable reasons, but simply to bring about the situation where placing capital at risk by investors will not become an uncommon practice of heroic men.

The Law on Deductibility of Expenditure Incurred for an "Unlawful Purpose"

by
CA S.Kalyanasundaram

The law on deductibility of expenditure incurred for an illegal purpose has had a long history with the Courts & Tribunals taking a practical view of the matter & upholding the assessee's claim. Though the Explanation to s. 37(1) was inserted to supersede these judgements, there is still scope to argue that some types of unlawful expenditure are deductible, says the author, and makes good his contention by reference to several case laws

Section 37 of the Income Tax Act, 1961 (the "Act") has been a source of numerous disputes between the department and the taxpayer. For the sake of convenience, the sub-section with explanation thereto is quoted below:

> *37 (1) Any expenditure (not being expenditure of the nature described in sections 30 to 36 and not being in the nature of capital expenditure or personal expenses of the assessee), laid out or expended wholly and exclusively for the purposes of the business or profession shall be allowed in computing the income chargeable under the head "Profits and gains of business or profession".*
>
> *Explanation—For the removal of doubts, it is hereby declared that any expenditure incurred by an assessee for any purpose which is an offence or which is prohibited by law shall not be deemed to have been incurred for the purpose of business or profession and no deduction or allowance shall be made in respect of such expenditure.*

The Explanation was introduced in 1998 and the amendment was made retrospective from 01st April, 1962. The *Memorandum Explaining the Provisions of the Finance Bill 1998* stated as follows:

> *It is proposed to insert an explanation after sub-section (i) of section 37 to clarify that no allowance shall be made in respect of expenditure incurred by an assessee for any purpose which is an offence or which is prohibited by law. This proposed amendment will result in disallowance of the claim made by certain tax payers of payments on account of protection money, extortion, hafta, bribes, etc. as business expenditure.*
>
> *This amendment will take effect from 1st April, 1962 and will accordingly apply in relation to the assessment year 1962-1963 and subsequent years.*

The disallowance under this Explanation, therefore, rests on the following conditions precedent:

(1) It should be an expenditure; and

(2) It should have been incurred for any purpose which is an offence or which is prohibited by law.

In a judgment delivered on 05th May, 1959 in the matter of *Indian Molasses Company Pvt. Ltd. v Commissioner of Income Tax, West Bengal* [1959] 37 ITR 66 (SC), their Lordships of the Supreme Court interpreted the meaning of the word "expenditure" in the context of Section 10(2)(xv) the Income Tax Act of 1922. Their Lordships' observed as follows:

> *'Expenditure' is equal to 'expense' and 'expense' is money laid out by calculation and intention though in many uses of the word this element may not be present, as when we speak of a joke at another's expense. But the idea of spending in the sense of paying out or away is the primary meaning and it is with that meaning that we are concerned. 'Expenditure' is thus what is 'paid out or away' and is something which is gone irretrievably.* In a later paragraph, their Lordships' observed as follows*:To be a payment which is made irrevocably there should be no possibility of the money forming, once again, a part of the funds of the assessee company.*

In another judgment delivered on 04th April, 1997 in the matter of *Madras Industrial Investment Corporation Ltd. v The Commissioner of Income Tax, Tamil Nadu* [1997] 225 ITR 802 (SC), their Lordships' of the Supreme Court, relying on the judgment in India Molasses Company Pvt. Ltd. (supra) held as follows: *Therefore, although expenditure primarily denotes the idea of spending or paying out, it may, in given circumstances, also cover an amount of loss which has not gone out of the assessee's pocket but which is all the same, an amount which the assessee has had to give up. It also covers a liability which the assessee has incurred in praesenti although it is payable in the future. A contingent liability that may arise in the future is, however, not 'expenditure'. It would also cover not just a one time payment but a liability spread out over a number of years.*

From the above two judgments, the following may be culled out: for something to qualify as an 'expenditure', it must be paid out in a manner that makes it irrecoverable (or, gone for good) and the amount should be an ascertained one, even if payable in the future.

Once it is established that the amount is 'expenditure', the second condition precedent for attracting disallowance under Explanation to Section 37(1) is whether it has been incurred by the assessee for any purpose which is an offence or which is prohibited by law.

The word "offence" is not defined in the Income Tax Act. However, it is defined in Section 3(38) of the General Clauses Act, 1887 as follows: *"offence" shall mean any act or omission made punishable by any law for*

the time being in force;". The expression "prohibited by law" , too, is not defined in the Income Tax Act. It may be viewed either as an act arising from a contract which is expressly or impliedly prohibited by statute, or contracts entered into with the object of committing an illegal act.

Prior to the retrospective amendment by way of insertion of Explanation to Section 37(1), there were some landmark rulings in relation to expenses that were deductible from income in order to ascertain profits. A large number of such rulings were in the context of Section 10(2)(xv) of the Act of 1922.

In their judgment delivered on 05th October, 1971 in the case of *CIT v S.C.Kothari* (1971) 82 ITR 794 (SC), their Lordships' of the Supreme Court held as under: *If the business is illegal neither the profits earned nor the losses incurred would be enforceable in law. But that does not take the profits out of the taxing statute. Similarly, the taint of illegality of the business cannot detract from the losses being taken into account for computation of the amount which can be subjected to tax as "profits'…* This decision was referred to by the Apex Court in the case of *CIT Patiala v Piara Singh* (1980) 124 ITR 40. In that case, Piara Singh was a smuggler who was apprehended in September, 1958 while attempting to cross the Indo-Pakistan border into Pakistan. A sum of INR 65,500/- was recovered from his person. On interrogation, Piara Singh stated that he was carrying the currency into Pakistan for the purpose of buying gold which he would then intended to smuggle into India. In proceedings initiated by the ITO, the amount was treated as undisclosed income of Piara Singh. Appellate Assistant Commissioner dismissed the appeal and Piara Singh preferred a second appeal before the ITAT in which he took the plea that if he was to be regarded as carrying on the business of smuggling, then he was entitled to a deduction u/s 10(1) of the Income Tax Act, 1922 of the entire sum that was confiscated on the ground that it was a loss incurred in business. The ITAT upheld the claim. The Revenue appealed before the High Court but the appeal failed. On further reference to the Supreme Court it was held that the assessee was carrying on the business of smuggling and, therefore, was liable to income tax on income from that business. The currency notes carried by the assessee across the border were an essential part of the smuggling operation. If the activity of smuggling can be regarded as a business, those who are carrying on that business must be deemed to be aware that a necessary incident involved in the business is detection by the Customs authorities and the consequent confiscation of the currency notes. It is an incident as predictable in the course of carrying on the activity as any other feature of it. Having regard to the nature of the activity possible detection by the Customs authorities constitutes a normal feature integrated into all that is implied and involved in it. The confiscation of the currency notes is a loss occasioned in pursuing the business; it is a loss in much the same way as if the currency notes had been stolen or dropped on the way while carrying on the business. It is a loss which springs directly from the carrying on of the business and is incidental to

it. Applying the principle laid down by the Court in *Badridas Daga v. Commissioner of Income Tax* the deduction must be allowed.

In another judgment delivered by their Lordships' of the Supreme Court on 24th November, 1960 in the matter of *Haji Aziz and Abdul Shakoor Bros. v CIT Bombay City II* (1961) 41 ITR 350, it was held that *In our opinion, no expense which is paid by way of penalty for a breach of the law can be said to be an amount wholly and exclusively laid for the purpose of the business. The distinction sought to be drawn between a personal liability and a liability of the kind now before us is not sustainable because anything done which is an infraction of the law and is visited with a penalty cannot on grounds of public policy be said to be a commercial expense for the purpose of a business or a disbursement made for the purposes of earning the profits of such business.*

The facts in Piara Singh's case as well as that of *S.C.Kothari* may be distinguished from the facts in *Haji Aziz and Abdul Shakoor Bros*' case. In the last-named case, the assessee was carrying on the lawful business of importing dates from abroad and selling them in India. The import of dates by steamer was prohibited under law but the assessee nonetheless did so. The consignment was confiscated by the customs authorities but was released on payment of a fine. The assessee claimed deduction of fine u/s 10(2)(xv) of the 1922 Act but the claim was rejected on the ground that the amount paid was for infraction of law. An infraction of law was not a normal incident of business carried on by a trader.

As a result of the decisions referred to above, a situation arose where a person conducting illegal business was at an advantage as compared to someone conducting a legal business but merely violates some law for one reason or another. In his erudite commentary on the Law of Income Tax, *A.C.Sampath Iyengar* states that this is difficult to justify.

The question that arises for consideration is whether all penalties/fine that are paid for lead to a disallowance?

In *CIT v KAP Scan and Diagnostic Centre P. Ltd.* [2012] 344 ITR 476, the Punjab & Haryana High Court dealt with the admissibility of commission paid to doctors for referring patients for diagnosis. Expenses claimed by the assessee towards such commission had been disallowed. The assessee sought to rely on the decision of the Apex Court in the case of *Dr. T.A.Quereshi* [2006] ITR 547 and of the Allahabad High Court in *CIT v Pt. Vishwanath Sharma* [2009] 316 ITR 419. In the case of Dr. Quereshi, the assessee was found manufacturing heroin and other contraband substances and claimed the value of heroin seized as a business loss. The Apex Court held that the value of heroin seized, being a part of stock-in-trade of the assessee, represented a business loss and not a business expenditure and was, therefore, not covered by section 37 in the first place. In the case of *Pt. Vishwanath Sharma*, the High Court had held that payment of commission to Government doctors for prescribing assessee's medicines was in contravention of public policy and not admissible as expenditure. The Punjab & Haryana High Court

distinguished the cases of *Dr. Quereshi* and *Pt. Vishwanath Sharma* on the grounds that the former did not deal with Section 37 and the latter did not distinguish between Government doctors and private doctors and was, therefore, of no use to the assessee in *KAP Scan's* case. The High Court further considered The Indian Medical Council (Professional Conduct, Etiquette and Ethics) Regulations, 2002 and concluded therefrom that such payment of commission was opposed to public policy. It consequently disallowed the expenditure.

In *J.K.Panthaki and Co. v ITO (Investigation)* [2012] 344 ITR 329, the Karnataka High Court dealt with a case where the assessee was a registered firm of construction engineers and designers. During the assessment years 1983-84 and 1984-85, its main income was from the contract receipts for civil construction from one KBBCL. There were some changes in structural designs of the building which resulted in a cost reduction of around INR 48 Lakhs as compared to original estimates. The Directors' of KBBCL entered into an agreement with the assessee whereby the managing partner of assessee agreed to pay such cost reduction of INR 48 Lakhs as commission to them in consideration of their awarding the contract of construction to the assessee. The assessee claimed deduction of the amount as an expenditure but this claim was rejected by the Assessing Officer. This was upheld by the Tribunal. The High Court dismissed assessee's appeal on the ground that what was being paid was a kick back or bribe couched in respectability by naming it "commission". It could not be allowed as expenditure u/s 37.

However, there are also instances of fines /penalties that have been allowed as admissible expenditure.

In *CIT v Prasad and Co.* [2012] 341 ITR 480, the Delhi High Court dealt with the case of assessee, a share broker, paying penalty to the Delhi Stock Exchange and National Stock Exchange for late deposit of margin monies and other violations of timely delivery. Following an ITAT decision in *Master Capital*, the High Court held that these payments were in the normal course of business of the assessee and there was no infraction of law.

In *Mahalakshmi Sugar Mills Co. v. Commissioner of Income Tax, Delhi*, [1980] 123 ITR 429, the Supreme Court had to decide the question whether the interest paid by the appellant-assessee therein under Section 3(3) of the U.P. Sugarcane Cess Act, 1956 for delayed payment of cess payable thereunder was an allowable expenditure under Section 10(2)(XV) of the I.T. Act of 1922. For deciding that question, the Court examined the provisions of Sugarcane Cess Act, 1956 which provided for taking of several kinds of action against a person who defaulted in payment of the cess imposed under that Act. Section 4 was found to make the defaulter liable to imprisonment or fine or both. Section 3(5) was found to make the defaulter liable for payment of penalty, an amount which far exceeded the amount of cess. Then, Section 3(3) was found to make the defaulter liable for payment of interest at 6 per cent per annum

from the date of default till the date of payment. On an analytical examination of the said provisions, the Court took the view that interest paid under Section 3(3) by the defaulter for delayed payment of the cess could not be described as a penalty imposed upon him for infringement of the law but ought to be regarded as an amount of compensation paid by him to the Government for delayed payment of the cess levied against him under the Act. In that view of the matter, the Court held that the interest paid by the appellant assessee on delayed payment of cess was an allowable expenditure under Section 10(2)(XV) of the I.T. Act of 1922.

Referring to its decision in *Mahalakshmi Sugar Mills'* case as well as a passage from a judgment of the Division Bench of the Andhra Pradesh High Court in *CIT v Hyderabad Allwyn Metal Works Limited* [1988] 172 ITR 113, the Supreme Court , in *Prakash Cotton Mills Pvt. Ltd. v CIT (Central) Bombay* held that whenever any statutory impost paid by an assessee by way of damages or penalty or interest, is claimed as an allowable expenditure under section 37(1) of the I.T. Act, the assessing authority is required to examine the Scheme of the provisions of the relevant statute providing for payment of such impost notwithstanding the nomenclature of the impost as given by the statute, to find whether it is compensatory or penal, in nature. The authority has to allow deduction under Section 37(1) of the I.T. Act, where ever such examination reveals the concerned impost to be purely compensatory in nature. Where ever such impost is found to be of a composite nature, that is, partly of compensatory nature and partly of penal nature, the authorities are obligated to bifurcate the two components of the impost and give deduction to that component which is compensatory in nature and refuse to give deduction to that component which is penal in nature.

Conclusion

The law relating to disallowances under Explanation to Section 37(1) remains contentious even after the insertion of the explanation. Disallowances under this Explanation are not as easy as they seem and require rigorous analysis to establish whether the ingredients of the Explanation are, indeed, satisfied. The law as it stands on date is not entirely free from controversy and each case has to be considered on its own merits.

United States-Switzerland

Swiss bankers charged for US tax evasion schemes

The US Department of Justice (DOJ) and the US Internal Revenue Service (IRS) announced that three Swiss bankers were charged with conspiring with US taxpayers to hide more than USD 420 million in offshore accounts and to evade US taxes on the income earned in those accounts. The announcement was made in a US Attorney Southern District of New York Press Release dated 19 December 2012.

The bankers were charged in an indictment filed on 19 December 2012. The indictment alleges that the bankers opened and managed undeclared accounts for US taxpayers at a Swiss bank using code names or in the names of sham corporate entities and that the bankers ensured that mail relating to those accounts would not be sent to the US clients in the United States.

It is further alleged that the bankers provided access to funds in the undeclared accounts to their US clients by mailing the clients checks drawn on a correspondent bank account maintained by the Swiss bank at a financial institution in the United States.

According to the press release, the bankers face a maximum sentence of five years in prison, a maximum term of three years of supervised release, and a fine.

IRS publishes Chief Counsel Advice on securities lending transactions

The Chief Counsel of the US Internal Revenue Service (IRS) has issued amemorandum that discusses whether securities lending transactions that were entered into prior to 20 May 2010 for the purpose of avoiding US withholding tax may be disregarded under the common law economic substance doctrine.

The memorandum provides a background of standard securities lending transactions undertaken in the normal course of business and the rules for withholding on substitute dividend payments made as part of such transactions.

The memorandum then discusses securities lending transactions undertaken for tax avoidance purposes, and considers a complex transaction involving, inter alia, a US securities loan between foreign persons, cash collateral posting, a substitute dividend payment agreement, an enhancement fee arrangement, a sale of

the loaned stock, a total return swap (TRS) agreement involving the stock, and a final unwinding and return of the stock to the original lender after a 20-day period.

Final regulations (T.D. 8735), issued on 14 October 1997, provide that substitute payments made pursuant to a securities lending transaction have the same source and character of the income, i.e. interest or dividends, that would be earned on the underlying transferred security.

The 1997 final regulations gave rise to concern that the total US tax paid on a series of securities lending transactions with identical underlying securities would be excessive because, if a dividend on the transferred security were US source, each substitute dividend payment in the series would be treated as US source income and be subject to gross-basis taxation under sections 871 and 881 of the US Internal Revenue Code (IRC), and subject to withholding under IRC sections 1441 and 1442, resulting in "cascading" taxation.

IRS Notice 97-66 was issued on 12 November 1997 to limit the aggregate US gross-basis tax on a series of securities lending transactions to no more than 30% of the underlying dividend. For this purpose, Notice 97-66 provided a formulary method under which the rate of US withholding tax on a foreign-to-foreign substitute dividend payment would be the excess of the rate of US withholding tax that would be applicable to US-source dividends paid directly to the recipient of the substitute payment over the rate of US withholding tax that would be applicable to US source dividends paid directly to the payor of the substitute payment.

Certain taxpayers took the position that no US withholding tax should be imposed on the substitute dividend payment under Notice 97-66 when both the foreign lender and the foreign borrower were subject to the same US withholding tax rate (e.g. 30% when no income tax treaties applied), regardless of the structure of the transaction.

On 18 March 2010, IRC section 871(m) was enacted to address the treatment of certain dividend equivalents (including substitute dividend payments). IRC section 871(m)(6) provides that reduction of tax may be allowed with respect to a chain of dividend equivalents only to the extent that the taxpayer can establish such tax has been paid with respect to another dividend equivalent in such chain, or is not otherwise due, or as the Secretary (Treasury

Department) determines is appropriate to address the role of financial intermediaries in such chain.

IRS Notice 2010-46, issued on 20 May 2010, withdrew Notice 97-66 for payments made on or after 14 September 2010 (the effective date of IRC section 871(m)). For payments made on or after 20 May 2010 and before 14 September 2010, Notice 2010-46 modifies Notice 97-66 so that Notice 97-66 cannot be relied on when a securities lending transaction, or series of such transactions, has a principal purpose of tax avoidance. Notice 2010-46 noted that no inference was intended with respect to transactions entered into prior to 20 May 2010.

The present memorandum states that the common law economic substance doctrine may apply to disregard a tax-motivated securities lending transaction depending on the facts and circumstances. The memorandum concludes that the transaction considered in the memorandum lacks economic substance on the grounds that:

- the securities loan had off-market terms, which were advantageous to both the lender and the borrower, and it was possible because the avoided US withholding tax was shared between them;
- the borrower participated in the transaction for no business reasons other than to facilitate the lender's tax avoidance;
- internal documents fail to show a business or regulatory purpose of the transaction; and
- the lender could not have profited, and actually did not profit, from the transaction apart from the tax savings.

The memorandum further states that the lender may be treated as having received a US source dividend subject to US gross basis tax and the borrower may be treated as a US withholding agent.

In addition, the memorandum states that other judicial doctrines may also apply to disregard such transaction, including the step transaction doctrine, and that agent-principal relationships may also be deemed to exist among the parties.

The memorandum also notes (in footnote 9) that the transaction that it discusses occurred prior to 31 March 2010, which is the effective date of the codification of the economic substance doctrine as IRC section 7701(o).

The memorandum is designated Chief Counsel Advice No. AM2012-009. It is dated 5 November 2012 and indicates that it was released on 16 November 2012.

Obama says fiscal cliff deal in sight, not done yet

President Barack Obama said on Monday that a deal with Congress to avoid the US "fiscal cliff," with its tax increases looming at midnight, was close, but he warned that it was not yet complete. "Today it appears that an agreement to prevent this New Year's tax hike is within sight, but it is not done," Obama said during remarks at the White House complex.

"There are still issues left to resolve, but we're hopeful that Congress can get it done, but it's not done." The president made his remarks surrounded by cheering supporters identified as "middle class Americans." Obama, who won re-election in November partially on a promise to raise tax rates for the top two percent of US earners, said the deal would ensure that taxes do not go up for middle income families.

He stressed that it would include an extension of unemployment benefits for the long-term jobless and extension of popular tax credits. Obama said the agreement being worked out with Republican leaders in Congress would not include a long-term solution to the government's debt problem.

"My preference would have been to solve all these problems in the context of a larger agreement, a bigger deal, a grand bargain, whatever you want to call it that solves our deficit problems in a balanced and responsible way," he said. "But with this Congress that was obviously a little too much to hope for at this time. Maybe we can do it in stages. We're going to solve this problem instead in several steps."

The outlines of a deal in the US Senate include raising income tax rates for individuals making more than $400,000 a year and households making more than $450,000 a year, but a sticking point remains on how long to delay automatic spending cuts to defence and domestic programs, known as a "sequester." Obama stressed that a deal over those spending cuts had to include revenue. "Any agreement we have to deal with these automatic spending cuts that are being threatened for next month, those also have to be balanced," he said.

"That means that revenues have to be part of the equation in turning off the sequester, in eliminating these automatic spending cuts, as well as spending cuts." The same would be true for any future deficit-cutting agreement, he said.

As he often stresses, Obama said deficit reduction would have to follow the principle of not hurting senior citizens, students, or middle class families. "If we're going to be serious about deficit reduction and debt reduction, then it's going to have to be a matter of shared sacrifice, at least as long as I'm president, and I'm going to be president for the next four years," he said.

Thailand

42nd SGATAR meeting

The 42nd meeting of the Study Group on Asian Tax Administration and Research (SGATAR) was held in Chiang Mai, Thailand on 19-22 November 2012. Delegates from 16 members attended the meeting. The countries and territories represented at the meeting were Australia, China (People's Rep.), Hong Kong, Indonesia, Japan, Korea (Rep.), Macau, Malaysia, Mongolia, New Zealand, Papua New Guinea, the Philippines, Singapore, Chinese Taipei, Thailand and Vietnam. The working group discussions during the meeting were on the following:

Administration of Large Taxpayers

The unique characteristics of large business taxpayers, e.g. complex finance and business structures, cross-border dealings with related parties, and international transactions, make such businesses unique and increases the risk which may arise from non-compliant behaviour. A number of SGATAR members have established Large Taxpayer Units (LTUs) to manage and administer such large business taxpayers. The focus of the discussions was on the administration of large business taxpayers, including:

- structure of LTUs;
- responsibilities of LTUs;
- management of compliance;
- promotion of voluntary compliance;
- how to improve large taxpayer compliance; and
- use of technology.

The conclusion was that due to resource limitations, there was a need to enhance the efficiency and effectiveness in administering large business taxpayers, constant review of assessment approaches and methods to improve voluntary compliance, and for those who have not, to establish LTUs.

Dispute Resolution under Mutual Agreement Procedures (MAPs)

This discussion centred on the following issues:

- organization structure;
- legislation in relation to MAPs;
- experience with regard to MAPs; and
- constraints and strengths including improving the efficiency of MAPs.

The experience with regard to MAPs varied widely among members but most members had a designated Competent Authority either at the respective Ministry of Finance or tax administration. Additionally, the legal basis for MAPs was varied with some members using the provisions contained in applicable tax treaties while others had domestic legislation or rules to supplement the provisions contained in the tax treaty

Problems experienced by members include resource constrains such as technical know-how, training and development, etc., as well the lack of precedents and experts to ensure consistency. It was agreed that MAPs are an important feature in resolving international tax disputes and there was a need to overcome any problems and ensure that the MAP process provided is as efficient as possible.

Investigation of Tax Crimes

Although the prosecution of serious tax offences is high on the agenda of SGATAR members, in most member states, tax crimes are not covered by the tax legislation. Tax crimes tend to be covered under general criminal legislation but some members do have specialized units to carry out tax crime investigations.

The discussion also looked at the problems encountered when investigating tax crimes including:

the complexity involved, i.e. cross-border transaction, electronic records, etc.;

- challenges posed by legislation such as banking secrecy laws;
- difficulties in obtaining information;
- limited capabilities and powers to investigate tax crimes; and
- lack of appropriate resources, amongst others.

Among the solutions to the issues identified include, amongst others, the establishment of specialised teams, improvement in training and skills, and increased use of technology.

Meeting of Heads of SGATAR Training Institutions (MHTI)

Additionally, the 6th MHTI meeting was also held in Chiang Mai from 19-22 November 2012. The main discussion among the members was on various coaching and mentoring strategies used in their respective administrations. The members also discussed the various joint training programmes organized by SGATAR.

The 43rd SGATAR meeting will be held in Korea (Rep.) in 2013. The 7th MHTI meeting will be held in Australia in 2014.

United Kingdom

Finance Bill 2013 – Targeted anti-avoidance rules: trade and property deductions

On 21 December 2012, the Government announced legislation for inclusion in the 2013 Finance Bill that will introduce targeted anti-avoidance rules (TAARs) to (i) sections 31 and 274 of The Income Tax (Trading and Other Income) Act 2005 and (ii) sections 51 and 214 of the Corporation Tax Act 2009, which govern the relationship between rules prohibiting and allowing deductions.

Currently, these provisions provide that certain business expenditure incurred by trades and property businesses, that would otherwise be disallowable, can be deducted from business profits.

Legislation will be introduced in Finance Bill 2013 to amend all of the above sections to include a TAAR. The TAAR will apply where a permissive rule would otherwise allow a deduction in calculating the profits of a trade or property business for an amount which arises from tax avoidance arrangements. The effect will be that the rules prohibiting a deduction take precedence over those allowing a deduction.

"Tax avoidance arrangements" are those to which the person is party and the main purpose, or one of the main purposes, is the obtaining of a tax advantage. The term "arrangements" will be widely defined.

The amendments will apply to amounts which arise directly or indirectly in consequence of, or otherwise in connection with:

- arrangements which are entered into on or after 21 December 2012; or
- any transaction forming part of arrangements which is entered into on or after 21 December 2012, except where the arrangements are, or any such transaction is, pursuant to an unconditional obligation in a contract made before 21 December 2012.

Malaysia

Malaysia Exceeds Increased 2012 Tax Revenue Target

Annual tax revenue collected by Malaysia's Inland Revenue Board (IRB) had, by December 28, exceeded the revised 2012 target set by the Ministry of Finance, and was well above its original budget.

Second Finance Minister Ahmad Husni Hanazlah confirmed that the IRB had collected almost MYR124.7bn (USD40.7bn) in taxes from January 1 until December 28 this year. That surpassed both the IRB's original 2102 budget of MYR109.1bn, as well as the Ministry's revised target of RM123.8bn that was established after it became obvious that the tax authority was becoming more successful in its efforts.

The IRB's success is welcome to the government, which has committed to a continued reduction in the country's fiscal deficit, while also raising public investment spending. Its annual tax revenue has increased in 2012 by 13.8% over its collections of MYR109.6bn in 2011, and by 44.2% over the MYR86.5bn raised in 2010.

Husni attributed IRB's improved performance to the implementation of performance targets over a number of its activities, including not only revenue collection but also such indicators as uncollected accounts, the conclusion of external audits, actual repayments received, successful investigations and the increased use of IRB electronic services, such as e-Filing.

Its actions against tax evasion were instigated through a special taskforce constituted in 2011, but its auditing and enforcement were further stepped up in 2012, by concentrating on cases where there was a significant amount of unpaid taxes. Husni reported that the IRB solved nearly 1.9m tax cases in 2012, well over the 636,000 cases solved in 2011, and bringing in an additional MYR2.94bn in revenue.

Canada

Canadian Govt Promotes 2012 Trade Accomplishments

Canada's International Trade Minister Ed Fast has been promoting his government's key trade accomplishments for 2012, stressing the importance of what he calls the most ambitious trade-expansion plan in Canada's history.

"Our government's top priority is creating jobs, growth and long-term prosperity in every region of Canada. That is why we are working hard to open new markets to increase Canadian exports to the world's largest, most dynamic and fastest-growing economies and regions," Fast said.

Fast added that Canada continued to oppose protectionist measures throughout 2012, while simultaneously promoting free and open trade. The result of such action, Fast said is that the country's workers, businesses and exporters "now have preferred access to, and a real competitive edge in, more high-growth and emerging markets around the world than at any other time in our history."

Among the achievements highlighted by Fast are Canada's participation in a full round of negotiations toward a Trans-Pacific Partnership (TPP), and the launch of trade talks with Japan and Thailand. Canada's free trade agreement (FTA) with Jordan has now entered into force, and its deal with Panama has recently received Royal Assent, while an arrangement with Chile has been tabled in parliament. In addition, a two-year extension to the Canada-United States Softwood Lumber Agreement has been signed, securing access to the US market for Canadian softwood lumber until 2015.

Progress has been made in negotiations with the European Union (EU) and India, and Canada has achieved observer status in the Pacific Alliance. Trade missions to Burma, India, China, Saudi Arabia, Jordan, Thailand, Cambodia, the Philippines, Russia and Libya, have also been carried out.

Switzerland-UK-Austria

Withholding tax agreements with the United Kingdom and Austria enter into force

On 1 January 2013, the withholding tax agreements between Switzerland and the United Kingdom and Austria enter into force. All British and Austrian taxpayers with a bank account or securities deposit in Switzerland are affected. The agreements solve the problem of untaxed funds. Clients either pay a withholding tax, which is deducted directly from their account and transferred anonymously to their country of domicile, or they must disclose their account details.

Banks must inform their affected clients about the new regulation by the end of February 2013. Clients will have until the end of May at the latest to announce whether the withholding tax is to be deducted from their account or whether they wish to disclose their account details. Already in the course of January 2013, the United Kingdom will receive an upfront payment of CHF 500 million from the banks in accordance with the terms of the agreement. This sum will be reimbursed to the banks in stages with anonymous retrospective taxation payments received from mid-year. No such upfront payment was agreed with Austria.

The actual implementation of the tax agreements will be governed by the Federal Act on International Withholding Tax (IWTA), which was brought into force by the Federal Council on 20 December 2012. The IWTA contains provisions on organisation, procedure, judicial channels, criminal law provisions and domestic procedural rules for the upfront payment.

Negotiations on similar agreements are under way with Greece and Italy. Other countries both within and outside Europe have also shown an interest. The signed agreement with Germany was not ratified by the German parliament in December 2012. The withholding tax model is part of the Federal Council's new financial market policy, the aim of which is to ensure that no untaxed foreign funds can be hidden in Switzerland.

Netherlands

Netherlands to establish a central register of shareholders

The advantage of a central register of shareholders is that it makes transparent who is involved in a BV or a non-listed NV as a shareholder

A central register of shareholders will be introduced. It has become clear during the tackling of financial-economic fraud that it currently takes a great deal of time to establish who is behind a private company with limited liability (BV), a non-listed public limited company (NV) or a construction involving several companies. This places a considerable burden on the investigative capacity.

A central register of shareholders means that information about BV's and non-listed NV's will be available in one location. This is an important added value when compared with the current situation, because the registration of shareholders is currently performed by several parties and this does not provide a complete picture, is not always current or is inaccessible for performing checks and supervision by the government.

The register will not be accessible for the public for reasons of privacy, but only to government services within the context of performing checks, supervision and enforcement. This concerns in any event the following government agencies: Justis, Ministry of Justice Agency for Scrutiny, Integrity and Screening, the Public Administration Probity Screening Agency, the Tax and Customs Administration, special investigative services, security and intelligence services, the police and the Public Prosecution Service.

During the elaboration of legislation, it will be considered whether other agencies have to be added. The notarial profession will also have access, because it will make it possible to significantly reduce the time-consuming investigative activities the civil-law notary has to perform within the context of a share transfer. Shareholders will also be authorised to inspect the data recorded in respect of them.

Minister Opstelten previously indicated that he will consider the administrative burden for entrepreneurs when introducing a central register of shareholders. Registration of the transfer of registered shares in BV's and non-listed NV's will take place through alignment with the information from the mandatory notarial deed of transfer. Civil-law notaries will have a role in supplying information to the central register. A decision still has to be made on where to house the central register of shareholders.

France

French Court Censures 75% Solidarity Tax

Dealing a severe blow to the Socialist government's 2013 budget, the French Constitutional Court has censured plans to impose a 75% tax on annual income in excess of EUR1m (USD1.3m).

The Court's decision follows an appeal submitted on December 20 by over sixty deputies and sixty senators, challenging the constitutionality of the government's 2013 finance bill.

In its ruling, the Court noted that article 12 of the 2013 budget, which institutes an exception solidarity contribution of 18% on income from activity in excess of EUR1m (taking the marginal rate of tax to 75%), is based on individual income. The Court pointed out that two fiscal households, benefiting from the same level of income from professional activity, could either be subject to the exceptional solidarity contribution or exempt from the levy, depending on the particular income distribution among taxpayers in the household.

According to the Court, the government had not taken into consideration ability to pay, and therefore censured article 12 for breaching the principle of equality before public charges.

Although the Court deemed that the government's new marginal income tax rate of 45% is in accordance with the country's constitution, it nevertheless explained that the new tax rate would serve to increase the marginal taxation of enhanced pensions in France, increasing taxation to 75.04% for those pensions collected in 2012, and to 75.34% for those collected from 2013. Underlining the fact that this new level of taxation and "excessive charge" is confiscatory, the Court said that the provisions are contrary to the constitution.

The Court also censured plans to integrate latent profits or income, which the taxpayer has not yet collected, when calculating the cap on wealth tax (ISF), and annulled the provision increasing the taxation of stock options and free shares.

Commenting on the Court's rejection of the 75% tax, emblematic of French President François Hollande's election campaign, French Finance Minister Pierre Moscovici underscored plans to take into consideration the principles defined by the Constitutional Court and to return in 2013 with a revised measure, "which implements this philosophy." The government has no intention of renouncing the initiative, Moscovici stressed.

Despite the setback, Moscovici maintained that the government would meet its public deficit reduction target of 3% of gross domestic product in 2013.

French government may water down 75 percent tax after setback

An embarrassing derailment of President Francois Hollande's 75 percent millionaires' tax may open an opportunity to water down a scheme that had damaged France's image with international investors, but he is unlikely to give up without a fight.

Finance Minister Pierre Moscovici has promised a redrafted tax on the wealthy will be pursued next year, following the Constitutional Council's decision on Saturday to strike down the emblematic rate on income over 1 million euros ($1.32 million). However, Moscovici has so far avoided referring specifically to the 75 percent rate which has made some of France's wealthy, including film star Gerard Depardieu, announce they will move abroad.

In the banking community at least, expectations are growing that the tax may look very different when the Socialist government comes back with the revised plan, even though the original enjoyed strong support among the French public. "I suspect this tax will be shelved. In the worst case he will come back with a lower rate and in the best case it will be binned," said Philippe Gudin, a France economist for Barclays and a former Treasury official.

"For the (low amount of) revenue it would raise, the outcry it has provoked and the damage it has done to France's image, it would be more sensible if it were quietly buried." The Council said the tax was unfair as it would hit married couples where only one partner earned above a million euros but would not affect couples where each earned just under a million.

Opinion polls show that six in 10 French people back the tax. But while it would have affected only 2,000-3,000 people and raised just a few hundred million euros a year, criticism from the business sector and high earners has been incessant. Hollande finds himself stuck between trying to appease investors who see him as anti-business and showing voters he remains serious about making the rich cough up more taxes.

Political analyst Olivier Duhamel said the government could accept the Council's ruling by making the 75 percent tax applicable to households, rather than individuals, and possibly raising the income threshold to 2 million euros. Alternatively, it could using the Council's rejection as justification for making the politically risky decision to ditch the whole idea. "In politics, when things get difficult, you are stuck with unpleasant choices," said Duhamel.

The ruling will have little effect on public finances but it embarrassed the government again only a few weeks after it suffered a public relations fiasco over an attempt to rescue two shuttered steel furnaces. Hollande will be wary of compounding his problems. “Giving up the 75 percent tax without a fight would be an admission of political weakness,” said Stephane Rozes, of the CAP political consultancy.

French media have reported even one of Hollande’s economic advisers muttered in private that a 75 percent tax rate amounted to turning France into “Cuba without the sunshine”. Deutsche Bank’s Gilles Moec also believed Hollande had little to gain by picking a fight with his own supporters by surrendering, but might go for the higher 2 million euro threshold, meaning far fewer people would be hit.

“The damage to France’s reputation is done. If they scrap it entirely they don’t gain much and they get into trouble with their left wing. This would be a compromise,” he said. Hollande may clarify his plans for a redrafted supertax rate in a New Year’s Eve speech on Monday evening. Hollande has been walking a tightrope since taking power in May as he tries to square his electoral priorities with the demands of financial markets and hold together a government made up of left-wingers and more pro-reform centre-leftists.

Famous for having once said that he disliked rich people, he vowed from day one to fight Europe’s focus on austerity policies and partially reversed a law that raised the retirement age.

He announced his 75 percent tax idea out of the blue on live TV midway through a campaign that was being overshadowed by a hard-line leftist rival. It came as a shock even to his future budget minister Jerome Cahuzac who stumbled when questioned about it on French radio, saying he was not aware of the plan. After six months in power, Hollande swung around and announced market-friendly moves to raise sales taxes and cut spending to fund tax relief for companies, explaining the nation that the scale of the economic crisis made this necessary.

He also capitulated to furious entrepreneurs who revolted over plans to raise capital gains taxes in 2013, agreeing to scrap the measure for small business owners. Hollande seems to be struggling, however, to find the right path to tread. The 75 percent tax reversal is the latest in a series of communications gaffes that

have critics muttering that he is figuring out policy as he goes along.

Hollande was ridiculed in November after London Mayor Boris Johnson, a British Conservative, likened his government to French revolutionaries for its threat to nationalise a steelworks where ArcelorMittal planned to shut two ageing blast furnaces. In the end, the government secured only a promise that furnace workers would get jobs elsewhere, infuriating unions.

The tax setback, which drew scathing reactions in French media, is a new blow to Hollande's credibility. Senate finance commission head Jean Arthuis said the government had been punished for its "dogmatic blinkered state and its amateurism". Commentators said Hollande was now in a corner over how to tweak the tax proposal to make it applicable to households - like regular income tax - rather than individuals without making it apply to tens of thousands more couples. "This is a major legal mistake that could clearly have been avoided," Thomas Piketty, an economist who backs supertaxes on the rich and helped inspire the 75 percent tax, told Liberation.

Philpine

Philippines 'sin tax' introduced, dampens New Year fun

A "sin tax" on cigarettes and alcohol dampened the New Year party spirit when it was introduced in the Philippines Tuesday, as part of a government bid to boost finances. Many stores started selling tobacco and drink at inflated prices before midnight, ahead of the official implementation of the tax hikes on January 1, hitting partygoers in the pocket.

Tax on cigarettes will gradually be raised to 30 pesos ($0.72) per pack by 2017, roughly doubling the current price to around 52 pesos. Duty on alcohol will also increase gradually until 2017, increasing the price of a bottle of beer by 23.50 pesos, with varying levels for other drinks including wine and spirits. It will be further increased by four percent each year thereafter.

"The new prices compared to countries like Singapore for example, are still low, but for the ordinary Filipinos they are expensive," said Laudemer Angeles, a 33-year-old shop owner in the town of Bacoor, south of Manila. "Many of my customers were complaining about the higher prices and were not too happy when they bought their booze and smokes for their parties last night." Anti-smoking

campaigner Emer Rojas said he hoped the new taxes would lead to a gradual decline in the number of people suffering from tobacco-related illness.

"I think the sin taxes should even be raised higher," he told AFP. "But we commend President Aquino for showing his resolve in signing the law." The government has said that the country of 100 million has the highest incidence of smoking in the region, with tobacco-related diseases costing the country 177 billion pesos ($4.3 billion) last year. The new taxes aim to raise 33 billion pesos ($800 million) this year alone, gradually increasing over the coming years.

United States

US Senate approves deal on 'fiscal cliff' crisis

The White House and top Republicans struck a dramatic deal to avert huge New Year tax hikes and postpone automatic spending cuts that had threatened to send the US economy into recession. After months of agonising over the crisis, weeks of debate about a possible solution, and days of intense, closed-door negotiations, members of the US Senate voted overwhelmingly 89-8 early Tuesday to pass a controversial bill that averts the so-called "fiscal cliff."

It now goes to the House of Representatives, which could hold a vote on the measure later New Year's Day. US President Barack Obama in a statement urged the House to "pass it without delay." If the measure is agreed by both chambers of Congress, it would hand Obama a victory by hiking tax rates on households earning over $450,000 a year, but exempt everyone else from a planned tax increase.

"While neither Democrats nor Republicans got everything they wanted, this agreement is the right thing to do for our country and the House should pass it without delay," Obama said in his statement. The deal puts off $109 billion in budget cuts across the government for two months, but in the process sets the stage for a new showdown between Obama's Democrats and Republicans in dysfunctional Washington at the end of February.

"There's more work to do to reduce our deficits, and I'm willing to do it," Obama said. Vice President Joe Biden, who negotiated the deal with top Senate Republican Mitch McConnell, trooped to Capitol Hill to sell it to Democratic senators, some of whom

wanted tax hikes to kick in at a lower threshold. Had no deal been struck, experts warned that the fragile US economy could have been sent spinning back into recession by the $500 billion combined whack from spending cuts and tax hikes.

In the end, the deal was clinched a few hours before a midnight deadline. The Senate vote came just after 2:00 am (0700 GMT), while the House was not due back into session until Tuesday. Now it remains for Republican House Speaker John Boehner to rally his restive conservative coalition around the pact, which will likely need some Democratic votes in the House to pass.

For two decades, Republicans have fought any attempt to raise taxes so White House officials will see vindication in a deal that enshrines one of Obama's top pledges in his re-election campaign. In a terse statement, Boehner said his chamber would pick up the legislation if it passed the Senate. "Decisions about whether the House will seek to accept or promptly amend the measure will not be made until House members - and the American people - have been able to review the legislation," he said.

Democrats suggested that the deal, like many congressional bargains, was not perfect, but that it was preferable to the alternative. "It's not that this proposal is regarded as great or is loved in any way. But it's a lot better than going over the cliff," Senator Chuck Schumer told reporters.

World stock markets, expected to be thrown into turmoil by a failure to beat the deadline, are closed New Year's Day, so lawmakers have a few extra hours of breathing room to get the deal concluded. The deal means a return to Bill Clinton-era tax rates for top earners to 39.6 percent, starting for couples who make $450,000 a year and above. Obama had originally campaigned for tax hikes to kick in on household income about $250,000.

The president said earlier that the deal would extend tax credits for clean energy firms and also unemployment insurance for two million people that had been due to expire. It also includes an end to a temporary two percent cut to payroll taxes for Social Security retirement savings and changes to inheritance and investment taxes.

A source familiar with the deal said that the delay to spending cuts - known as the sequester - was financed by increased revenues and spending cuts from defence and non-defence spending. Earlier, on a day of drama and brinkmanship, Obama had angered

Republicans when he warned that he was not done with seeking higher taxes on the rich to pay down the US budget deficit.

"I know the president has fun heckling Congress. It's unfortunate he doesn't spend as much time solving problems as he does with campaigns and pep rallies," said Republican Senator Bob Corker, fuming over the remarks. Signs that a deal could be close cheered investors as US markets rose before closing for the year. The Dow Jones Industrial Average closed up 1.28 percent at 13,104.14. Relief seemed to course through the Senate during and after the vote, but both sides were already gearing up for the next legislative showdown, over the need to lift the government's statutory borrowing limit of $16.4 trillion, reached Monday.

The Treasury will take extraordinary measures to keep the government afloat for an undisclosed period of time until the ceiling is raised. Republicans are already demanding spending cuts in return. That fight will now be doubled, with the deadline for the two-month sequester postponement set up by the fiscal cliff agreement.

Brunei-United Kingdom

Details of protocol to treaty between Brunei and United Kingdom

Details of the amending protocol, signed on 11 December 2012i - United Kingdom Income Tax Treaty (1950), as amended by supplementary arrangements from 1968 and 1973 have become available. The protocol was signed in the English and Malay languages, both texts being equally authoritative. In the case of divergence, however, the English text prevails.

The protocol contains an exchange of information provision which is generally in line with article 26 of the OECD Model with a few deviations, as follows:

– Paragraph 2 addresses privacy issues, noting that exchanged information may be disclosed only to bodies (including courts and administrative bodies) involved in the assessment, collection, the enforcement or prosecution in respect of, the determination of appeals in relation to the taxes covered by the treaty. Such information may additionally be disclosed in public court proceedings and judicial decisions. A deviation from article 26 of the OECD Model is that the information may be used for other

purposes under the laws of both territories, and the competent authority of the territory supplying the information authorizes such use.

- Paragraph 3 limits the required action on behalf of the contracting states. It provides, in part, that the obligation does not extend to information that is outside the administrative practices or not obtainable in the normal course of administration. Furthermore, the contracting states are not obliged to provide information which would disclose any trade, business, industrial, commercial or professional secret or trade process, or information, the disclosure of which would be contrary to public policy. A deviation from article 26 of the OECD Model is that the obligation also does not extend to obtaining or providing information which would reveal confidential communications between a client and an attorney, solicitor or other admitted legal representative, where such legal communications are (i) produced for the purposes of seeking or providing legal advice; or (ii) produced for the purposes of use in existing or contemplated legal proceedings.
- Paragraphs 4 and 5 state that a contracting state cannot decline to supply information solely because (i) it has no domestic interest in such information; or (ii) because the information is held by a bank, other financial institution, trust, foundation, nominee or person acting in an agency or fiduciary capacity; or (iii) because it relates to ownership interests in a person.

United States

New Medicare taxes for 2013

Two new Medicare taxes have taken effect beginning on 1 January 2013. The taxes were enacted as part of the Affordable Health Care Act of 2010, popularly known as Obamacare.

Additional Medicare tax on earnings from wages

A new Medicare tax of 0.9% applies to high-income employees who receive wages in excess of prescribed threshold amounts (section 3101(b)(2) of US Internal Revenue Code (IRC)). The new tax

applies to employees and to self-employed individuals but not to employers.

The tax is in addition to the regular Medicare tax that applies at a rate of 1.45% for employees and employers (IRC sections 3101(b) and 3111(b)) and at a rate of 2.90% for self-employed individuals (IRC section 1401(b)).

The prescribed thresholds at which the new 0.9% Medicare wage tax applies are as follows:

- USD 250,000 for married taxpayers who file a joint tax return;
- USD 125,000 for married taxpayers who file separate tax returns; and
- USD 200,000 for single taxpayers.

Additional Medicare tax on net investment income

A new additional Medicare tax of 3.8% applies to the net investment income of high-income individuals (IRC section 1411). The tax applies to individuals but not to employers.

The additional tax is imposed on the amount of the individual's net investment income that exceeds a threshold amount. Specifically, the tax applies to the lesser of:

- the individual's net investment income for the taxable year; or
- the excess of (i) the individual's modified adjusted gross income (modified AGI) over (ii) the applicable threshold amount.

The prescribed thresholds at which the additional 3.8% Medicare tax on net investment income applies are as follows:

- USD 250,000 for married taxpayers who file a joint tax return and for individuals who are eligible to file a tax return in the surviving spouse category;
- USD 125,000 for married taxpayers who file separate tax returns; and
- USD 200,000 for single taxpayers.

The term "net investment income" can be defined generally to include net income from interest, dividends, annuities, royalties, rents, and net gains from dispositions of property held in certain types of specified trades or businesses (i.e. generally passive or financial trading businesses).

Income received by self-employed individuals from a trade or business that is subject to self-employment tax under the regular social security tax for such persons (SECA) is not subject to the additional Medicare tax.

The additional Medicare tax does not apply to non-resident individuals or to charitable trusts that meet certain requirements. Special rules apply to the computation of the additional tax by estates and trusts.

The additional tax is referred to in the legislative history as the Unearned Income Medicare Contribution Tax, but is included in the regular income tax provisions of the Internal Revenue Code rather than in the provisions dealing with social security and Medicare taxes.

The legislative history states that the tax is subject to the estimated tax provisions and is not deductible in computing the individual's regular income tax.

Legislation enacted to avert fiscal cliff

The US Congress has enacted legislation (the American Taxpayer Relief Act of 2012) to avert the fiscal cliff that would have resulted from the expiration of the Bush-era personal income tax rates. The legislation also includes changes in the tax rates for capital gains and dividends and the rates for US estate and gift taxes. The complete details of the legislation will follow in a subsequent report.

Vietnam

Draft amendments to Law on VAT

It has been reported that the Ministry of Finance has proposed the following key amendments to the Law on VAT:

- Article 5: Expanding the exemptions to items such as health insurance, personal insurance services, and the goods and services of sole proprietors with an annual revenue of less than VND 100million.
- Article 7: Including enviromental protection tax in the VAT base.
- Article 10: The tax deduction method is to apply to businesses earning revenue from sale of goods or provision

of services over the threshold (as specified by the Government).

- Article 12: Input VAT claim timeframe to be increased from 6 months to 12 months.
- Article 13: For refund purposes, the threshold for input VAT not fully deducted to be increased from VND 200 million to VND 500 million. This is in respect of enterprises having projects in the investment period and enterprises having goods and services for export in the month or in the quarter.

France

Allowances on inheritance and gift taxes for 2013

The allowance on inheritance and gift taxes is updated on 1 January of each year based on the first instalment of the scale for the personal income tax. According to the Finance Law for 2013 (Loi de finances pour 2013, LF 2013), the scale for personal income tax will remain the same as in 2012 except for the top bracket. The scale has been frozen since 2011.

As a consequence, the amount of allowances on inheritance and gift taxes will remain the same as in 2012 as follows:

- a EUR 100,000 personal allowance applies to inheritances and gifts in direct line;
- a EUR 159,325 allowance applies to inheritances and gifts to mentally or physically handicapped beneficiaries;
- a EUR 15,932 allowance is granted for inheritances and gifts between siblings;
- a EUR 80,724 allowance applies to gifts between spouses and between unmarried individuals who live together and have entered into a partner contract (known as “PACS”);
- a EUR 31,865 allowance applies to gifts made to grandchild beneficiaries (EUR 5,310 for great-grandchildren). However, the beneficiary must be at least 18 years old, whereas the donor must be younger than 80;
- a EUR 7,967 allowance applies to donations to nephews and nieces; and
- a EUR 1,594 allowance is granted if no other allowance is available.

2013 TRI 1 (Trib. Ind.)

INCOME TAX APPELLATE TRIBUNAL
MUMBAI "K" BENCH, MUMBAI

B. Ramakotaiah, Accountant Member and Amit Shukla, Judicial Member

FACTS/HELD

1. **Section 263: Assessment order following binding TPO's order is not "erroneous or prejudicial". Doubt raised whether TPO's order can at all be revised u/s 263**
2. The assessee sold equity shares held by it in PT Essar, Indonesia, to Essar Global Ltd, Mauritius, and claimed a capital loss of Rs. 19 crores by adopting the NAV method for computing the sale price. The TPO rejected the NAV method and held that the PE method was the appropriate method. He recomputed the ALP and reduced the capital loss to Rs. 7.41 crores. The AO passed an assessment order in conformity with the TPO's order. The TPO thereafter submitted a proposal to the DIT which was forwarded to the CIT that the average of the NAV & PE method should have been adopted instead of the PE method to compute the capital loss and that the TPO's order be revised u/s 263. However, instead of revising the TPO's order, the CIT passed an order u/s 263 holding that the assessment order was erroneous and prejudicial to the interests of the revenue. On appeal by the assessee to the Tribunal, HELD:
   (i) While the TPO proposed, in his application to the DIT/CIT that s. 92CA(3) order be considered for revision, the CIT revised the assessment order passed u/s 143(3). This action of the CIT is not appropriate because as so long as the TPO's s. 92CA(3) is not revised, it is binding on the AO u/s 92CA(4). There is no fresh reference to the TPO nor is there any revised order of the TPO. As, in the assessment order, the AO followed the binding order of the TPO, there is no error in the assessment order capable of revision (Sun Microsystems (ITAT Bang) distinguished on the ground that at that the AO was not bound by the TPO's order);

(ii) The issue whether the TPO's order could be revised by the CIT or by the DIT is not considered as it does not arise in the present case though as the CIT has no administrative jurisdiction over the TPO, he could not have revised the s. 92CA(3) order passed by the TPO. There seems to be no clarity about the authority competent to modify the TPO's order in case it is is prejudicial to the interests of the revenue. The CIT cannot exercise jurisdiction over the TPO as the TPO functions separately under the DIT (TP). The DIT should have initiated the s. 263 proceedings himself instead of sending a proposal to the CIT for revising the TPO's order though the question would also arise whether the DIT can revise an order which he himself has approved as per the Board's Circular;

(iii) Further, the issue as to whether the TPO ought to have adopted the NAV method or the PE method or an average of the two is a debatable issue on which two opinions are possible. If the AO/TPO has taken a possible view, the order cannot be branded erroneous merely because the CIT feels that the other view should have been taken (Max India295 ITR 282 (SC) followed).

Appeal allowed.

ITA No.4007/Mum/2010 (Assessment year: 2005-06).

Heard on: 22nd October, 2012.

Decided on: 31st October, 2012.

Present at hearing: Vijay Mehta, for Appellant. Ajeet Kumar Jain, for Respondent.

JUDGMENT

Per B. Ramakotaiah:– (Accountant Member)

This is an assessee's appeal against the order of the CIT-5, Mumbai, dated 29/03/2010 under section 263 of the Income Tax Act. The short issue for consideration is whether the CIT-5 is correct in invoking the jurisdiction under section 263 for setting aside the order of Assessing Officer u/s 143(3) dated 01.01.08 which was passed in consonance with the TPO's order determining the arms length price for certain transactions.

2. Briefly stated, assessee filed return of income on 31.10.2005 declaring taxable income at Nil and book profit under section 115JB at

Rs.59,82,70,426/-. Subsequently the return was revised declaring nil income and book profit under section 115JB at Nil. In the scrutiny proceedings, as assessee has sold some shares and claimed long term Capital Loss, AO referred the matter to the TPOI(3) for determination of arm's length price for these transactions. During the year assessee sold 10,700 equity shares in PT Essar Dhananjaya in Indonesia to M/s. Essar Global Ltd, Mauritius, a non-resident associate concern of assessee. TPO-I(3) after analyzing the issue and rejecting the net asset value adopted by assessee while supporting the sale price however, considered that the most appropriate method is the PE method and determined the arm's length price and the value of the share at USD7197.22 per share. Therefore, he arrived at the cost of total sale price at Rs. 335.61 crores. As assessee has sold the shares at Rs.33.36 crores this resulted in enhancement of total income by Rs.302.24 crores. TPO order was dt. 22-11-07. AO following the provisions of the order have to adopt this value. However, in the meantime noticing that there was an error in computing the PE ratio of Essar Steel Ltd, TPO passed an order u/s 154 read with 92CA(5) dt.19-12-07 reducing the Arm Length price to Rs.44,99,23,887/- thereby the difference in shares worked out at Rs.11,62,46,042/-. As against the capital loss claimed at Rs.19.04 crores, the Long Term Capital loss was determined at Rs.7.41 crores which could not be adjusted from any other source and was allowed to be carried forward by the order of AO dated 1.1.2008.

3. Subsequently the DIT (TP-I) vide his letter No. DIP (TP)-I/Mum/Revision/2007-08 dated 28.12.2007 forwarded a proposal submitted by the TPO for considering action under section 263 of the Income Tax Act. It was the contention of the TPO that the transfer pricing order dated 22.11.2007 rejecting the net asset value (NAV) method was not correct and the correct method should have been to determine under NAV method according to which the rectified arms length price would come to US$ 2454.46 and yield method would arrive at US$ 964.87, thereby the average value per share would come to US$ 1709.46. This would result in under valuation of Rs. 34,72,05,236/-. Accordingly, the CIT was requested to initiate proceedings u/s 263 on the TPO order which according to the TPO was erroneous and prejudicial to the interest of the Revenue.

4. The CIT following the above request from the DIT initiated proceedings under section 263 and issued a show cause notice to assessee seeking its comments, why proceedings under section 263 could not be initiated. In the show cause notice it was clearly stated that the Transfer Pricing Officer has pointed out that the arm's length price transactions has been erroneously under determined by him by Rs.34.72 crores which was prejudicial to the interest of the Revenue. Assessee filed its objections which were summarized by the CIT in page-5 of the order under section 263. The CIT after considering the issue and relying on various case law set aside the order of AO holding that it is erroneous in

so far as AO has not adopted arm's length price as determined by the TPO, therefore, prejudicial to the interest of the Revenue. Therefore, he set aside the assessment order with a direction to reframe the same after considering the observations given above (in the order under section 263) and after giving assessee a reasonable opportunity of being heard. This was challenged by assessee in the present appeal.

5. The learned Counsel referred to the provisions of section 92CA(4) to submit that AO after receipt of the order under subsection 3 of section 92CA has proceeded to compute the total income of assessee in conformity with the arm's length price as determined by the TPO. Referring to the orders passed by the TPO, it was submitted that the TPO originally determined a higher amount as arm's length price and having noticed an error in computation passed an order under section 154 which was forwarded to AO and AO in compliance to the provisions of subsection 4 of 92CA adopted the same value. Therefore, the order of AO which was subject matter of revision by the CIT does not suffer any mistake or error.

6. Another contention was that in Page 2 of the CIT's order reference was made to the revised order of TPO-I(3) on the basis of which the CIT directed AO to revise the computation, whereas there is no such order by the TPO-I(3). It was the submission that once a reference was made by AO during the assessment proceedings which culminated by the order of the TPO dated 22.11.2007 the TPO cannot revise his own order unless there was any other reference. There was no order passed by the TPO after conclusion of proceedings therefore, reference to the revised order of the TPO by the CIT while initiating proceedings u/s 263 itself is factually wrong. In support, he filed the order of the assessment passed by AO consequent to the proceedings under section 263 to submit that even the revised assessment order there is no reference to revised TPO order. I It was the contention that internal communication between the DIT and the CIT cannot be considered as an order. Since the original order passed by the TPO which is valid even as of now, has been complied with by AO, there cannot be any modification of the said order and any other action taken by AO is in violation of provisions of section 92CA(4).

7. The next contention of the AR was that the learned CIT has not applied his mind while coming to the satisfaction that there was an erroneous order as at the time of initiation itself he referred to the non existing revised TPO order and while passing the order also he referred to the revised order of the TPO and directed AO to adopt the same order which in fact does not exist. Therefore, the order is bad in law.

8. The next submission of the Counsel was that even on merit when there are two views possible, to value either on net asset value or on price earning method and TPO adopted one method on one of the possible view, there cannot be any action under section 263 as held by the Hon'ble Supreme Court in the case of *CIT vs. Max India Limited*, 295 ITR 282(SC). He also questioned the jurisdiction of the CIT to revise the order

of AO u/s 143(3) which is in conformity with the order of the TPO as per section 92CA(4), whereas the proposal by the TPO is to initiate action under section 263 on the TPO order itself.

9. The learned DR however, in reply submitted that according to the Board Circular, the orders of the TPO are approved by the DIT. Therefore, the CIT has jurisdiction to revise the order of AO under section 263 when it is pointed out that there was error in computation of Arms length price by the TPO himself. He relied on the Coordinate Bench decision in the case of Sun Microsystems India Pvt. Ltd vs. CIT in ITA No. 661(Bang.)2007 dated 29th March, 2011. He also referred to the Hon'ble Supreme Court decision in the case of *T.N. Civil Supplies Corporation Ltd vs. CIT*, 260 ITR 82 (SC) to submit that the CIT has power to revise the order which was passed on the directions of superior authority either under section 144A or section 144B. He referred to the facts to submit that the CIT has validly invoked the jurisdiction under section 263 to set aside the order of AO.

10. The learned Counsel in reply relied on the amended provisions of section 92CA(4) to submit that the words "having regard to" has been amended w.e.f. 1.6.2007 and mandated that AO has to proceed to compute in conformity with the arms length price as determined by TPO. Therefore, when AO has complied with the arms length price determined by the TPO, there cannot be any error in the order so as to revise under section 263.

11. We have considered the issue and examined the record. There is no dispute with reference to the fact that assessee has sold some shares it was holding in PT Essar Dhananjaya in Indonesia to M/s. Essar Global Ltd, Mauritius. It has claimed long term capital loss at Rs.19,04,35,383/-. It filed valuers report wherein the valuer adopted the average of net asset value and price earning value to support assessee sale price. The RBI also approved the sale based on the valuer's report. In assessment proceedings, AO referred the matter to the TPO-I(3) for determination of arms length price on these sale transactions. The TPO after analyzing the issue, in his order dt. 22-11-07 running to 23 pages, rejected the net asset value adopted by the valuer and discussed the most appropriate method vide Para 7.6 and determined the arms length price at Rs.335,61,06,459/-. Subsequently, he noticed an error in calculation and vide order dated 19.12.2007 he modified the order invoking 92CA(5) and determined the arms length price at Rs.44,99,23,887/-. As assessee has shown sale value at Rs.33,36,76,364/- the enhancement proposed as per the TPO order dated 19.12.2007 at Rs.11,62,47,523/- was adopted by AO in the assessment order dated 01.01.2008.

12. The entire issue boils down to the reference by the CIT to the revised order of the TPO-I(3) which was stated to have been forwarded to the CIT by the DIT(TP-I) vie his letter No. DIP(TP)-I/Mum/Revision/2007-08 dated 28.12.2007. Even though the learned CIT

referred to the revised order of the TPO, there is no such revised order on record, except a proposal by the TPO to the DIT that the value according to net asset value should have been determined and average price could have been taken (Reasons for consideration for revision under section 263 by the TPO were placed in the paper book at Page Nos. 40 to 45). This indicate that after passing the order under section 154, the TPO sent a proposal for rectification of the said order dated 22.11.2007. A proposal by the TPO clearly indicates that the order under section 92CA(3) dated 22.11.2007 that was rectified the order under section 92CA(5) r.w. section 154 dated 19.12.2007, be considered for revision under section 263. However, instead of revising the TPO order as proposed, the learned CIT revised the order passed by AO under section 143(3) dt. 01.01.2008. In our view, the CIT erred in revising the assessment order whereas the proposal is for revising the TPO order. This action of the CIT cannot be considered as appropriate action as so long the order of the TPO dated 22.11.2007 was not revised and was binding on AO under section 92CA(4). There is no point in directing AO to follow the revised TPO order which was not in existence. Even as seen from the order under section 143 r.w.s. 263 by the AO, there is no fresh reference to the TPO nor there was any revised order by the TPO. Therefore, under the provisions of section 92CA(4) since AO followed the order of the TPO, there is no error in the order dated 01.01.2008 passed by AO.

13. We are not considering the issue whether the TPO order could be revised by the CIT or by the DIT as that issue is not before us at this moment. As seen from the provisions, the CIT has no jurisdiction over the TPO administratively and therefore, the CIT could not have revised the order under section 92C(3) passed by the TPO. Whether the DIT can revise the order which he himself has approved as per the Board Circular can only be examined when such issue arises but for deciding this issue, we can safely conclude that the order of the CIT revising the assessment order dated 1.1.2008 passed under section 143(3) is not erroneous or prejudicial to the interests of the Revenue, as it complied with the order of TPO u/s 92CA(4).

14. Whether the order passed by the TPO is correct on the method adopted is a subject matter of opinion as TPO has clearly stated in the order passed on 22.11.2007 that the net asset value adopted by assessee cannot be accepted and he went on to determine the price on price earning Method. Whether the TPO is right in stating that average price of net asset value and price earning method value (valuation arrived at in the proposal for revision under section 263) is a debatable issue on which two opinions can be formed. The Hon'ble Supreme Court in the case of *CIT vs. Max India Limited*, 295 ITR 282 has considered the phrase 'prejudicial to the interests of the Revenue' as under:

> *"The phrase "prejudicial to the interests of the Revenue" in section 263 of the Income-tax Act, 1961, has to be read in conjunction with the expression "erroneous" order passed by the*

> *Assessing Officer. Every loss of revenue as a consequence of an order of the Assessing Officer cannot be treated as prejudicial to the interests of the Revenue. For example, when the Assessing Officer adopts one of two courses permissible in law and it has resulted in loss of revenue, or where two views are possible and the Assessing Officer has taken one view with which the Commissioner does not agree, it cannot be treated as an erroneous order prejudicial to the Revenue, unless the view taken by the Assessing Officer is unsustainable in law".*

15. Respectfully following the above, where two views are possible and the TPO has taken one possible view the proceedings under section 263 cannot be invoked. Even otherwise, in this case instead of initiating proposal on TPO order as suggested, the CIT initiated the proceedings under AO's order which is not erroneous or prejudicial to the interests of the Revenue, as AO sincerely followed the mandate of provisions of section 92CA in proceeding to compute the total income under sub section 4 of section 92CA in conformity with the arms length price so determined by the TPO. As the provisions of section 92CA(4) have been amended w.e.f. 1.6.2007 which used the word "shall" AO is bound to follow the TPO's order determined under sub section 3 (which was itself modified by an order under sub section-5) of 92CA. Accordingly, we do not see any error in the order of AO so that it can be considered as erroneous and prejudicial to the interests of the Revenue.

16. The learned DR referred to the order of the ITAT in Sun Microsystems India Pvt. Ltd in ITA No. 661(Bang.)/2007. The assessment year therein was assessment year 2002-03 and the TPO order was dated 24.03.2005. At that time the relevant provisions of section 92CA(4) empowers AO to compute the total income 'having regard to' the arms length price. It was not a mandatory provision, therefore under those provisions invoking of power under section 263 by the CIT was upheld. However, provisions of section 92CA(4) were modified w.e.f. 1.06.2007. So long as the order under section 92CA(3) by the TPO was available on record, AO has no other option than to follow the same which AO did in this case. Accordingly reliance on the above decision cannot be accepted in view of the change in the provisions.

17. The learned DR also relied on the decision of the Hon'ble Supreme Court in the case of *T.N. Civil Supplies Corporation Ltd vs. CIT*, 260 ITR 82 (SC) to submit that the CIT has power to revise the order passed by AO on the directions of the superior authority. Reliance on this case also is misplaced in the sense that the issue involved in that appeal was whether the order passed by the Income Tax Officer was prejudicial to the interests of the Revenue when the same was passed with the approval of the IAC under section 144B. In that case the CIT was the superior authority to the IAC. Therefore, on the set of facts the Hon'ble Supreme Court held that there is no scope for limiting the order passed

by the Income Tax Officer under section 263 to exclude the orders passed by the Income Tax Officer on the directions of the superior authority either under section 144A or under section 144B. In this present case, no such issue arises as the CIT wrongly invoked the proceedings under section 263 on AO's order when the proposal by the TPO itself is for initiating the proceedings under section 263 on the TPO order under section 92CA(3). Therefore, we are not persuaded by the arguments of the DR that the order of the TPO can also be revised. For these reasons, we are of the opinion that the order passed by the CIT cannot be justified on the facts of the case and accordingly the same was set aside.

18. Before parting, we would like to observe that there seems to be no clarity about the authority who has to modify the TPO order in case, any order of TPO is prejudicial to the interests of Revenue. CIT cannot exercise jurisdiction over TPO as TPO functions separately under the Director of Income Tax (TP). In our view the DIT should have initiated the proceedings under section 263 on the order of the TPO instead of sending proposal to the CIT for revising the order of the TPO. Be that as it may, the CIT, however, wrongly initiated the proceedings on the assessment order under section 143(3) which was in conformity with the TPO order under section 92CA(3). As there is no revised TPO order in this case, the order of CIT holding the order of AO u/s 143(3) dtd.01-01-08 as erroneous and prejudicial to the interests of revenue can not be upheld.

19. In the result appeal filed by assessee is allowed and the order of the CIT u/s 263 is set aside.

Order pronounced in the open court on 31st October, 2012.

2013 TRI 8 (Trib. Ind.)

INCOME TAX APPELLATE TRIBUNAL
BANGALORE "C" BENCH, BANGALORE

N.V. Vasudevan, Judicial Member and Jason P. Boaz, Accountant Member

FACTS/HELD

1. **Section 54EC limit of Rs. 50L does not apply to the transaction but financial year. Cheque has to be issued within 6 months. Encashment of Cheque & Allottment of Bonds beyond 6 months is irrelevant**
2. In AY 2008-09, the assessee sold land on 14.12.2007 and computed capital gains of Rs. 1.57 crores. He invested Rs.50 lakhs on 3.3.2008 (FY 2007-08) in REC Bonds and Rs. 50 lakhs

on 4.6.2008 (FY 2008-09) in NHAI Bonds and claimed a deduction of Rs. 1 crore u/s 54EC. The NHAI Bonds were allotted on 30.6.2008. The AO & CIT(A) restricted the assessee's claim to Rs. 50 lakhs on the ground that (i) the Proviso to s. 54EC imposed a ceiling of Rs. 50 lakhs for the investment and (ii) the allotment of the NHAI Bonds was made beyond 6 months of the date of transfer. On appeal by the assessee, HELD allowing the appeal:

(i) In Aspi Ginwala (ITAT Ahmedabad) it was held that the Proviso to s. 54EC merely restricted the investment that can be made in one FY to Rs. 50 Lkahs but it did not restrict the exemption to Rs.50 lakhs. However, a contrary view was taken in Raj Kumar Jain & Sons (ITAT Jaipur) that the exemption u/s 54EC had to be restricted to Rs.50 lakhs. However, Circular no.3/2008 dated 12.3.2008 issued by the CBDT makes it clear that the Proviso only intended to restrict the investment in a particular financial year and did not intend to restrict the maximum amount of exemption permissible u/s 54EC. The fact that the Proviso uses the words "in a financial year" fortifies this interpretation. Accordingly, it has to be held that the assessee is entitled to total deduction of Rs. 1 crores in respect of the investment of Rs. 50 lakhs made in each financial year;

(ii) The cheque was issued to NHAI before the expiry of 6 months from the date of transfer. The fact that the allotment of the Bonds was made after 6 months is irrelevant. A payment by cheque which is encashed subsequently relates back to the date of receipt of the cheque. The date of payment is the date of delivery of the cheque and not the date of its encashment (Kumarpal Amrutlal Doshi (ITAT Mumbai) followed).

Appeal partly allowed.

I.T.A. No.236/Bang/2012 (Assessment Year : 2008-09).

Heard on: 20th November, 2012.

Decided on: 14th December, 2012.

Present at hearing: V. Chandrashekar, for Appellant. Etwa Munda, for Respondent.

JUDGMENT

Per Jason P. Boaz:– (Accountant Member)

This appeal by the assessee is directed against the order of the CIT(A)-IV, Bangalore dated 21/12/2011 for the assessment year 2008-09.

2. The facts of the case, in brief, are as under:–

2.1 The assessee, a non residential individual, working as a Scientist with Ford Motor Company, U.S.A., filed his return of income for the assessment year 2008-09 on 30/3/2009 declaring income of Rs.1,63,74,362/- comprising capital gains of Rs.1,57,82,650/- on sale of an agricultural property bearing Survey No.43/1, situated at Kothanur Village, K R Puram Hobli, Bangalore measuring about 6 acres 5 guntas for a sale consideration of Rs.3,50,93,750/- which was purchased by Regd. Sale Deed dated 25/11/1981 at a total consideration of Rs.48,500/- in December, 2007 and interest income of Rs.5,91,712/-. The return was processed under section 143(1) of the Income Tax Act, 1961 (hereinafter referred to as 'the Act') and taken up for scrutiny by issue of notice under section 143(2) of the Act. The assessment was completed by an order dated 16/12/2010 determining the income from long term capital gains (LTCG) at Rs.2,98,26,515/- by making the following disallowances:–

(i)	Indexed cost of improvement	Rs. 53,47,235
(ii)	Expenses incurred on transfer of property	Rs. 35,00,000
(iii)	Professional fees paid to Chartered Accountant	Rs. 1,96,630
(iv)	Rebate for reinvestment u/s 54EC	Rs. 50,00,000

2.2 Aggrieved by the order of assessment, the assessee carried the matter in appeal before the CIT(A)-IV, Bangalore. The learned CIT(A) disposed off the assessee's appeal by order dated 21/12/2011 allowing the assessee partial relief of Rs.10,00,000/-, being the amount paid to the Advocate for putting through the sale transaction out of the disallowed sum of Rs.35,00,000/- mentioned at (ii) of the disallowances above. The learned CIT(A) confirmed the other disallowances mentioned at (i), (iii) and (iv) above.

3.0 Aggrieved by the order of the learned CIT(A) dated 21/12/2011 the assessee is now in appeal before the Tribunal. In this appeal, the grounds raised are as under:–

> *"1. The order of the authorities below in so far as it is against the appellant is opposed to law, equity, weight of evidence, probabilities and the facts and circumstances in the appellant's case.*
>
> *2. The appellant denies himself liable to be assessed over and above the income reported of Rs.1,63,74,362 by the appellant under the facts and circumstances of the case.*

3. The learned authorities below are not justified in law in disallowing a sum of Rs.55,47,235 as indexed cost of improvement under the facts and circumstances of the case.

4. The learned authorities below failed to appreciate the fact that the appellant had incurred a sum of Rs. 12,13,075 as cost of improvement and thus calculated indexed cost of acquisition as per the provisions of Act. The authorities below failed to appreciate the fact that without any cost of improvement there cannot be any damages as claimed by the appellant under the facts and circumstances of the case.

5. The learned CIT (Appeals) is not justified in law restricting the claim of the expenses incurred by the appellant towards the sale of the property amounting to Rs.10,00,000 as against the actual expenditure incurred by the appellant towards the protection and incidental expenses incurred by the appellant for transfer of the property which was incurred wholly and exclusively towards the transfer of the property under the facts and circumstances of the case.

6. The learned authorities below are not justified in law in disallowing the claim of exemption of Rs.50 lakhs being the investment made in the NHAI Bonds which the appellant is eligible to invest under the provisions of section 54EC of the Act under the facts and circumstances of the case.

7. The learned authorities below are not justified in law in not allowing the professional charges paid by the appellant amounting to Rs. 1,96,630 to the chartered accountant for advising on the transfer of the property holding that the same is not an allowable expenditure under the facts and circumstances of the case.

8. The appellant denies himself liable to be charged to interest under sections 234A, 234B & 234C of the Income Tax Act, 1961, under the facts and circumstances of the case.

9. The appellant craves leave to add, alter, delete or substitute any of the grounds urged above.

10. In the view of the above and other grounds that may be urged at the time of the hearing of the appeal, the appellant prays that the appeal may be allowed in the interest of justice and equity."

4.0 We have heard both the parties on their respective contentions. The learned AR of the assessee has filed a paper book, compilation of 107 pages and also placed on record certain judicial decisions and copies of CBDT Circulars in support of the assessee's case. The learned DR has also placed on record copies of certain judicial decisions in support of the stand of Revenue. After consideration of the same, the issues in dispute will now be disposed off.

5.0 The grounds raised at Sl.No.1, 2, 9 and 10 (supra) are general in nature and therefore, no adjudication is called for thereon.

6.1 In the ground raised at S.Nos.3 & 4, the assessee has challenged the action of the authorities below in disallowing a sum ofRs.55,47,235 claimed as indexed cost of improvement while computing LTCG on sale of the said property at S.No.43/1, Kothanur village, K.R. Puram Hobli, Bangalore, without appreciating the fact that the assessee had actually incurred an amount of Rs.12,13,075 as cost of improvement thereon during the period 1983 to 1985 and had attached the valuation certificate of an approved valuer in regard to the same. The learned counsel for the assessee filed a copy of the valuation report which contained an estimate of the losses determined at Rs.12,13,075 suffered by the assessee due to acts of damages, pilferage and valuation committed in the property sold. The learned counsel for the assessee in his arguments, while conceding that no part of the sale consideration can be said to have been received towards the assets which did not exist at the time of the sale however urged that the assessee had made improvements to the property after purchasing it in the form of additions to movable and immovable assets. He drew our attention to the valuation report at page 25 of the paper book compilation in which the list of structures on the said land, namely, Vivek Farms are mentioned; a gate and gate pillars, multipurpose room near gate, electric room, RCC structure near open well, main bungalow etc. The learned counsel for the assessee submitted that it is clear from the sale deed dt.25.11.1981 (at pages 14 to 22 of assessee's paper book) for purchase of the said property, that what the assessee had purchased was only agricultural lands and that he developed the same by constructing a farm house bungalow and also other improvements which were transferred to the purchaser of the property vide Regd. Sale Deed dt.14.12.2007 (at pages 78 to 92 of assessee's paper book). It was thus contended by the learned counsel for the assessee that the sale consideration includes these immovable assets and therefore a reasonable amount has to be allowed as cost of constructing these immovable assets.

6.2 Per contra, the learned Departmental Representative supported the findings in the orders of the authorities below and prayed that the grounds raised by the assessee be dismissed.

6.3 We have heard both parties and carefully perused and considered the material on record. Section 48 of the Act lays down that while computing capital gains the income chargeable to tax shall be computed by deducting from the full value of consideration received the following amounts, namely:–

(i) expenditure incurred wholly and exclusively in connection with such transfer;

(ii) the cost of acquisition of the asset and the cost of improvement thereto.

In order to ascertain as to whether at the time of sale or transfer of the said property, any improvement to the property was in existence, we have perused both the sale deed 25.11.1981 whereby the assessee purchased the said property and sale deed dt.14.12.2007 whereby he sold the said property in the relevant period. On perusal thereof we find that when the property was purchased by the assessee on 25.11.1981 the said property was agricultural land with no structure thereon as admitted. We also find that according to the sale deed dt.14.12.2007 the said property continued to be agricultural land, but however notably find no mention therein of any bungalow / building being thereon or any details of improvements made thereto as claimed. We have also perused the valuation report dt.4.8.1999 (at pages 23 to 31 of the assessee's paper book) and find that this was made in regard to complaints and FIR's lodged with the Police Department by the father of the assessee and the valuation is stated to have been made based on documents and information furnished to the valuers by the owner. We also find that the assessee has not brought on record any evidence whatsoever to establish that he had in fact incurred any expenditure on such improvement as claimed. In this factual matrix, we are of the considered opinion that, the question of allowing any deduction under section 48(ii) of the Act for indexed cost of improvement at Rs.53,40,235 as claimed by the assessee is not warranted. We, therefore, decline to interfere in the finding of the learned CIT(Appeals) that the Assessing Officer was justified in denying the said deduction while computing LTCG on the sale of the said property. We accordingly dismiss the grounds raised at 3 and 4 (supra) by the assessee.

7.1 <u>In the ground raised at S.No.5</u>, the assessee has challenged the learned CIT(Appeals)'s action / finding in restricting the claim of expenses incurred by the assessee towards sale of the said property to Rs.10 lakhs as against the claim of Rs.40 lakhs being incurred for this purpose. The learned counsel for the assessee submitted that these expenses include amounts aggregating to Rs.20 lakhs paid to one M.S. Narayan, Advocate who is said to have represented and advised the assessee in respect to the transfer of the said property. It is further submitted that the said Advocate has also represented the assessee and successfully defended him in a law suit numbered as OS No.7276/2005, involving the property sold, before the Hon'ble Additional City Civil Judge, Bangalore City (CCH No.8) which was instituted by one Sri B. Bhaskar and disposed by order dt.27.11.2007 (copy of order furnished at pages 32 to 74 of assessee's paper book) and the said property was sold by the assessee soon thereafter on 14.12.2007. On examination, it was submitted, that the Assessing Officer allowed only an amount of Rs.5 lakhs as expenses incurred for transfer of the said property and disallowed the balance Rs.35 lakhs holding that these cannot be said to have been incurred wholly and exclusively for transfer of the property. The learned CIT(Appeals) however held that without getting the dispute

cleared, it was not possible to sell the property and that the payments made to settle the legal disputes was well within the ambit of section 48 of the Act. He allowed a further amount of Rs.10 lakhs out of the balance amount of Rs.15 lakhs paid to M.S. Narayan, Advocate but disallowed a sum of Rs.5 lakhs paid to him, as it was paid by the assessee in March, 2008 which was after a period of six months from the date of sale, holding that the same could not have been incurred in respect of the sale of the impugned property. It is the contention of the learned counsel for the assessee that the balance of Rs.5 lakhs paid to Sri M. S. Narayan, Advocate be allowed as the time lag of 3 months should in no way affect the claim of the assessee and more so when no appeal has been preferred by revenue against the relief of Rs.10 lakhs allowed by the learned CIT(Appeals). It is also submitted that the balance of Rs.20 lakhs paid by cheques by the assessee to four different persons as commission @ Rs.5 lakhs each be allowed as copies of receipts from these parties have been obtained and placed on record.

7.2 Per contra, the learned Departmental Representative supported the orders of the learned CIT(Appeals) on this issue.

7.3 We have heard both parties and carefully perused and considered the material on record. In the relevant period, the assessee claimed to have incurred amounts aggregating to Rs.40 lakhs in connection with the sale / transfer of the said property, the details of which are as under:

Sl.No.	Name & Address	Date of payment	Amount paid in Rs.
1.	V Saraswathi, NO.55, Kadirappa Road, Coxtown, Bangalore	18.12.2007	5,00,00
2.	M S Srinivas, No.16, G-1, Annayappa Block, II Cross, Kumarapark West, Bangalore-560 020	18.12.2007	5,00,000
3.	M S Ramanujam, No.16F2, Annayappa Block, II Cross, Kumarapark West, Bangalore-560 020	18.12.2007	5,00,000
4.	M S Jayashree, No.528, 2nd Main Raod, A Block, Rajajinagar, Bangalore-560 010	18.12.2007	5,00,000
5.	M S Narayan, Advocate, No.4601 & 4602, 6th Floor, High Point IV, 45, Palace Road, Bangalore-560 001	12.3.2008	5,00,000
6.	M S Narayan, Advocate, No.4601 & 4602, 6th Floor, High Point IV, 45, Palace Road, Bangalore-560 001	18.12.2007	5,00,000
7.	M S Narayan, Advocate, No.4601 & 4602, 6th Floor, High Point IV, 45, Palace Road, Bangalore-560 001	7.5.2007	5,00,000

8.	M S Narayan, Advocate, No.4601 & 4602, 6th Floor, High Point IV, 45, Palace Road, Bangalore-560 001	6.5.2007	5,00,000

7.3.2 It is the claim of the assessee that the four payments of Rs.5 lakhs each at S.Nos 5 to 8 of the table to Sri M.S. Narayan, Advocate aggregating to Rs.20 lakhs were made in connection with litigation relating to the said property. The material on record indicates that there was a civil suit No.7276 of 2005 filed against the assessee for specific performance of sale of the said asset by one Sri A. Bhaskar before the XI Addl. City Civil Judge,Bangalore on 23.9.2005 in which the assessee was represented by Sri M.S. Narayan, Advocate. This suit was dismissed by the Hon'ble Court by its judgment dt.27.11.2007 and thereafter the assessee sold the said property on 14.12.2007. Section 48 of the Act mandates that expenditure incurred wholly and exclusively in connection with the transfer of the said asset and the cost of acquisition of the asset is to be allowed as a deduction from the full value of the consideration received from the transfer on record. On careful consideration of the material on record, we are in agreement with the finding of the learned CIT(Appeals) that the expenses incurred as payment of fees to the Advocate Sri M.S. Narayan of Rs.5 lakhs each on 6.5.2007, 7.5.2007 and 18.12.2007 aggregating to Rs.15 lakhs are incurred wholly and exclusively in connection with the transfer of the said asset for getting the suit dismissed by the Hon'ble City Civil Judge, Bangalore on 27.11.2007 without which it would not have been possible to transfer the said asset. We, however, do not agree with the action of the learned CIT(Appeals) in disallowing the payment of Rs.5 lakhs paid to Sri M.S. Narayan, Advocate on 12.3.2008 only on the ground that there was no rationale in making the said payment on 12.3.2008, almost six months after the sale of the asset for the reasons that –

(i) the said payment of Rs.5 lakhs is made on 12.3.2008 which is almost 3 months after the date sale and not 6 months as held by the learned CIT (Appeals) and

(ii) the time lag of 3 months should in no way affect the claim of the assessee and it is not stipulated anywhere that every payment in connection with the transfer of asset is to be made only prior to the sale of the property.

We, therefore, hold that the 4 payments of Rs.5 lakhs each made by the assessee to Sri M.S. Narayan, Advocate aggregating to Rs.20 lakhs are incurred in connection with the sale / transfer of the said property and are to be allowed as a deduction under section 48 of the Act while computing the LTCG on sale of the said property. It is ordered accordingly.

7.3.3 As regards the other amounts aggregating to Rs.20 lakhs paid @ Rs.5 lakhs each to 4 different persons, namely, Ms. V. Saraswathi, Sri M.S. Srinivas, Sri M.S. Ramanujam and Ms. M.S. Jayashree on

18.12.2007, we are in agreement with the findings of the authorities below that these persons were neither a party to the civil suit nor were connected with the original owners of the land and that merely by making payments by cheque and producing receipts for the same are not sufficient to establish that these expenses were incurred wholly and exclusively for the purpose of transfer of the said property. The learned counsel for the assessee has not been able to controvert the findings of the learned CIT(Appeals) on this issue that the assessee has failed to adduce any evidence to establish that payments aggregating to Rs.20 lakhs to these 4 persons @ Rs.5 lakhs each were incurred wholly and exclusively in connection with the transfer of the said property and we therefore find no reason to interfere with the finding of the learned CIT(Appeals) on this issue. This part of the ground raised by the assessee is accordingly dismissed.

8.1 In the ground raised at S.No.7, the assessee challenges the findings of the authorities below in not allowing the claim of professional charges of Rs.1,96,630 paid by the assessee to M/s. Amarnath Kamath & Co., Chartered Accountant for advising him on the transfer of property on the ground that the same payment is not an allowable expenditure.

8.2 We have heard both parties, perused and carefully considered the material on record. The learned counsel for the assessee argued that the provisions of section 48 of the Act was similar to that of section 37 of the Act and just as expenses incurred by a business by way of payment to chartered accountants for audit of books, filing of returns of income, etc. of a business house are allowed under section 37 of the Act, similarly the payment made for advise on capital gains ought to be allowed under section 48 of the Act for the assessee who has no other source of income other than capital gain and interest income as a result of sale of property. After careful consideration, we do not find the arguments put forth by the learned counsel for the assessee to be sustainable. We, rather, agree with the finding of the learned CIT(Appeals) that this expense on payments to chartered accountants is not allowable as a deduction under section 48 of the Act which computing LTCG as it is clear that this expense is not incurred in connection with the cost of improvement or in connection with the transfer of the said property. We, therefore, dismiss this ground raised by the assessee.

9.1 In the ground raised at S.No.6, the assessee challenges the action of the learned CIT(Appeals) in disallowing the claim of exemption of Rs.50 lakhs being the investment made in NHAI Bonds which he was eligible to invest in as per the provisions of section 54EC of the Act.

9.2 The assessee, in the relevant period, sold agricultural property measuring 6 acres and 5 guntas situated at Survey No.43/1, Kothanur Village, K.R. Puram Hobli, Bangalore on 14.12.2007 for a consideration of Rs.3,50,93,750. As per the details on record, the assessee invested a sum of Rs.50 lakhs on 3.3.2008 in bonds issued by Rural Electrification

Corporation (REC Ltd) and a further sum of Rs.50 lakhs by cheque dt.4.6.2008, which got encashed on 9.6.2008, in bonds of National Highways Authority of India (NHAI). Thus in all he has invested an amount of Rs.1 Crore out of sale consideration in bonds issued by REC Ltd and NHAI. The Assessing Officer relying upon the proviso to sectin 54EC restricted the claim of exemption to Rs.50 lakhs holding the same to be the maximum amount of exemption permissible under section 54EC of the Act. The proviso to section 54EC reads as under :

> *"Provided that the investment made on or after the 1st day of April, 2007 in the long term specified asset by an assessee during any financial year does not exceed Rs.50,00,000."*

The Assessing Officer was of the view that a literal interpretation of the proviso would lead to discrimination between a person who sells property in any month from April to September of a financial year and a person who sells a property in any month from October to March of the same year as the former can avail of an exemption of a maximum amount of Rs.50 lakhs as that is the maximum amount that can be invested in a financial year and also within six months from the date of the sale is Rs.50 lakhs whereas the latter category can avail an exemption of Rs.1 Crore by investing a sum of Rs.50 lakhs before 31st March of the relevant financial year and a further sum of Rs.50 lakhs in the immediately succeeding financial year and at the same time ensuring that the second investment of Rs.50 lakhs is also made before the expiry of six months period from the date of sale. The Assessing Officer therefore was of the view that the time limit of section 54EC is to limit the exemption to Rs.50 lakhs and hence restricted the exemption to Rs.50 lakhs.

9.3 The learned CIT(Appeals) while disposing off the appeal appeared to agreed in principle with the assessee that as per the proviso to section 54EC of the Act the limit of Rs.50 lakhs pertains to the investment that can be made in a single financial year and that the section does not prevent an assessee from availing exemption of Rs.1 Crore in the event the assessee were to invest a sum of Rs.50 lakhs in a particular financial year and a further sum of Rs.50 lakhs in the immediately succeeding financial year, subject to the basic condition of section 54EC of the Act that both investments are made within a period of six months from the date of sale of the property. The learned CIT(Appeals) however restricted the claim of deduction to Rs.50 lakhs by holding that the second investment of Rs.50 lakhs in NHAI Bonds falls outside the period of six months from the date of sale i.e. 14.12.2007, since the Bonds were allotted by NHAI only on 30.6.2008. The learned CIT(Appeals) in his order goes on to observe that inspite of the fact that the assessee had tendered the payment and the NHAI has also encashed the same before the expiry of six months from the date of sale, the assessee is not entitled to exemption under section 54EC due to the fact

that NHAI have allotted the Bonds on 30.6.2008 which is after the period of six months from the date of sale of the said property on 14.12.2007.

9.4 The issues now before us for adjudication are the following:

(i) Whether the proviso to section 54EC of the Act restricts the exemption to Rs.50 lakhs or does it merely restrict the investment that can be made in a single financial year to Rs.50 lakhs ?

(ii) If the answer to the above is that it is the investment that is restricted and not the exemption, then in view of the fact that NHAI had allotted the Bonds only on 30.6.2008 in respect of the second investment of Rs.50 lakhs, which is beyond the period of six months from the date of sale of property, can it be said that the second investment of Rs.50 lakhs is said to have been made outside the period of six months and no exemption is to be allowed under section 54EC of the Act in respect of the same.

9.5 The learned counsel for the assessee has placed reliance on the decision of the ITAT, Ahmedabad Bench in the case of *Aspi Ginwala & Others vs. ACIT* in ITA Nos.3226 & 3227/Ahd/2011 dt.30.3.2012 wherein on similar facts i.e investment of Rs.50 lakhs each was made in two different financial years but within the period of six months from the date of sale, it was held in para 8 of the said order that the assessee is entitled to exemption of Rs.1 Crore as the six months period for investment in eligible investments involved in two financial years.

9.6 The learned Departmental Representative however placed before us an earlier judgment, contrary to the decision of the Ahmedabad Bench of the ITAT, rendered by the ITAT, Jaipur Bench in the case of *ACIT vs. Raj Kumar Jain & Sons* in ITA No.648/JP/2011 dt.30.1.2012 wherein the Tribunal on similar facts, was of the view that a liberal interpretation will lead to discrimination adversely affecting those who sell a property at any time from April to September of a financial year vis-à-vis those who sell property in the period October to March of the same financial year. In this view of the matter, they came to the conclusion that for the investment to be made within a period of six months, the exemption under section 54EC of the Act is to be restricted to Rs.50 lakhs only.

9.7 The learned counsel for the assessee placed reliance on circular No.3/2008 dt.12.3.2008 issued by CBDT, being an explanatory note on the provisions relating to Direct Taxes in Finance Act, 2007. In the said para 28.2 thereof the reason for it to set a limit on the quantum of investment by a person in a financial year, reads as under:

> "28.2 The quantum of investible bonds issued by NHAI and REC being limited, it was felt necessary to ensure that the benefit was available to all the investors. For this purpose, it was necessary to ensure that the limited number of bonds available for subscription is also available for small investors. Therefore,

with a view to ensure equitable distribution of benefits amongst prospective investors, the government decided to impose a ceiling on the quantum of investment that could be made in such bonds. Accordingly, the said section has been amended so as to provide for a ceiling on investment by an assessee in such long-term specified assets. Investments in such specified assets to avail exemption under section 54EC, on or after 1st day of April, 2007 will not exceed fifty lakh rupees in a financial year."

It is clear form the Circular no.3/2008 of CBDT (supra) that the Government only intended to restrict the investment in a particular financial year and thus has fixed a limit of Rs.50 lakhs as permissible investment in a particular financial year. It also appears clear that the Government did not intend to restrict the maximum amount of exemption permissible under section 54EC of the Act. The fact that the Legislature has consciously used the words "in a financial year" in the proviso to section 54EC of the Act also fortifies the same. If the Legislature wanted to restrict the exemption itself to Rs.50 lakhs it could have simply dispensed with using the words "in a financial year."

9.8 The judicial decisions relied upon by the learned counsel for the assessee also support the stand of the assessee. The Hon'ble Apex Court while deciding the case of *Vikrant Tyres Ltd vs. First ITO* reported in 247 ITR 821 have already laid down the law on interpreting of statutes by holding thereof that:–

> *"It is settled principle in law that the courts while construing Revenue Acts have to give a fair and reasonable construction to the language of a statute without leaning to one side or the other, meaning thereby that no tax or levy can be imposed on a subject by an Act of Parliament without the words of the statute clearly showing an intention to lay the burden on the subject. In this process, the courts must adhere to the words of the statute and the so called equitable construction of those words of the statute is not permissible. The task of the court is to construe the provisions of the taxing enactments according to the ordinary and natural meaning of the language used and then to apply that meaning to the facts of the case and in that process if the tax payer is brought within the net he is caught, otherwise he has to go free."*

In the case of *CWT vs. Hashmatunnisa Begum* reported in 176 ITR 98 (SC), the Hon'ble Apex Court held that while interpreting statutes, literal construction has to be applied regardless of results and that only in a situation where two views are reasonably possible, should reference be given to that view which promotes constitutionality and not where the statute can be read only in a particular way.

The following decisions of the Hon'ble Apex Court have laid down the proposition that provisions for deduction, exemption or relief are to be

construed liberally in order to advance the objective and not to frustrate it.

(i) *CIT vs. Gwalior Rayon Silk Manufacturing Co. Ltd.* (196 ITR 149)(SC)

(ii) *CIT vs. Vegetable Products Ltd.* (88 ITR 192)

(iii) *Bajaj Tempo Ltd. vs. CIT* (196 ITR 188)(SC)

Taking into consideration the overall facts and circumstances of the case, the CBDT's Circular No.3/2008, and the principles laid down by the Hon'ble Apex Court for interpreting statutes, we are of the considered view that it would be in the fitness of things, to follow the decision of the ITAT, Ahmedabad Bench in the case of Aspi Ginwala & Others (supra) relied on by the assessee and hold that the assessee is entitled to total deduction under section 54EC of the Act spread over a period of two financial years @ Rs.50 lakhs each on investments made in specified instruments within a period of six months from the date of sale of the property.

10.1 We now proceed to address the issue at (ii) as laid out in para 9.4 (supra). As per facts on record, the assessee had issued a cheque for Rs.50 lakhs to NHAI for allotment of Bonds that was encashed by NHAI on 9.6.2008. The sale of the said property took place on 14.12.2007 and the six months period ended on 13.6.2008. NHAI, however, as evident from the record, has allotted the bonds only on 30.6.2008 which is after the six month period. The learned CIT(Appeals) held that the date of allotment is what is to be considered for reckoning the six months period and the same (viz. 30.6.2008) being beyond the period of six months, in the instant case, has denied the exemption claimed under section 54EC of the Act for the second investment of Rs.50 lakhs.

10.2 The assessee has placed reliance on a decision of the ITAT, Bombay Bench in the case of Kumarpal Amrutlal *Doshi vs. DCIT* in ITA No.1523/Mum/2010 dt.9.2.2011 wherein the Tribunal relying on the decision of the Hon'ble Apex Court in the case of *CIT vs. Ogale Glass Works Ltd* (25 ITR 529) has held that payment by cheque subsequently realized on the cheque being honoured and encashed relates back to the date of receipt of the cheque and in law the date of payment is the date of delivery of the cheque. In the cited case the assessee therein had issued a cheque to NABARD on 9.2.2006 which was within the period of six months as specified in sectin 54EC. The cheque got encashed on 15.2.2006 which was after a period of six months. The Tribunal held that the date of payment is the date of tender of the cheque i.e. 9.2.2006. In the instant case of the assessee, the cheque dt.4.6.2008 issued by the assessee for NHAI Bonds was encashed by NHAI on 9.6.2008 which is before the expiry of the period of six months (i.e. 13.6.2008) and therefore the assessee in the present case is on an even better footing than the case relied upon by the learned counsel for the assessee.

10.3 Further, in the case of Aspi Ginwala & Others (supra) cited earlier in this order, the assessee was unable to invest in Bonds within a period of six months as the issue was not open and did so the moment the same was made open to public and thus the allotment was made after the statutory period of six months. The ITAT, Ahmedabad Bench, relying on an earlier decision of the ITAT, Mumbai in the case of *Ram Agarwal vs. JCIT* reported in 81 ITD 163 held that the assessee therein was prevented by sufficient cause from investing within the statutorily permitted period of six months and allowed the assessee exemption under section 54EC of the Act in respect of the said investment. In the present case before us, the assessee has made payment for the investment in NHAI which was encashed on 9.6.2008 well within the statutorily permitted period of six months from the date of sale of the property (i.e. upto 13.6.2008). What is to be reckoned here is the date of payment and not the date of allotment as the same is not in the control of the assessee. In this view of the matter, we hold that the date of payment (i.e. date of encashment of cheque) is to be reckoned for calculating the six month period and since in this case the date of payment / encashment being well within the period of six months, the assessee is entitled to exemption under section 54EC of the Act even on the second investment of Rs.50 lakhs made in Bonds issued by NHAI. It is ordered accordingly.

11. In the result, the assessee's appeal is partly allowed.

Order pronounced in the open court on 14th Dec., 2012.

2013 TRI 21 (Trib. Ind.)

INCOME TAX APPELLATE TRIBUNAL
MUMBAI "L" BENCH, MUMBAI

B. Ramakotaiah, Accountant Member and Amit Shukla, Judicial Member

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FACTS/HELD

1. **Section 153C search assessment is void if AO's satisfaction not recorded**
2. A search & seizure action u/s 132(1) was carried out in the case of Ingram Micro India Pvt. Ltd. As certain documents were found which allegedly showed that the assessee (a Singapore compnay) was not paying tax in India though it had a PE, an assessment u/s 153C was made to bring such profits to tax. The assessee challenged the s. 153C assessment on the ground that

the AO who had conducted the search had not recorded satisfaction that any income belonged to the assessee. HELD by the Tribunal:

> U/s 153A & 153C, proceedings can be initiated only after the AO comes to the satisfaction that the seized material pertains to a person other than the searched party and comes to the conclusion that proceedings are required to be initiated in the other party's case. In Manish Maheshwari 289 ITR 341 (SC), it was held in the context of s. 158 BD that the recording of satisfaction by the AO that any undisclosed income belongs to any person, other than the person searched, is a "condition precedent" and that a notice issued without recording satisfaction and application of mind was a nullity. This principle has been applied to s. 153C in SSP Aviation 207 Taxman 260 (Delhi) & P. Satyanarayana (ITAT Chennai). On facts, as the Department was not able to produce any material to show that the AO assessing the searched party had reached the satisfaction that any income belonged to the assessee, the assessment had to be annulled.

Appeals allowed.

ITA Nos. 8133, 8137,8138,8136, 8135 & 8132/Mum/2010 (Assessment years: 2002-03 to 2007-08).

Heard on: 19th December, 2012.

Decided on: 21st December, 2012.

Present at hearing: J.D. Mistri, Shri Nishant Thakker & Shri K.K. Ved, for Appellant. Nerender Kumar, DR, for Respondent.

JUDGMENT

Per B. Ramakotaiah:– (Accountant Member)

These six appeals are by assessee, a foreign company registered in Singapore against whom proceedings under section 153C were initiated and orders under section 144C(13) r.w.s. 143(3) were passed vide the orders dated 18.10.2010. As the said orders were covered by the proceedings of the DRP under section 144C(5), assessee preferred the present appeals before the ITAT questioning the various issues. In all the orders the issues are similar, therefore, for the sake of record the grounds raised in assessment year 2002- 03 are extracted for this purpose:

> *1:0 Re.: Holding that the Appellant has a Permanent Establishment ("PE") in India:*

1:1 The Assessing Officer has erred in holding that the Appellant has a Permanent Establishment ("PE") in India through which it carries out its sales in India.

1 : 2 The Appellant submits that considering the facts and circumstances of its case and the law prevailing on the subject, it has no PE in India and the stand taken by the Assessing Officer in this regard is erroneous, misconceived and not in accordance with law.

1 : 3 The Appellant submits that the Assessing Officer has erred in arriving at various unwarranted and erroneous conclusions unsupported by any relevant material to hold that the Appellant had a PE in India. Further he also failed to consider the contrary material and evidence adduced by the Appellant.

1: 4 The Appellant submits that the Assessing Officer be directed to recompute its total income accordingly.

Without prejudice to the foregoing:

2:0 Re.: Attribution of profits:

2 : 1 The Assessing Officer has erred in attributing the profits made by the Appellant.

2 : 2 The Appellant submits that considering the facts and circumstances of its case and the law prevailing on the subject and in particular considering the functions carried out by Ingram Micro India Ltd. it is apparent that the said Ingram Micro India Ltd. has been remunerated on an appropriate basis through the incentive mechanism and hence no further attribution of income is called for.

2 : 3 The Appellant submits that the Assessing Officer be directed to delete the addition so made by him and to recompute its total income accordingly.

Without prejudice to the foregoing:

3:0 Re.: Estimation of business income taxable in India:

3 : 1 The Assessing Officer has erred in holding that 90% of the business income earned by the Appellant is attributable to its Indian PE.

3 : 2 The Appellant submits that considering the facts and circumstances of its case and the law prevailing on the subject 90% of its business income cannot be attributed to the Indian PE and said to be its profits taxable in India and the stand taken by the Assessing Officer in respect thereof is erroneous, misconceived and illegal.

3 : 3 The Appellant submits that the Assessing Officer be directed to recompute its total income accordingly.

4:0 Re. : Non-consideration for details placed on record:

4 : 1 The Assessing Officer has erred in not considering all the details placed on record by the Appellant and in passing an order in violation of the principles of natural justice.

5:0 Re.: Levy of interest u/s. 234A and 234B of the Income-tax Act, 1961:

5 : 1 The Assessing Officer has erred in levying interest u/s. 234A and 234B of the Income- tax Act, 1961 on the Appellant.

5 : 2 The Appellant submits that considering the facts and circumstances of its case and in the particular the fact that the Appellant is a non-resident as also the law prevailing on the subject, no interest u/s. 234A and 234B of the Income-tax Act, 1961 should be levied on it.

5 : 3 The Appellant submits that the Assessing Officer be directed to delete the interest levied on it.

6:0 Re.: General:

6: 1 Each of the above grounds of appeal is without prejudice to the other

6 : 2 The Appellant craves leave to add, alter, amend, substitute and I or modify in any manner whatsoever all or any of the foregoing grounds of appeal at or before the hearing of the appeal.

2. Consequent to raising of substantial demands, assessee preferred stay applications and vide the orders dated 21.01.2011, stay was granted for a period of 180 days i.e. till 20th July, 2011 and the case was originally posted on 06.04.2011. As the matters involved were of international transactions, the cases were transferred to 'L' Bench and on 20.04.2011 the learned Counsel for assessee submitted that assessee had sought inspection of records and the copies of certain documents which AO has not allowed so far. Therefore, the case was adjourned to 30.06.2011 with a direction to the learned DR to produce the relevant assessment records in order to expedite the disposal of these stay granted appeals. Subsequently due to various reasons the cases were not heard either because the DR sought adjournment or because the Bench was not functioning. Accordingly assessee's stay was extended periodically by the orders dated 05.08.2011, 10.02.2012 and further order dated 07.09.2012. The stay of demand granted in these cases will expire on 31.12.2012.

3. In the course of appeal proceedings as the inspection was not permitted by AO, as submitted by the learned Counsel, vide letter dated 19.04.2011 assessee raised additional grounds on the validity of the orders passed under section 153C of the IT Act 1961 as under:-

> *"1.0 Re: Validity of order passed under section 153C of the Income Tax Act, 1961:*
>
> *1.1 AO has erred in passing the impugned assessment order under section 144C(13) r.w.s. 153C r.w.s. 143(3) without complying with the mandatory provisions of section 153C.*
>
> *1.2 The appellant submits that the considering the facts and circumstances of its case and the law prevailing on the subject the impugned assessment order has been passed without complying with the mandatory provisions of section 153C of the Income Tax Act, 1961 and hence the same is void ab-initio.*
>
> *1.3 The proceedings under section 153C and the assessment order passed under section 144C (13) r.w.s. 153C r.w.s. 143(3) are bad in law in as much as no satisfaction as contemplated under section 153C of the Income Tax Act, 1961 has been recorded prior to initiation of proceedings under section 153C.*
>
> *1.4. The appellant submits that the impugned assessment order be held to be bad in law and struck down".*

4. There is a direction from the Bench to produce the relevant assessment records vide entry dated 20.04.2011 and consequent to this, the learned DR has written letters to AOs and copies were filed explaining that the required documents were not submitted by the AO concerned. The learned CIT (DR) sought adjournments, originally to 25.04.2012 for complying with the directions of the Bench and the case was adjourned to 11.06.2012. He further sought adjournment in writing as the relevant records were not submitted by AO and the case was adjourned further to 02.08.2012. Again the learned CIT (DR) sought adjournment on the reason that the DDIT concerned was requested to comply with the said direction and also has deputed his Inspector for collecting the requisite material and the matter was being pursued with the DCIT (CC) (OSD) Central Range-7, Mumbai to locate the requisite documents. On his request the case was adjourned to 02.08.2012. This letter of adjournment request was accompanied by a letter from DDIT(IT)3(1) dated 31/07/2012 intimating the position that the efforts made by the said Officer with other Officers for procurement of the relevant documents. Subsequently, the case came up for hearing on 03.09.2012, 06.11.2012 and 06.12.2012. On 06.12.2012 the Bench finally gave a last opportunity with a direction to the learned CIT (DR) to produce the assessment records and the correspondence between AOs if any, so that assessee's contention that there is no satisfaction recorded before initiating the proceedings under section 153C can be verified. It was further noted that since these are stay granted matters, which was extended four times so far, no further adjournment in this case would be granted and the parties were informed accordingly. Therefore, the case was taken up on 19.12.2012 on which date the learned CIT (DR)

furnished the correspondence addressed by the Asstt. Director (IT) (Invest.) Unit 7(2) Mumbai to Additional DR (IT) International Taxation Range-3 Mumbai and a letter by DDIT(IT)3(1) dated 13.12.2012. After placing the above two correspondence on record, the learned CIT (DR) submitted that the original record with reference to satisfaction note is not made available to his office so far and on the basis of the letter addressed by the Asstt. Director of Income Tax (Invest.), ACIT (OSD)-2 Central Range Mumbai would have recorded satisfaction for the purpose of initiating proceedings under section 153C and therefore, since the record was not available at the moment, it was the submission that the matters can be set aside to AO to furnish the satisfaction to assessee and then complete the assessment if required, as this issue was not raised by either before AO or before the DRP and have been raised for the first time before the ITAT as an additional ground.

5. The learned Counsel submitted that this matter being adjourned from 20.04.2011 and referred to various order sheet notings recorded and opportunities were given to the Revenue for furnishing the necessary documents to satisfy that the satisfaction was recorded before initiating proceedings under section 153C and submitted that since assessee has got the stay extended for the last two years which is expiring on 31.12.2012, it was prayed that no further opportunity should be given and assessee's preliminary objection on the jurisdiction itself can be decided in view of the judgment of the Hon'ble Supreme Court in the case of *Manish Maheshwari vs. ACIT*, 289 ITR 341 (SC) which in turn was followed by the Coordinate Bench in the case of P. Satyanarayana vs. ACIT, Central Chennai reported as 50 SOT 168 Chennai (URO)/20 Taxmann.com 56, Chennai. He also placed on record the judgment of the Hon'ble High Court of Delhi in the case of *SSP Aviation Ltd vs. DCIT* 20 Taxmann.com 214 (Del) for the proposition that in view of the provisions of section 153C satisfaction that required to be reached by AO having jurisdiction over searched persons is that valuable article of books of account or documents seized during the search belongs to a person other than searched persons and it is not necessary that the documents so seized must reflect undisclosed income. He also placed Coordinate Bench decision in the case of *M/s Apex Time P. Ltd vs. DCIT* in ITSS(A) No.34/Mum/2008 for the block period from 09.09.1996 to 09.01.2010 dated 30.03.2011 wherein on similar facts the ITAT quashed the block assessment order following the judgment of the Hon'ble Supreme Court in the case of *Manish Maheshwari vs. ACIT*, 289 ITR 341 (SC).

6. We have considered the rival submissions and examined the record as placed before us. The preliminary issue raised by assessee by way of additional ground is with reference to the validity of the proceedings under section 153C. The issue arose on the following facts. A search & seizure action under section 132(1) of the Act was carried out in the case of Ingram Micro India Pvt. Ltd/M/s Tech. Pacific (India) Ltd at

their business premises at Gate No.1A, Godrej Industries Complex, Pirojshah Nagar, Vikhroli (E) Mumbai 400079 on 06/07.09.2007. The basic allegation against the group was that Ingram Micro India Exports Pte Ltd/Tech Pacific India (Exports) Pte Ltd Singapore based company is not paying any Income Tax in India though it is having a permanent establishment in India though Ingram Micron India Limited/Tech Pacific India Ltd. It was communicated from the Investigating Wing that the proceedings are required to be initiated in this case to bring to tax the profits of Ingram Micro India Exports Pte Ltd/Tech Pacific India (Exports) Pte. Ltd.

7. A notices under section 153C dated 18.11.2008 were issued in the case of Ingram Micro India Exports (P) Ltd for assessment years 2002-03 to 2007-08 and stated to be duly served upon assessee. In response assessee filed returns of income on 12.12.2008 declaring total income at Nil and in the notes to the return of income, it was stated that return of income is being filed in protest and in response to the notice under section 153C as assessee does not have a PE in India as defined in Article 5 of the DTAA and accordingly profits arising to its from its Indian operations will not be liable to tax in India under Article 7 of the DTAA with Singapore. The further facts recorded by AO in page 2 of the order as under:

> M/s Ingram Micro India Pvt. Ltd and M/s Tech Pacific (India) Ltd are into the business of trading in computer peripherals and software to customers in India and abroad. TPIL had a wholly owned subsidiary by name and style of Tech Pacific (India) Exports Pte Ltd (TPIEPL) registered at Singapore. In November 2004, the company known as Ingram Micro, USA has acquired all the shares of Tech Pacific, one of the Asia Pacific's largest Technology Distributors for 730 million Australian Dollars. After this take over, TPIEPL came to be known as M/s Ingram Micro India Exports Pte. Ltd (IMIEPL).
>
> A. The set up of the Ingram group of companies is as under:
>
> (i) M/s Ingram Micro India Exports Pte Ltd formerly Tech Pacific (India) Exports Pte. Ltd is a Singapore based company and is a wholly owned subsidiary of Ingram Micro India Pvt. Ltd having its registered office at Bangalore.
>
> (ii) M/s Ingram Micro India Pvt. Ltd is substantially (87.60%) owned by M/s Ingram Micro Asia Ltd, a Mauritius based company, which in turn is substantially (99.98%) owned by M/s. Ingram Micro Inc., a California based company.
>
> B. The set of Tech Pacific group of companies is as under:
>
> (i) Tech Pacific (India) Exports Pte. Ltd is a Singapore based company and is a wholly owned subsidiary of M/s Tech Pacific (India) Ltd, a Mumbai based company, having 12.40%

shareholding in Ingram Micro India Pvt. Ltd, a Bangalore based company.

(ii). Tech Pacific (India) Ltd is wholly owned by Tech pacific Mauritius Ltd., a company registered in British Virginia Island.

(iii) Tech Pacific Mauritius Ltd is wholly owned by M/s Tech Pacific Asia Ltd, a company registered in British Virginia Island.

(iv) Tech Pacific Asia Ltd is wholly owned by M/s Tech Pac. Holdings, a Bermuda based company.

After the acquisition of the Tech. Pac. Holdings' shares by Ingram Micro Inc. in Nov. 2004,TPIEPL has come to be known as IMIEPL.

For the calendar years 2001 to 2002 Tech Pacific (India) Ltd was known as Godrej Pacific Technology".

8. In the course of search, certain documents, email correspondence etc., were seized by the Department and after analysis of the same, AO came to the conclusion that assessee had a permanent establishment in India and accordingly on the basis of the seized documents arrived at the incomes in the respective assessment years and proposed a draft assessment order. Assessee objected to the draft assessment order before the DRP-I and DRP-I vide direction dated 29.09.2010 affirmed the stand of AO that there is a permanent establishment and also computation of income. However, vide Para 6 of the order, instead of assessing the 100% income of assessee as attributable to PE in India, the DRP directed that 90% of the income to be assessed as attributable to PE in India, whereas the balance 10% can be treated as activities related to Singapore. Consequent to the directions of the DRP, AO assessed the incomes in the respective assessment years as under:

Assessment year	Amount (Rs.)
2002-03	49,67,123
2003-04	1,50,21,580
2004-05	3,73,20,602
2005-06	5,77,74,172
2006-07	7,20,90,268
2007-08	8,12,33,549

9. The additional ground raised by assessee being a legal ground goes to the root of the matter. As briefly stated, it seems AO did not allow the inspection of the record to assessee/Counsel and accordingly they have raised an additional ground about the validity of the proceedings under section 153C in the absence of any satisfaction being recorded by the Officer who was assessing the searched party. There is no dispute on

the fact that assessee was not searched and the search has been conducted in the case of Ingram Micro India (P) Ltd/Tech Pacific India Ltd at their business premises in Mumbai. Therefore, as per the provisions of section 153A and 153C, proceedings can only be initiated only after AO comes to a satisfaction that the seized material pertains to other persons other than the searched party and consequently AO also comes to the conclusion that proceedings are required to be initiated in the other parties case. Nowhere in the assessment order there is any recording of the fact that there was satisfaction recorded by AO assessing Ingram Micro India (P) Ltd. In fact after assessee has raised an additional ground, the Department was specifically asked to produce the relevant correspondence between AOs and the satisfaction note recorded for initiating proceedings and in fact the entire record of the assessments have been to directed to be produced to examine the contentions raised by assessee that there is no satisfaction recorded. As stated earlier, this Bench has directed the DR to furnish the necessary records as early as 28.04.2011 followed by repeated directions and as the last opportunity on 06.12.2012. The DR was directed to produce the assessment record and the correspondence between AOs and it was further stated that since the stay was extended four times, no further extension will be granted. Inspite of the above and also on the basis of the correspondence placed by the DRs on record, it seems that no serious efforts were made by the Revenue to furnish the relevant satisfaction note recorded by AO nor the relevant records were submitted as directed by the Bench. Despite repeated efforts and requests for adjournment by the DR for furnishing the record, the record has not been sent by the officers or any satisfaction has been placed on record. Since more than 20 months have passed from the time the first direction was given to the Revenue and since three different CIT (DRs) have followed up the matter with the concerned AOs, we are of the opinion that there is no satisfaction recorded while initiating the proceedings under section 153C either by AO who assessed the searched party or even by AO who completed the assessment in assessee's case.

10. Since assessee is not searched party, it is necessary to record a satisfaction under the provisions of section 153C. The provisions of section 153C are as under:

> *"**153C.** [(1)] Notwithstanding anything contained in section 139, section 147, section 148, section 149, section 151 and section 153, where the Assessing Officer is satisfied that any money, bullion, jewellery or other valuable article or thing or books of account or documents seized or requisitioned belongs or belong to a person other than the person referred to in section 153A, then the books of account or documents or assets seized or requisitioned shall be handed over to the Assessing Officer having jurisdiction over such other person and that Assessing Officer shall proceed*

against each such other person and issue such other person notice and assess or reassess income of such other person in accordance with the provisions of section 153A :]

Provided that in case of such other person, the reference to the date of initiation of the search under section 132 or making of requisition under section 132A in the second proviso to 91[sub-section (1) of] section 153A shall be construed as reference to the date of receiving the books of account or documents or assets seized or requisitioned by the Assessing Officer having jurisdiction over such other person :

Provided further that the Central Government may by rules made by it and published in the Official Gazette, specify the class or classes of cases in respect of such other person, in which the Assessing Officer shall not be required to issue notice for assessing or reassessing the total income for six assessment years immediately preceding the assessment year relevant to the previous year in which search is conducted or requisition is made except in cases where any assessment or reassessment has abated.

(2) Where books of account or documents or assets seized or requisitioned as referred to in sub-section (1) has or have been received by the Assessing Officer having jurisdiction over such other person after the due date for furnishing the return of income for the assessment year relevant to the previous year in which search is conducted under section 132 or requisition is made under section 132A and in respect of such assessment year–

(a) no return of income has been furnished by such other person and no notice under sub-section (1) of section 142 has been issued to him, or

(b) a return of income has been furnished by such other person but no notice under sub-section (2) of section 143 has been served and limitation of serving the notice under sub-section (2) of section 143 has expired, or

(c) assessment or reassessment, if any, has been made, before the date of receiving the books of account or documents or assets seized or requisitioned by the Assessing Officer having jurisdiction over such other person, such Assessing Officer shall issue the notice and assess or reassess total income of such other person of such assessment year in the manner provided in section 153A.]"

This provision is *pari materia* with the provisions of section 158BD (in the block assessment procedure).

11. The Hon'ble Supreme Court in the case of Manish Maheshwari (supra) analyzed the provisions of section 158 BD r.w.s. 158BC and decided as under:

> *"Condition precedent for invoking a block assessment is that a search has been conducted under section 132, or documents or assets have been requisitioned under section 132A. The said provision would apply in the case of any person, in respect of whom search has been carried out under section 132A or documents or assets have been requisitioned under section 132A. Section 158BD, however, provides for taking recourse to a block assessment in terms of section 158BC in respect of any other person, the conditions precedent wherefor are : (i) Satisfaction must be recorded by the Assessing Officer that any undisclosed income belongs to any person, other than the person with respect to whom search was made under section 132; (ii) The books of account or other documents or assets seized or requisitioned had been handed over to the Assessing Officer having jurisdiction over such other person; and (iii) The Assessing Officer has proceeded under section 158BC against such other person.*
>
> *The conditions precedent for invoking the provisions of section 158BD thus, are required to be satisfied before the provisions of the Chapter XIV-B are applied in relation to any person, other than the person whose premises had been searched under section 132 or whose documents and other assets had been requisitioned under section 132A.*
>
> *A taxing statute, as is well-known, must be construed strictly. Law in this regard is clear and explicit. The notice in question issued under section 158BD did not record any satisfaction on the part of the Assessing Officer. Documents and other assets recovered during search had not been handed over to the Assessing Officer having jurisdiction in the matter.*
>
> *No proceeding under section 158BC had been initiated. There was, thus, a patent non-application of mind. A prescribed form had been utilized. Even the status of the assessee had not been specified. It had only been mentioned that the search was conducted in the month of November, 1995. No other information had been furnished. The provisions contained in Chapter XIV-B are drastic in nature. It has draconian consequences. Such a proceeding can be initiated only if a raid is conducted. When the provisions are attracted, legal presumptions are raised against the assessee. The burden shifts on the assessee. Audited accounts for a period of ten years may have to be reopened.*
>
> *Since the Assessing Officer had not recorded its satisfaction, which is mandatory and the Assessing Officer also had not*

transferred the case to the Assessing Officer having jurisdiction over the matter, the impugned judgments of the High Court could not be sustained.

12. Coordinate Bench of the ITAT in the case of *P. Satyanarayana vs. ACIT Chennai* (supra) has considered the notice issued under section 153C as invalid if no satisfaction was recorded as to whom seized material belongs. It was held as under:

> *"FACTS. A search and seizure operation on residential and business premises of assessee's father was carried out. On the basis of the seized material found in the course of the search, notice under section 153C, read with section 153A, was issued to the assessee. In response thereto, the assessee filed its return and assessment was completed. The assessee contended that the Assessing Officer had not recorded any satisfaction either in case of searched person or in case of the assessee and, therefore, impugned notice was invalid and consequential assessment was to be annulled.*
>
> *On appeal:*
>
> *HELD*
>
> *A perusal of the order sheet recording itself clearly shows that the Assessing Officer when he made the recording, was categorical in his view that the reasons recorded is no pre-condition for action under section 153C and the points noted are for the sake of ready reference and appropriate action. Once the Assessing Officer himself has accepted that the recording of reasons is not a pre-condition for action under section 153C and has accepted that the points are noted for the sake of ready reference and appropriate action, obviously cannot be treated as reasons recorded. A reading of the provisions of section 153C clearly shows that it is in pari materia with the provisions of section 158BD. While interpreting the provisions of section 158BD in the case of Manish Maheshwari v. Asstt. CIT [2007] 289 ITR 341/159 Taxman 258 (SC), more specifically the satisfaction of the Assessing Officer, the Supreme Court has categorically held that the satisfaction is to be recorded. Admittedly, the Assessing Officer in the instant case is the same as that of father of assessee also. The revenue has not been able to show any recording of satisfaction either in the case of searched person or in the case of the assessee and, consequently, in view of the principles laid down by the Supreme Court in the above case, the notice issued under section 153C read with section 153A is liable to be held as invalid. Thus, the consequential assessment passed under section 153C, read with*

> *section 153A are annulled on account of the invalidity of the notice under section 153C read with section 153A".*

13. In the case of *M/s Apex Time Pvt. Ltd vs. DCIT* in ITSS(A) No.34/Mum/2008, dated 30.03.2011 the ITAT 'A' Bench considered the provisions of section 158BD, and has decided as under:

> *5. The learned counsel for the assessee, Mr. M.P. Makhija, submitted that there was no satisfaction recorded by the AO, who completed the block assessment of Nandokya Group of cases, that undisclosed income belonging to the assessee has been found during the course of search and hence the notice u/s 158BD was bad in law.*
>
> *6. This Bench, in view of the rival contentions on the issue as to whether a satisfaction note has been recorded or not, on 8-9-2009, directed the learned DR to produce the assessment records. Similar directions were given on 10-11-2009. Thereafter the learned DR had sought adjournment on 18-01-2010. On 26-10-2010 the directions were once again repeated by the Bench. On 13-01-2011 the learned DR sought adjournment on the ground that the records are not available. Today before us the learned DR Mr. P.K. Das, filed a set of correspondence, wherein the DR has requested the concern AO as well as the concern CIT vide letter dated 26th Oct., 2010 and 8th March, 2011 to furnish the satisfaction note recorded by the AO, and also to submit the assessment record as directed by the Bench. He submitted that despite these repeated efforts, the record has not been sent by the concerned authorities. He prayed for more time.*
>
> *7. Mr. M.P. Makhija, the learned A.R. submitted that adverse inference should be taken and the Bench should decide the case in his favour as more than 1½ years has elapsed since directions were given to the Revenue and no records are produced till date.*
>
> *8. After hearing rival contentions, we agree with the submissions of Mr. M.P. Makhija that no useful purpose would be served by adjourning the matter once again, to give further time to the Revenue, for producing the records, as more than 1 ½ year has elapsed since the date of issual of directions. Hence adverse inference is taken and ground No.2 of the assessee that no satisfaction was recorded by the AO who completed the block assessment of Nandokya group of cases, appears to be factually correct. Thus we quash the block assessment order by applying the judgment of the Hon'ble Supreme Court in the case of Manish Maheshwari 289 ITR 341 wherein it is held that (i) Satisfaction must be recorded by the Assessing Officer that undisclosed income belong to any person, other than the person with respect of whom search was made u/s 132 of the Act, and (ii) the books*

> *of account or the documents or assets seized or requisitioned had to be handed over to the AO having jurisdiction over such other persons".*

14. The Hon'ble High Court of Delhi in the case of *SSP Aviation Ltd. vs. DCIT* 20 Taxmann.com 214 (Del.) dated 29.03.2012 held as under:

> *"In view of provisions of section 153C, satisfaction that is required to be reached by Assessing Officer having jurisdiction over searched person is that valuable article or books of account or documents seized during search belong to a person other than searched person and, it is not necessary that documents so seized must reflect any undisclosed income".*

15. Respectfully following the judicial precedents on the issue as discussed above, we are of the opinion that there is no satisfaction recorded by AO before initiating proceedings under section 153C. Inspite of giving sufficiently adequate time to the Revenue for production of the necessary records and considering the fact that AO refused to allow inspection to assessee as recorded by the bench on 20.04.2011, we have no option than to take an adverse view that no satisfaction was recorded by AO before issuance of notice under section 153C. The Revenue has not been able to show any satisfaction recorded either in the case of searched person or in the case of assessee and consequently in view of the principles laid down by the Hon'ble Supreme Court in the case of Manish Maheshwari vs. ACIT (Supra), a notice issued under section 153C r.w.s. 153A is liable to be held as invalid. Thus, the consequential assessments passed under section 153C r.w.s. 144C are annulled on account of the invalidity of the notices under section 153C. Assessee's additional grounds are accordingly allowed in all the impugned assessment years. Since assessee's additional ground is allowed on the preliminary issue of jurisdiction, there is no need for adjudicating the issues on merit in any of the assessment years. Accordingly, the other grounds raised are considered academic and hence, not adjudicated.

16. All the impugned assessment orders passed in these respective assessment years by AO are hereby annulled.

17. In the result, appeals filed by assessee are allowed.

Order pronounced in the open court on 21st December, 2012.