cyril amarchand mangaldas
ahead of the curve

tax scout

Tax Scout | July - September, 2021

Main Stories

Dear Readers,

The steady endeavour towards pro-active vaccinations have resulted in a steady decline in active Covid cases, leaving behind the horrors of the pandemic witnessed in the first half of this year. The vaccination drive has helped India undertake the 'back to normal' journey with a considerable degree of conviction.

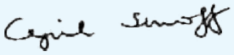
As we celebrate 1 billion vaccinations and our return to office, we at Cyril Amarchand Mangaldas have continued with our endeavor to keep up the tradition of presenting our quarterly tax update covering some of the important decisions and legislative changes that took place in the third quarter of calendar year 2021 i.e. July 1, 2021 to September 30, 2021. This quarter has seen some interesting rulings not only from the Apex Court and several High Courts, but also from the Authority for Advance Rulings and Tribunals.

In our main story, we have discussed Taxation Laws (Amendment) Act 2021 and its implication which corrects the monumental mistake made by India by introducing certain amendments to Section 9 of the IT Act vide Finance Act 2012, on a retrospective basis. The story not only discusses the impact of the amendment on non-resident / foreign investors but also how India will be perceived in the global marketplace. The article also focuses upon on the hurdles created through the additional conditions in granting relief to the foreign investors.

In addition to the above story, we have also dealt with other important developments and judicial precedents in the field of taxation for this quarter.

We hope you find the newsletter informative and insightful. Please do send us your comments and feedback at cam.publications@cyrilshroff.com.

Regards,
CYRIL SHROFF



Managing Partner
Cyril Amarchand Mangaldas

India's leading law firm

Index

Index

Withdrawing Retrospectivity of Indirect Transfer Taxation: Losing The Battle, Winning The War

Introduction

Collection of taxes is one of the primary tools available with the government of a country to provide the necessary fuel to run the economy. Most governments are keen to find ways and means to keep the tax laws in line with the modern methods of earning income employed by various businesses, so that the total amount of taxes collected by them can be increased. At the same time, it is necessary to find a balance where the businesses/ investments find no reason to move out of India for unfair levy of tax.

Indian income tax laws are updated regularly by adopting the path of amendments to evolve the tax laws and achieve the said objective.

The amendments are of two types: prospective and retrospective. While the prospective amendments are applicable from a future date and are generally accepted, the retrospective amendments are generally frowned upon and end up in creating more controversies.

One such (in)famous retrospective amendment in the Indian IT Act was introduced in the year 2012 related to indirect transfer i.e. imposition of capital gains tax on the transfer of shares of a foreign company deriving substantial value from Indian assets.

In this article, we have discussed the legislative background of the amendment, cases of a couple of taxpayers which received global attention, its impact and the recent actions undertaken by the Indian government to withdraw the retrospectivity aspect of the said amendment.

Relevant Legal Framework

India follows a mixed basis of residence and source-based taxation of income. While the residents of India are taxed in India on their global income irrespective of the location of the source of income, the taxation of non-residents is limited to income earned from Indian sources i.e. income that accrues or arises in India or is deemed to accrue or arise in India[1]. The income deemed to accrue or arise in India, *inter-alia*, includes income which arose either directly or indirectly through any business connection, property in India, any asset or source of income in India, and transfer of capital assets situated in India.

The gains derived from the transfer of a capital asset situated in India is included within the ambit of income deemed to accrue or arise in India and hence, the gains derived from the transfer of shares of an Indian company is taxable in the hands of a non-resident. Thus, there has to be an existence of a direct nexus of the transaction of the non-resident with India, which has led to income for the non-resident, in order to consider the same as taxable in India in the hands of such non-resident That is how it was thought of and interpreted for a long time.

However, the narrative changed drastically with litigation arising on the interpretation of the section by the Bombay HC in the case of Vodafone.

The Vodafone judgment and its after-effects: The controversial amendment

Vodafone International Holdings BV ("**Vodafone**") acquired the shares of CGP, a wholly owned subsidiary of Hutchison Tele communications International Ltd. ("**HTIL**"), indirectly acquiring a 67% stake in the Hutchison Essar Ltd, an Indian joint venture between Hong Kong-based Hutchison Group and India-based Essar Group. Hutchison Essar was engaged in providing telecommunication services in India. The IRA held Vodafone liable under Section 195 of the IT Act for failure to withhold taxes on capital gains earned by HTIL. Vodafone challenged the position of IRA before the Bombay HC ("**HC**"), which held[2] that an offshore transaction involving the transfer of shares of a foreign company between two non-residents was held to be taxable in India, since it had ultimately led to change of control or ownership of Indian assets.

Vodafone challenged the decision of HC before the SC. The SC reversed the HC decision and held that Vodafone was not required to withhold tax from the payments made to HTIL since it was an offshore acquisition of shares of CGP that was a bonafide Foreign Direct Investment transaction in India and fell outside IRA's territorial tax jurisdiction. Hence, it was not taxable.[3]

The position adopted by the SC was not amenable to the Government and hence, they came up with several amendments through Finance Act, 2012, including the provisions pertaining to indirect transfer. It enhanced the scope of the terms 'through', 'property' and 'transfer' to tax the transactions involving indirect transfer of shares. It encapsulated that any asset including shares of offshore corporations would be deemed to be situated in India if such shares directly or indirectly derived their value substantially from the assets located in India.

However, the most striking part of the amendment was its retrospectivity with the intention to address the situations where transfer of shares or interest took place in the past between non-residents, but which had an indirect effect of changing control of Indian assets. Resultantly, after the introduction of the amendment, the IRA tried to tax other taxpayers wherein such an indirect transfer had taken place in the past and raised similar demands for capital gains tax.

The Cairn Saga

Post the retrospective amendment, the IRA imposed a tax liability on Cairn India Ltd. for the capital gains earned by it during the 2006 restructuring transaction in the hands of Cairn UK Holdings Ltd. In January 2016, the AO initiated proceedings against Cairn and held that indirect transfer of Indian assets was subject to capital gains tax amounting to INR 102 Billion. Thereafter, Cairn filed an appeal before the ITAT which confirmed the AO's order in March 2017. [4]

Later, to recover the tax demand, the IRA seized and sold shares of Vedanta Ltd. (there was a subsequent merger between Cairn India and Vedanta Ltd. pursuant to which the shareholders of Cairn India were allotted shares in Vedanta Ltd.) held by Cairn group[5] along with confiscating dividend on those shares and certain tax refund due to the company[6].

Arbitration proceedings

Aggrieved by the imposition of the capital gains tax retrospectively, both Vodafone and Cairn invoked arbitration proceedings against the Indian government.

1 Section 9 of the IT Act.
2 Vodafone International Holdings B.V. v. Union of India [2010] 193 Taxman 100 (Bombay).
3 Vodafone International Holdings B.V. v. Union of India [2012] 17 taxmann.com 202 (SC).
4 Cairn U K Holdings Ltd.v. Deputy Commissioner of Income-tax (International Taxation) Circle 1(2)(1), New Delhi [2017] 79 taxmann.com 128 (Delhi - Trib.).
5 https://economictimes.indiatimes.com/markets/stocks/news/i-t-dept-sells-shares-of-cairn-energy-to-recover-retrospective-tax/articleshow/66793898.cms?from=mdr.
6 https://economictimes.indiatimes.com/industry/energy/oil-gas/cairn-tax-dispute-income-tax-department-orders-recovery-of-rs-10000-crore/articleshow/59215018.cms?from=mdr.

(a) Vodafone arbitration

Vodafone initiated arbitration under the India-Netherlands Bilateral Investment Treaty ("**BIT**"). On September 25, 2020, the arbitration tribunal held that the Indian government was in violation of the fair and equitable treatment standard under Article 4(1) of the India-Netherlands BIT[7]. The award did not require the government to pay any compensation to Vodafone, but it required the government to refund the tax collected from Vodafone and pay partial compensation of INR 850 Million towards legal costs.

(b) Cairn arbitration

Cairn initiated international arbitration proceedings under the India - United Kingdom BIT in 2015 against the Indian government. It stated that the retrospective taxation was in breach of the BIT, which obligated India to treat investment from the UK in a "fair and equitable manner".

On December 21, 2020, the arbitration award was pronounced in favour of Cairn[8] wherein the Arbitration Tribunal held that India had failed to uphold its fair and equitable treatment obligation under the BIT. The Arbitral Tribunal also held India liable for imposing retrospective tax liability and unfairly adopting measures to enforce the liability.

Events following the arbitral order

The award was challenged by the government since India took a stand that the dispute is about 'tax' and not about 'investment' and tax matters are outside the purview of the BITs.

In response, in early 2021, Cairn initiated proceedings against India in courts of the UK, the USA, Canada, Netherlands, Singapore and France for the enforcement of the award. Simultaneously, Cairn also initiated proceedings in the US District Court for the Southern District of New York on May 14, 2021 against Air India Ltd ("**Air India**")[9]. Cairn's contention was that Air India should be held jointly and severally liable as it is an instrumentality of the Indian government. Cairn took support of the judgment of National City Bank v. Banco Para El[10] wherein the US Supreme Court had held that in exceptional circumstances, a foreign creditor can enforce its judgment against an instrumentality of the sovereign debtor when the instrumentality is extensively controlled by the state.

Apart from Air India, Cairn targeted shipping corporation vessels, bank accounts, oil and gas field, and cargos of the Indian state-owned enterprises notwithstanding the fact that state-owned enterprises are generally presumed to be immune from attachment and execution in cases against the sovereign governments as they are considered to be separate commercial entities.

Taxation Laws (Amendment) Act, 2021 and its implications

The Indian government brought in Taxation Laws (Amendment) Act, 2021 ("**New Amendment**") to do away with the retrospectivity aspect of the amendments made *vide* Finance Act 2012. The New Amendment provided that no tax demands shall be raised in the future for any indirect transfer of Indian assets undertaken prior to May 28, 2012. The purpose of the New Amendment was to provide benefit to the parties in respect of capital gains income arising from indirect transfer of capital assets situated in India before May 28, 2012, in any of the following cases (i) where assessments had been initiated in the past for normal assessment, income escaping assessment, search related cases, etc., (ii) where an order enhancing assessment of tax or reducing a refund already granted or increasing the liability by rectification has been passed, (iii) where an order has been passed deeming the assessee liable for not withholding taxes on indirect transfer taxes, and (iv) where an order was passed imposing a penalty under the IT Act.

The New Amendment provides that orders that had already been passed against the assessee for indirect transfers shall be deemed never to have been passed and the amount so deposited in relation to the demands raised by the IRA will be refunded without any interest under Section 244A of the IT Act. It is estimated that the Indian government will have to pay back approximately INR 80 Billion collected towards the retrospective amendments from four taxpayers, including Cairn and Vodafone[11]. The Statement of Objects and Reasons which accompanied the Taxation Laws (Amendment) Bill, 2021 provided the following reasoning for bringing in the said amendment:

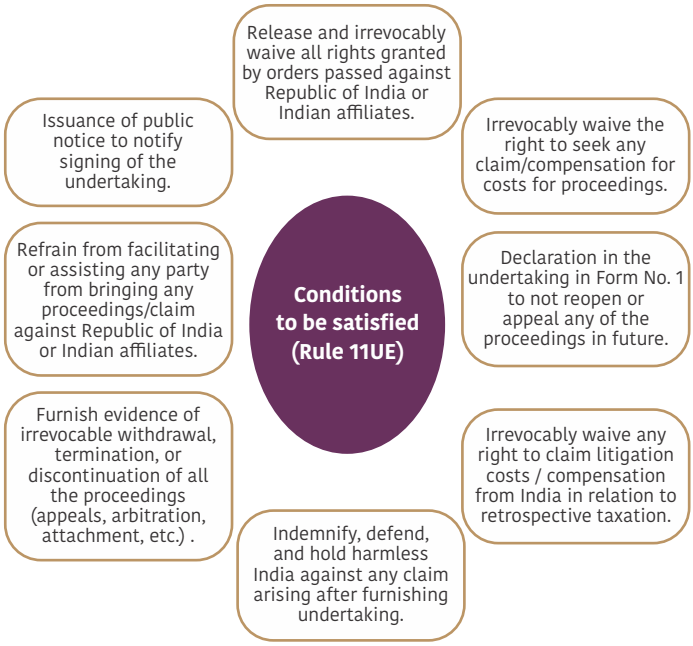
"It is argued that such retrospective amendments militate against the principle of tax certainty and damage India's reputation as an attractive destination. In the past few years, major reforms have been initiated in the financial and infrastructure sector which has created a positive environment for investment in the country. However, this retrospective clarificatory amendment and consequent demand created in a

[7] Vodafone International Holdings BV v. Government of India, PCA Case No. 2016-35 (Dutch BIT Claim).
[8] Cairn Energy PLC and Cairn UK Holdings Limited v. The Republic of India, PCA Case No. 2016-07.
[9] https://www.thehindu.com/business/Industry/cairn-moves-us-court-to-attach-air-india-assets/undefined.
[10] FNC Bank v. Banco Para el Comercio, 462 U.S. 611 (1983).
[11] https://www.business-standard.com/article/companies/govt-will-refund-rs-8000-cr-to-4-companies-under-new-taxation-laws-cbdt-121081000146_1.html.

few cases continues to be a sore point with potential investors. The country today stands at a juncture when quick recovery of the economy after the COVID-19 pandemic is the need of the hour and foreign investment has an important role to play in promoting faster economic growth and employment."

On August 28, 2021, the CBDT issued draft rules to amend the IT Rules, which specified fulfilling of conditions to nullify the demand on account of retrospective amendment and requisitioned public comments. After examining the stakeholder comments on the draft rules, the CBDT notified[12] the final rules by inserting Rule 11UE and Rule 11UF to the IT Rules, which specified the form and manner of submitting the requisite undertaking by the declarant as well as the interested party. The rules also specified the conditions to be fulfilled by the said foreign company so as to ensure that the demand is not pressed upon and the amount already paid by the foreign company against the demand is refunded. In addition, these rules state the need for the company to file a declaration along with a board resolution or legal authorisation besides an indemnity bond.

The conditions that the taxpayers are required to fulfil under the Rule 11UE in order to get the demand nullified and to receive the refund of taxes already deposited are provided below:



Further, the CBDT via Notification dated October 13, 2021[13] also inserted Relaxation of Validation (Section 119 of the Finance Act, 2012) Rules, 2021. This insertion extends the applicability of Rule 11UE (1) and Rule 11UF (3) of the IT Rules to clauses of Section 119 of the Finance Act, 2012. This notification has been specifically brought in to widen the scope of rule 11UE and rule 11UF to the demands raised before the 2012 amendment, with the objective of settling the Vodafone tax claim.

Implications of the amendment

The implications arising out of the New Amendment could be manifold. We have discussed below certain major issues that may arise:

(i) <u>Interest on Refund</u>

Section 244A of the IT Act provides for granting refund of any amount due to the assessee under the Act, along with interest of 0.5% per month. The said interest provided within Section 244A(1)(b) of the IT Act starts to accrue from the date of payment of such tax or penalty till the date of grant of refund[14]. The provision of Section 244A is an equitable provision seeking to compensate a taxpayer for unjustly denying him the use of his funds, in the same manner as the Government levies interest on delayed payment of taxes by the taxpayers.

The New Amendment completely disregards the established norms as well as bypasses Section 244A, defeating the very purpose of the provision. The New Amendment relinquishes the government from the liability of paying interest on the amount recovered by it and used for almost a decade, thereby unjustly harming the interest of the investors.

[12] CBDT Notification No. 118/2021, dated October 01, 2021.
[13] CBDT Notification No. 120/2021, dated October 13, 2021.
[14] CIT v. South Indian Bank Ltd., (2012) 340 ITR 574 (Ker).

The judicial stance establishes that an assessee cannot be denied interest on the deposit made following a tax demand that stood subsequently quashed.[15] In the case of Tata Chemicals Ltd[16], with respect to the grant of refund, the SC noted as below:

"Interest payment is a statutory obligation and non-discretionary in nature to the assessee. In tune with the aforesaid general principle, 244A is drafted and enacted. The language employed in Section 244A of the Act is clear and plain. It grants substantive right of interest and is not procedural...

As held by the Courts while awarding interest, it is a ***kind of compensation of use and retention of the money collected unauthorisedly by the Department****. When the collection is illegal, there is corresponding obligation on the IRA to refund such amount with interest* ***as much as possible in as much as they have retained and enjoyed the money deposited.*** *Even the Department has understood the object behind insertion of Section 244A, as that, an assessee is entitled to payment of interest for money remaining with the Government which would be refunded."*

Thus, utilising the above principle, it may be clearly submitted that where taxes are paid by a taxpayer over and above the actual liability, such amount is due to be refunded to the assessee along with interest.

Relying on the precedent, one may take a view that the government may be made liable for payment of interest on the principal amount held and utilised by them.

(ii) <u>Hurdles in Refund – Cumbersome Procedure</u>

The hidden hurdles within the process may lead to creation of a less-than-ideal environment for regaining the trust of investors on an international platform. The refund procedure given under Rule 11UE necessitates any party seeking a refund to furnish an undertaking indemnifying the Indian government from any future action by certain related/ interested parties. The number of entities, who are connected with the transaction and are required to give the undertaking, would alone prove to be a cumbersome and lengthy process. Further, the entities seeking refund under this provision would have to forego the claim towards the huge costs of litigation incurred by them to fight a sovereign government in the various domestic and international platforms. They would also have to forego any claim for the costs of litigation borne by them at the behest of the arbitration tribunals, even though the arbitration award clearly holds India liable to pay these costs to the entities.

However, a glimpse of flexibility was seen when the Indian government asked for public comments from those directly affected by the rules before notifying the same. It acted as a step to ease the turmoil on both the sides. For example, the draft rules contained a vague declaration to be presented by the declarant indemnifying the Indian government against any third-party suit in relation to retrospective taxation. This declaration implied that all the third-party suits, whether certifiable or frivolous, shall be encompassed within the said declaration and the liability would be cast upon the declarant. In effect, this could expose the declarants to a wide array of risk if frivolous law claims were made in relation to the retrospective taxation. The same concern was collectively raised by both Vodafone and Cairn during the feedback sought by the Indian government after the release of the draft rules. The government took these concerns seriously and modified the third-party indemnification clause in the final rules. The final rules in the Notification provided that the distressed taxpayers or declarants only have to refrain from facilitating, procuring, encouraging or otherwise assisting any person (including but not limited to related party or interested party) from bringing any proceedings or claim of any kind related to the relevant orders.

Protection from any action by interested and related parties was also proposed in the draft rules, however, there was a lack of objectivity on the term 'parties'. Thus, concerns were raised by stakeholders on the viability of such an open-ended waiver since its interpretation could even involve third parties who could be considered to have become interested later, for instance, due to a future merger and acquisition transaction. Taking these concerns into account, the final rules now clarify that interested parties could be the companies or entities in the entire chain of holding of the declarant till the ultimate holding company or entity, any person to whom the declarant has transferred any of its claims under any award, judgment, or court order pertaining to the relevant orders or any person in whose favour rights have been created or assigned or any person who has initiated such proceedings.

[15] Metso Minerals (I)(P.) Ltd. v. Deputy Commissioner of Income Tax. [2013] 32 taxmann.com 209 (Delhi - Trib.).
[16] Union of India v. Tata Chemicals Ltd. [2014] 43 taxmann.com 240 (SC).

Having said the above, the rule and the forms provide a very cumbersome and detailed procedure, which has been brought by the government in relation to an amendment that was eventually withdrawn. Thus, by first bringing the retrospective amendment and inconveniencing the taxpayers with prolong litigation for multiple years, and then agreeing to withdraw the same with a host of conditions attached may not go down well in the spirit of ease of doing business in India.

(iii) India's standpoint

Having said the above, the New Amendment is definitely a step towards reincarnating India as a foreign investor-friendly nation that respects and incorporates international verdicts to ensure a stable and predictable tax environment. India has tried to conquer the position by removing the thorny retrospective tax provision and thereby aligning itself with the principles of international taxation. The New Amendment leans in favour of the Indian government who is proposing to issue refund of only the taxes i.e. the amount paid by the companies in respect to the tax demand raised through retrospective taxation. Thus, India has conveniently tried to ignore the problematic subject involving the amount of interest, damages and cost of litigations as well as protection from future litigations by the major corporations in the international courts.

While the New Amendment is primarily aimed at saving India's reputation in the international community, it also ensures protection of its foreign assets including assets and vessels of State-Owned Enterprises. During the process of enforcement of the arbitration award, Cairn had requested attachment of offshore assets of Air India, along with other state-owned offshore assets of India and its commercial entities. However, with the New Amendment, Cairn and others will have to furnish an undertaking waiving their rights to claim any benefits arising from any order as well as foregoing their right to pursue any further litigation / proceedings. The rules also expect the investor claiming relief under the New Amendment to forego any benefit provided under their respective BITs.

The applicability of the Amendment is dependent upon whether disputing taxpayers actually withdrew their appeals / arbitration proceedings against the Indian government.

(iv) Major Impact on Cairn

The arbitration tribunal had ordered India to pay approximately USD 1.7 Billion (INR 127 Billion) to Cairn, which included a principal of USD 1.2 Billion (INR 90 Billion) and an interest. However, Cairn would have to forego the interest if it accepts the conditions of the withdrawal of the amendments, this is a serious setback for Cairn as it may lose about half a billion dollars. Secondly, in order to recover the tax demand, the IRA sold the confiscated shares of CUHL held in Vedanta pursuant to its merger and also confiscated the dividends and past tax refunds. Cairn ended up suffering a major loss when the shares of Cairn UK, held in another entity, were attached and sold during the process of realisation of retrospective tax demand.

The International law favours interest on refunds along with compensation for any assets seized or sold for recovery of any government dues. India seized the shares, dividend and the tax refund due to Cairn for the alleged tax demand made after the retrospective amendment. However, the New Amendment only talks about reimbursement of the principal amount and is quiet on any interest or compensation payable to Cairn.

However, withdrawing the litigations / proceedings and accepting the refund on India's terms would be more beneficial for Cairn than enforcing the awards granted by the arbitration tribunal. The process of enforcement of award against the sovereign power in the state may prove to be cumbersome and may also prolong the process of litigation. It also goes against the action proposed by India to mend ways, bring peace and end the long-standing litigation.

(v) The Two Ways

The New Amendment could be beneficial only if Cairn and the other taxpayers, who are looking to end the disputes with the Indian government, accept the settlement offer to find certain immediate solution as well as to preserve the time value of money. Generally, disputes between corporations and sovereign are long drawn battles and ending them amicably is beneficial for both the parties.

Nevertheless, considering the high stakes and the negative publicity the matter has received, even the states are expected to be involved in a significant way and taxpayers may meet the relevant finance authority in their respective countries which may advise them regarding their next course of action.

Given the current situation, it is likely that even though the withdrawal of the retrospective amendment is tilted in favour of the Indian government, it is most likely that the same would be accepted by the taxpayers in order to put the retrospective amendment to rest.

(vi) Applicability of BITs on Tax Matters

States enter into BITs with the intention to protect the investments made by the investors from one contracting state in the territory of the other contracting state. The BITs contain mutual promises to promote the economic development of the contracting states and express the rights of the states to regulate investments in good faith.

The BITs are generally equipped with Fair and Equitable Standard ("**FET**"), which puts an obligation on the states to provide such guarantees as a stable and predictable legal framework to foreign investors, following due process while modifying the legal framework that might potentially impact foreign investors, etc. Since 2011, India saw numerous arbitrations claims after losing the claims brought by 'White Industries'[17] of Australia and 'Devas Multimedia' of Mauritius. But these were not related to tax issues. In the last decade, four cases were filed by foreign investors against India against the aforesaid indirect transfer.

While four cases were filed by foreign investors against India's retrospective amendment for indirect transfer tax, Vodafone and Cairn cases, discussed in detail above, had hurt India's reputation as an investor-friendly state. The arbitral tribunal viewed the IRA in violation of the FET standard as given under the India – Netherlands BIT.

Taking the cue, India decided to unilaterally terminate BITs and expressed its intention to negotiate future BITs on the basis of the 2016 Model BIT. Post-2016, India started signing BITs which either did not have income-tax provisions (India – Brazil BIT) or had highly restrictive income tax provisions in case of BITs based on the 2016 Model. It is important to note that the India Model BIT specifically excludes from its scope certain regulatory measures. These include measures by local government, taxation measures, compulsory licenses, government procurement, grants, and subsidies by body or organ of the host state. The 2016 Model BIT empowers the host state with wide discretionary powers to even decide matters of taxation, wherein the decision of the host state shall be non-justifiable and be exempted from the review by an arbitral tribunal. Thus, it may be said that issues related to tax would not be a part of future BITs and going forward, any action under BITs by any foreign investor for tax aspects has already been taken care of by the Indian government.

India has plugged the loopholes in the BIT to make future tax policies immune to invocations by the foreign investors, who rely on the amended BITs for any action. While this gives a comfortable position to India, the same may not go down well with the foreign investors considering they may be exposed to similar kinds of litigation with no protection available under the BITs.

Conclusion

The main objective behind introducing the New Amendment is to restore the image of India as an investor-friendly state. It shows that India has realised it has lost more from the retrospective amendment than it had sought to gain. This is a bold step taken towards saving the country from any further damage to its reputation. The New Amendment shall also provide the necessary relief to both parties as it will save costs of litigation in international courts. However, whether the New Amendment will be accepted by the impacted taxpayers or not, shall be known in the times to come.

As India strives to create and reinstate its reputation as an investment-friendly nation, it is essential for the government to respect foreign investment and foreign investors and abide by its sovereign commitments to other nations under the international treaties. The way forward is to recognise sovereign powers but exercise them in a manner that honours international law and practice. The government should ensure that tax laws are not frequently amended, and ample time should be given to the stakeholders to be financially and operationally ready for incorporating the effects of the amendment. Further, retrospective amendments should not be done as they go against the basic expectation of certainty. Therefore, the New Amendment comes as a great relief to all the taxpayers who faced issues regarding retrospective taxation, and positively impacted the investor sentiment across the country.

It is important that the tax policies and the regulatory framework give comfort to the foreign investors. This will help India showcase itself as a destination which welcomes foreign investments and reinstate the lost investor confidence in a major way.

[17] White Industries Australia Ltd v. India IIC 529 (2011).

CASE LAW UPDATES- DIRECT TAX

INTERNATIONAL TAX

HC dismisses petition on account of fresh evidence being produced during writ proceedings

In the case of ***Tapas Kumar Basak***,[18] the HC rejected the claim of the Assessee for relevant AY on account of fresh evidence being produced only during writ proceedings.

Facts

Tapas Kumar Basak ("**Assessee**") was on foreign waters for a total period of 184 days during AY 2004 – 05. The AO issued a notice to Assessee, under Section 148 of IT Act, asking him to file his income-tax return for the said AY. However, on Assessee's failure in doing so, the AO concluded assessment under Section 147/ 144 of IT Act, subjecting his entire global income to tax in India.

Against the said order, the Assessee did not file for any rectification under Section 154 of the IT Act, nor preferred an appeal before the CIT(A). The Assessee invoked the provisions of Section 264 and filed for revision of the order of the AO. The Director of Income Tax (International Taxation) declined to interfere with the order of the AO proposed to be revised by the Assessee.

Thereafter, the Assessee filed an appeal against the order of the IRA and a writ petition before the HC.

Issue

Whether the Assessee was considered as Resident in India for taxation purposes and whether he is liable to pay tax in India on his global income?

Arguments

The Assessee argued that the he had been on foreign waters for a total period of 184 days. Hence, his residential status should have been treated as 'non-resident' and accordingly, the salary received by him was exempt from tax in India. In order to support his contention of duration of stay in India, the Assessee furnished a certificate issued by his employer. The Assessee also relied on CBDT Circular no. 586 dated November 28, 1990, which provided clarification on taxability of crew members of foreign - bound Indian ships and also specified about the applicability of TDS provisions on them. The Assessee contended that the said circular was in conflict with the provisions of Section 6(1) of the IT Act, which the AO relied upon. Along with the CBDT circular, the Assessee also placed reliance on the SC rulings in *KT Shaduli Grocery Dealer*[19] and *UCO Bank, Calcutta*[20] cases.

The IRA, on the other hand, relied on the calculation of duration of stay by the employer of the Assessee. The employer had calculated the Assessee's stay in India for 182 days and accordingly withheld his taxes in India under Section 192 of the IT Act. Thus, relying on Section 2(42) read with Section 6 of the IT Act, the IRA contended that the Assessee was a resident in India for taxation purposes and hence, his global salary was liable to tax in India.

Judgment

The HC observed that the Assessee had neither filed any reply to the notice issued by the AO under Section 148 of IT Act nor challenge the said notice in his writ petition filed before the HC.

[18] Tapas Kumar Basak v. Assistant Director of Income Tax, International Taxatio – II & Ors. Writ Perition No. 931 of 2007, Calcutta HC.
[19] State of Kerala v. KT Shaduli Grocery Dealer Etc. (1977) 2 SCC 777.
[20] UCO Bank, Calcutta v. Commissioner of Income Tax, West Bengal (1999) 4 SCC 599.

Also, the Assessee had not filed for any rectification of the order passed under Section 154 of IT Act or appealed against the said order before the CIT(A).

Further, evidence relied upon by the Assessee, i.e. the certificate obtained from his employer, was not produced before the AO or during the revision proceedings. The first time the said piece of evidence was produced was before the HC writ proceedings. The HC held that being a writ court in exercise of its jurisdiction under Article 226 of the Constitution of India, it cannot scrutinise any fresh piece of evidence that was never produced before the IRA during assessment or revision proceedings.

With respect the Assessee's contention of a conflict between the CBDT notification and Section 6(1) of IT Act, the HC held that it was settled position that in case there is a conflict between circulars/ notifications issued by the CBDT and the IT Act, the IT Act will prevail.

Given the same, the HC dismissed the writ petition refusing to interfere with the revision order passed under Section 264 of IT Act and treating the Assessee as 'Petitioner'.

Significant Takeaways

The CBDT circular no. 586 relies on Section 6 of IT Act to state that if an Indian Citizen who is a member of crew of an Indian Ship, shall be regarded as resident in India if he is in India for 182 days or more. The said circular also states that Indian members of the crew of a foreign-bound Indian ship would be considered non-resident in India if they were on board of such ship outside the territorial waters of India for 182 days or more during any FY.

In the unique case as that of an Assessee, which relate to FY 2003-04 [i.e. FYs with 366 days], the condition of being on territorial waters for 182 days or more was satisfied for he was on territorial water for 184 days. However, for the remaining period of 182 days, if the Assessee was resident in India, the condition under Section 6 was also fulfilled. In cases such as these it may have been pertinent for the Assessee to rely on the landmark SC rulings in the case *Mysore Minerals LTd.*[21] and *Vegetable Products Ltd.*[22] wherein the SC held that in the event of ambiguities in the language of taxing provisions the courts have to adopt the interpretation that is in favour of the Assessee. However, in order to avail such beneficial interpretations, it is important that the Assessee must have sufficient documentary evidence to support its facts and should have resorted to appropriate procedures to seek relief from judicial authorities.

In the present case, by not following the proper course of litigation and by producing fresh evidences and facts during writ proceedings, Assessee had created an adverse case for itself. Further, Assessee did not have sufficient evidence to support its claims. This led to HC holding against the Assessee in this case.

> **"HC dismisses writ petition of Assessee on production of fresh evidence only before it."**

[21] Mysore Minerals Ltd. v. CIT [1999] 239 ITR 775 (SC).
[22] CIT v. Vegetable Products Ltd. [1973] 88 ITR 192.

Payments for online advertising, marketing, and information technology facilities to non-residents not taxable as royalty

In the case of ***Urban Ladder Home Décor Solutions Pvt. Ltd.***[23], the ITAT held that the payments made by an Indian company to non-residents for availing online advertising and marketing services, bulk email facility and information technology infrastructure are not taxable as royalties under the provisions of the IT Act and the Indo-US and Indo-Ireland DTAA.

Facts

Urban Ladder Home Décor Solutions Pvt. Ltd ("**Assessee**") was engaged in the business of dealing in home décor products, sold mainly through online marketing. The Assessee had utilised the services of Facebook, Ireland ("**Facebook**") for placing advertisement of its products on the walls of Facebook users. The Assessee had also availed the bulk mail facility offered by Rocket Science Group LLC ("**Rocket Science**"), USA, through its 'Mail Chimp' platform to send bulk email advertisements/ marketing content to its customers. Further, the Assessee availed cloud computing services of Amazon Inc. USA ("**Amazon**") for its online business needs.

In FY 2017-18, a survey was conducted on the premises of the Assessee under Section 133A of IT Act to examine TDS compliances. During the survey proceedings, the AO found out that the Assessee had made payments to the non-resident entities without deducting taxes at source. The AO observed that certain payments were in the nature of advertisement and marketing expenses. Accordingly, AO examined the taxability of the payments under Explanation 2 to Section 9(1)(vi) of the IT Act, along with relevant provisions of the DTAA and took the view that the Assessee was liable to deduct tax at source from the payments made to such non-residents. Accordingly, the AO held the Assessee as Assessee in default for three AYs and raised a demand under Section 201(1) of the IT Act, with interest.

On appeal to CIT(A), the CIT(A) observed that the Assessee was given privilege of accessing/ using various components of advertisement program created by Facebook in its website. The CIT(A) also observed that obtaining the services of 'Mail Chimp' involved payments for the use of or right to use of patented software processes. Similarly, the CIT(A) observed that the use of Amazon Web Services ("**AWS**") for cloud computing involved payments for the use of, or right to use of software processes. Consequently, the CIT(A) upheld the order of the AO, stating that the consideration paid by the Assessee was for the use of, or the right to use of software and hence, was taxable as royalty.

Being aggrieved by the order of the CIT(A), the Assessee went on to appeal before the ITAT.

Issue

Whether the payments made by Assessee to non-residents were taxable in India?

Arguments

The Assessee contended against the reliance placed by the IRA on the provisions of the IT Act only. Further, the Assessee relied on the principles laid down by the SC in the case of *Engineering Analysis*[24] to contend that the payments made to non-resident parties i.e. Facebook, Rocket Science and AWS were not taxable as royalties.

The IRA, on the other hand, relied on the provisions of Section 9(1)(vi) of the IT Act to argue that the payments made to Facebook, Rocket Science and AWS were taxable as royalties. With respect to AWS, the AO did refer to provisions of India US DTAA in addition to provisions of the IT Act.

Judgement

The ITAT relied on the landmark ruling of the SC in the case *Engineering Analysis*[25] and observed that the relevant DTAA provision should have been considered while analysing the taxability of the payments made to non-resident parties.

The ITAT perused the agreements between the Assessee and Facebook as well as Rocket Science and observed that the agreements indicated that both the entities had allowed the Assessee to use the facilities provided on their sites which, *inter alia*, included software facilities also.

The ITAT observed that the Assessee was compelled to use these facilities to create an environment of ease that would mutually benefit both the parties. However, the right to use these facilities was available only when the parties had entered into an agreement with these non-resident entities to host advertisement or to send bulk emails. Thus, the use of facilities was intertwined with the activity of hosting advertisement on Facebook or with the activity of sending bulk emails on Rocket Science. In case of web hosting charges paid to AWS, the ITAT observed that the taxpayer was allowed to use IT infrastructure facilities.

[23] Urban Ladder Home Décor Solutions Pvt. Ltd. (ITA No. 615 to 620/ Bang/ 2020).
[24] Engineering Analysis Centre of Excellence Private Limited v. CIT (2021) 125 taxmann.com 42 (SC).
[25] Engineering Analysis Centre of Excellence Private Limited v. CIT (2021) 125 taxmann.com 42 (SC).

The ITAT also analysed judicial precedents on the matter. The ITAT observed that Kolkata Tribunal in the case of *Rights Florists*[26] referred to a catena of rulings to hold that the receipts in respect of online advertising on Google and Yahoo cannot be brought to tax in India under the provisions of the IT Act, as also under the provisions of India-US and India-Ireland DTAA. The ITAT also referred to Madras HC ruling in the *Skycell Communications Ltd.*[27] wherein it was observed that the point that mere usage of a facility does not give rise to the provision of any technical service. Using the same analogy, the ITAT held that mere usage of facility provided by the aforesaid non-residents to the Assessee does not render the payments as 'royalty', since the core point of parting of any 'copyright' attached to the said facilities does not arise at all.

Further, the ITAT also relied on the case of *Engineering Analysis*, the issue related to 'issuing of license to use software', i.e. the software purchased by a person shall be used by the buyer for his own business purposes. Since the license was granted without parting with the copyrights attached to the software, the SC held that the payments received by the non-resident software companies cannot be taxed as 'royalties' under the provisions of the relevant DTAAs and hence, there was no requirement to deduct taxes at source from the payment made to them by a resident taxpayer.

Applying the above-mentioned observations to the case at hand, the ITAT held that Facebook and Rocket Science group only allow the Assessee to use their facilities for the purpose of creating advertisement content. The payment made to AWS was only for using the IT facilities provided by it, that too the billing would depend upon the extent of usage of those facilities. It was also observed by the ITAT that the non-resident entities did not give any specific license for the use of or the right to use of any of the facilities (including software).

The right to use the facilities was intertwined with the main objective of placing advertisements. In the case of AWS, the payment was made only for the use of IT infrastructure facilities on rental basis, Hence, the question of transferring the copyright over to those facilities did not arise at all.

The agreements entered by respective parties indicated that the copyright over those facilitating software was not shared with the Assessee. In any case, the main purpose of making payment was to place advertisements only and not to use the facilities provided by the non-resident entities. Thus, the facilities provided by the non-resident entities were only enabling facilities, which help a person to place his advertisement contents on the platform of Facebook or to avail bulk email facility of Rocket Science. In case of AWS, the payment was in the nature of rent for the use of infrastructure facilities. Accordingly, the non-resident recipients of payments stood on a better footing than before the SC ruling in the case of *Engineering Analysis*. Accordingly, following the ratio laid down by the SC, the payments made to such non-resident entities do not fall within the meaning of 'royalty' as defined under relevant DTAA. The ITAT also observed that the IRA had not put out an alternative case that these payments were taxable as business income. Hence, there was no necessity to deal with that aspect. Given the same, the ITAT held that the payments made by the Assessee to the non-resident entities cannot be considered as 'royalty payments' under the relevant DTAA. Therefore, it was not chargeable to tax in India and consequently there was no requirement for the Assessee to withhold taxes under Section 195 of the IT Act.

Significant Takeaways

In cases of advertisement arrangements with a non-resident web-based search company, where the responsibility of uploading and displaying the advertisements is on the foreign company, the fee paid may not get taxed as 'royalty' considering the Indian taxpayer may not have any access to the portal of the foreign company. Further, such income may not get taxed as business income if the foreign company did not have a PE in India. Judicial rulings[28] have also held that search engines could have a presence in India in the form of a PE if their web servers were located in India. However, if the agreements also include facilitating the display and publishing of the advertisement for a targeted customer base with the help of patented tools and software, then the taxpayer may have access to various data and information. In such cases, the taxpayer may have a license to use the confidential information, technical know-how, trademark, brand features etc. In such cases, the payments made to such non-residents were held as taxable.[29]

In the case of *Engineering Analysis,* SC had held that the amounts paid by the resident end users/ distributors to non-resident software manufacturers/ suppliers, as a consideration for resale/use of the computer software through distribution agreements, was not a payment of royalty for the use of copyright in computer software. It did not give rise to any income taxable in India under the DTAA and hence the residents taxpayers were not held liable to withhold taxes.

[26] ITO v. Rights Florists [2013] 32 taxmann.com 99 (Kol.).
[27] Skycell Communications Ltd. v. DCIT [2001] 251 ITR 53 (Mad.).
[28] ITO v. Rights Florists [2013] 32 taxmann.com 99 (Kol.); Pinstrom Technologies (P) Ltd v. ITO [2012] 54 SOT 78 (Mum); Yahoo India (P) Ltd. v. DCIT [2011] 140 TTJ 195 (Mum).
[29] Google India Pvt. Ltd. v. ACIT [2017] 190 TTJ 409 (Bang.).

The ITAT has reiterated some of the principles of SC's ruling in the present case and held that payments to AWS were done to only use its IT facilities and that there was no question of transfer of copyright. Thus, the payments were not taxable as royalty payments.

In 2016, 6% equalisation levy was also introduced on online advertisement, digital advertising space or any other facility or service. The scope of equalisation levy was subsequently broadened in 2020 to include 2% levy on the consideration received or receivable by an e-commerce operator from e-commerce supply or service. It would be interesting to analyse the imposition of equalisation levy with respect to services provided under the agreements with non-resident entities in the present case. However, once subject to tax in India under the provisions of the IT Act, the non-resident entities would not be liable for the levy of equalisation levy.

The CBDT has also notified[30] thresholds for the applicability of Significant Economic Presence ("**SEP**") provisions. SEP provisions have been introduced to tax digital transactions which were otherwise not taxable in India due to lack of a physical presence. However, considering SEP is defined under the IT Act, any beneficial provisions DTAA would have to analysed for the applicability of SEP provisions in an instant case.

> **"Payments made to non-residents for online advertising, bulk mail and IT Facilities not taxable as royalty payments."**

[30] CBDT Notification 41/2021 dated 3 May 2021.

Bundle of inter-connected services under a unified agreement constitute a PE under the India-Norway DTAA

In the case of ***Telenor ASA***[31], the Delhi ITAT observed that in the facts and circumstances of the case, various activities undertaken by the employees of a non-resident taxpayer in India under different Service Order Forms ("**SOF**") were inter-connected and were rendered under a uniform agreement, such that no single activity in itself could have constituted performance of service for the service recipient. Accordingly, the period spent by the employees in rendering such interconnected services should be aggregated to determine whether such employees constituted a Service Permanent Establishment ("**Service PE**") of the non-resident taxpayer in India under the India-Norway DTAA.

Facts

Telenor ASA ("**Assessee**"), a tax resident of Norway, entered into a Business Service Agreement ("**BSA**") with an Indian company ("**Ind Co.**") for provision of certain business support services through different SOFs. The fees received for providing such services was offered to tax as FTS.

During the assessment, the AO observed that the time spent by Assessee's employees in India, while rendering services to Ind Co., exceeded the minimum threshold prescribed under Article 5(2)(l) of the India-Norway DTAA. Thus, the AO held that the Assessee constituted a Service PE in Indian under Article 5(2)(l) of the India-Norway DTAA and sought to tax the profits attributable to such PE. The AO rejected the argument of the Assessee that various activities should be considered as separate projects for determining the period of stay for the purpose of 'physical presence test' under Article 5(2)(l) of the India-Norway DTAA, and held that the said Article does not distinguish between same or similar types of services.

The Assessee unsuccessfully objected against the draft assessment order passed by the AO before the DRP. Subsequently, the Assessee filed an appeal before the ITAT, against the final assessment order passed by the AO pursuant to the directions of the DRP.

Issue

Whether inter-connected services rendered through separate SOFs, under an agreement, can be considered as a single project for determining the period of stay for the purpose of 'physical presence test' under Article 5(2)(l) of the India-Norway DTAA?

Arguments

The Assessee argued that the duration of stay of its employees in India did not exceed six months per project and contended that each SOF needs to be considered separately as a separate project for the purpose of applying Article 5(2)(l) of the India-Norway DTAA. The Assessee stated that Article 5(2)(l) of the India-Norway DTAA provides that the time spent in rendering services in relation to a *"same or a connected project"* should be considered for the purpose of physical presence test under Article 5(2)(l) of the India-Norway DTAA. The Assessee relied on OECD's Commentary on the Articles of the Model Tax Convention ("**OECD Commentary**") and argued that the term *"same or a connected project"* needs to be interpreted from the perspective of the service provider.

The Assessee contended that activities undertaken under separate SOFs cannot be consolidated as each SOF constituted a separate project and services rendered under one SOF were not dependent or linked with the other. It was also pointed out that each invoice provided for a detailed working clearly specifying (a) time spent by each personnel, and (b) travel incurred by such personnel for each SOF separately. Thus, it was argued that in absence of any economic or geographic coherence between separate SOFs, the time-period for rendering services under such SOFs should not be consolidated. In this regard the Assessee also placed reliance on the rulings in the case of *Sumitomo Corporation*[32], *Krupp Uhde GmbH*[33], *Valentine (Mauritius)Ltd*[34], etc. wherein it was held that where different purchase orders/contracts were issued for various activities, unless there is commercial coherence between the said activities, the duration test of six months or such other duration as specified under the applicable DTAA between the parties has to be applied with reference to each activity.

On the other hand, the IRA argued that activities of the same nature performed under various SOFs should be aggregated to apply the duration test. The IRA argued that Article 5(2)(l) of the India-Norway DTAA covers not only services in a particular project but also connected projects and hence, the duration of any connected projects should also be considered. Reliance in this regard was also placed on the OECD Commentary.

The IRA also contended that various services rendered under various SOFs were inter-connected since one SOF formed the input for the subsequent SOF and constituted the same project. The IRA also argued that common invoices were raised by the Assessee on a quarterly basis as per the underlying agreement i.e. the BSA, which also implied that these activities should be considered together.

[31] ITA No. 1307 of 2015, [2021] 129 taxmann.com 198 (Delhi ITAT).
[32] Sumitomo Corporation v. DCIT 114 ITD 61 (Del ITAT).
[33] ADIT v. Krupp Uhde GmbH [2008] 28 SOT 254 (Del ITAT).
[34] ADIT v. Valentine (Mauritius) Ltd 130 TTJ 417 (Mum ITAT).

Decision

The ITAT rejected the Assessee's contentions that services under various SOFs constituted separate projects and observed that the underlying agreement i.e. the BSA was a unified agreement which duly defined the mutual obligations between the parties. Further, the ITAT observed that a common consolidated billing and a common payment further showed that there was overall a single agreement between the parties irrespective of the multiple SOFs.

The ITAT referred to the OECD Commentary on Article 5(2)(l) of DTAAs which laid down certain factors to determine whether certain projects were connected, such as:

- Whether the projects were covered by a single master contract;
- Whether the projects that were covered by different contracts concluded with the same person or with related persons and whether the conclusion of the additional contracts would reasonably have been expected when concluding the first contract;
- Whether the nature of the work under different projects was the same;
- Whether the same individuals were performing the services under the different projects.

On the basis of the above, the ITAT concluded that activities of the Assessee under various SOFs were interconnected, interlaced and constituted sequential technical services as no single activity could stand in isolation or perform and achieve the purpose of the recipient individually. It further held that together they represented one seamless function and outcome of one SOF became the input of the other SOF, as can be seen from the nature of the activities

Hence, as a result of services being rendered under a unified agreement, consolidated billing pattern and the inter-relation amongst the activities, the ITAT held that the existence of PE under Article 5(2)(l) of the India-Norway DTAA was undeniable.

Significant Takeaways

It would be relevant to note that constitution of a PE is an amalgamation of a factual and legal analysis. Even in the instant case, the Delhi ITAT has rendered its ruling after giving due regard to the nature of the activities performed. However, the ITAT has clarified that in order to determine whether the time spent for various activities by a non-resident can be consolidated for the purpose of determining Service PE, true test would be to determine interconnection and interdependency of the activities i.e. whether the activities can be regarded as a coherent whole in conjunction with each other.

The decision of the Delhi ITAT in the case of the Assessee is in consonance with an earlier decision of the Mumbai ITAT in the case of *Valentine (Mauritius)Ltd (supra)*, in which it held that for the purpose of determining the existence of a PE, aggregation of time spent on various business activities would depend on the nature of such activities as well as their inter-connection and interdependence on each other in addition to geographical proximity and commercial nexus. Work performed for the same principal or performed in the same area would not by itself imply that projects were commercially coherent and therefore be aggregated to apply the duration test specified under the applicable DTAA between the parties in a particular case. Similarly, the Delhi ITAT in the case of *Sumitomo Corporation (supra)* observed that mere commonality of the principal does not constitute a sufficient basis to aggregate the activities performed in a particular case. In case of various purchase orders that were not only independent but also did not complement each other, thereby ruling out any effective connection, the activities performed should not be aggregated while applying the duration test for the constitution of a PE.

As mentioned earlier, these rulings have taken into account the specific facts and circumstances of each case i.e., activities performed under an agreement were brought under scrutiny to ascertain whether or not they were inter-connected or inter-dependent, which is necessary to decide if the duration test was met for the constitution of a Service PE in India. Thus, taxpayers should evaluate the impact of this ruling in light of the specific facts of their cases.

> **"Bundle of inter-connected and inter-related services rendered by a foreign entity in India vide a unified agreement constituted a Service PE in India if the employees satisfied the duration test."**

CASE LAW UPDATES- DIRECT TAX

TRANSACTIONAL ADVISORY

SC holds debentures issued in lieu of interest, as actual payment of interest

In the case of ***MM Aqua Technologies***[35], SC allowed the discharge of interest liability through issue of debentures, as deduction under Section 43B.

Facts

MM Aqua Technologies ("**Assessee**") had taken loans from financial institutions under the agreement, which provided for conversion of 20% of the amount in default into equity capital of the Assessee at the option of the lenders. The agreements were subsequently revised and the new terms and condition provided for the repayment of the principal and the interest, accrued at the time of default..

In AY 1996-97, the Assessee was unable to pay interest and liquidated damages. Hence, it approached the lead lender, which on behalf of other lenders, approved a rehabilitation plan. While the lenders did not avail the option of conversion of amount in default into equity, they agreed on the rehabilitation plan, under which the Assessee issued convertible debentures to the lenders in lieu of the outstanding interest and other charges. Pursuant to the debenture issue, interest liability of INR 28.4 million was discharged. Subsequently, the Assessee also claimed deduction of this amount in its income-tax return for the relevant AY.

The AO disallowed the expense claimed by the Assessee stating that the issuance of debentures does not amount to an actual payment of interest. The AO maintained that the original terms and conditions, on which the loans were granted, did not include the issuance of debentures; and subsequent change in terms of the agreement was contrary to Section 43B(d) of IT Act.

The CIT(A) reversed the decision of the AO and ruled in favour of the Assessee. The CIT(A) held that since the lenders had accepted the debentures as effective discharge of interest liability of the Assessee, it would amount to actual payment of interest under Section 43B.

The ITAT upheld the decision of CIT(A) stating that when both the creditor and debtor had agreed to the conversion of outstanding interest liability into fully-paid debentures, the IRA could not dispute that the interest liability was not discharged.

The IRA filed an appeal before the HC. At the time when the appeal was filed before the HC, Explanation 3C to Section 43B was introduced with retrospective effect from 1 April 1989. The HC held that the issue in the present case was squarely covered by Explanation 3C and it negated the Assessee's contention that interest converted into a term loan is deemed to be actually paid. Given the explanation, the deduction claimed by the Assessee was disallowed by the HC.

Subsequently, the Assessee filed an appeal before the SC.

Issue

Whether the interest liability discharged by the Assessee in the form of debenture can be claimed as an expense under Section 43B of the IT Act.

[35] MM Aqua Technologies Ltd. v. Commissioner of Income-tax, Delhi – III, [2021] 129 taxmann.com 145 (SC).

Arguments

The Assessee highlighted that the question framed by the HC in its judgment was incorrect in so far as the use of the term 'loan' instead of 'debenture' was concerned. The Assessee argued that Explanation 3C, which was introduced with retrospective effect, would have no applicability on the facts of the case as interest was not converted into a loan or borrowing. The Assessee argued that debentures were actionable claims and could be sold in the market as such. Further, the Assessee also relied on the ruling in the case of *Cape Brandy Syndicate*[36] to submit that fiscal and tax statutes have to be strictly construed. Given the same, since the word 'debenture' was not specified in Explanation 3C, it could not be read into it.

On the other hand, the IRA argued that Section 43B departs from other provisions of IT Act, as indicated from the non-obstante clause of the provision. The Section was introduced with the intent that no deductions could be claimed based on mercantile system of accounting as actual payment would have to be made. The IRA relied on the ruling of *Gujarat Cypromet Ltd.*[37] to state that debenture meant nothing but a loan, and thus interest had, in fact, been converted into a loan in the present case and, therefore, squarely attracted the applicability of latter part of Explanation 3C.

Judgement

The SC looked at the legislative intent behind the enactment of Section 43B, which was to allow certain deductions only on actual payment. This was also made clear by the *non-obtstante* clause contained in the beginning of the provision, coupled with the deduction being allowed, irrespective of the years in which the liability of such sum was incurred because of the method of accounting regularly employed by the taxpayer. Thus, only 'actual payment' as against incurring of liability, could allow for a deduction. However, Section 43B did not provide for a mode of payment, as is a requirement for claiming deduction.

Thus, the issue at hand was only whether the interest was actually paid by issuing debentures. The SC observed that as per the rehabilitation plan, debentures were accepted by the lenders in lieu of the debt on account of outstanding interest, which also led to the extinguishment of liability to pay interest not only from the account of the Assessee but also from the accounts of lenders. This evidenced the fact that the interest was actually paid by issuance of debentures in the relevant AY.

Further, the SC also held that the Explanation 3C introduced to Section 43B, with retrospective effect, was not applicable in the present case because the Explanation was only to clarify that the unpaid interest converted into a loan or borrowing shall not be deemed to have been actually paid. The Explanation was introduced to plug a loophole in Section 43B, whereby taxpayers were misusing it to claim a deduction on the interest that was not actually paid but converted into a fresh loan. However, in the present case, the issue of debentures happened pursuant to a rehabilitation plan, in order to extinguish the liability of interest altogether. Thus, there was no misuse of provisions of Section 43B and the Explanation shall not apply in the present case.

[36] Cape Brandy Software v. Inland Revenue Commissioner, 1921, (1) KB 64.
[37] CIT v. Gujarat Cypromet Ltd. (2020) 15 SCC 460.

With respect to the ruling in the case of *Gujarat Cypromet Ltd.*, the SC distinguished the ruling with the present case on facts.

Further, the SC also observed that even if there was an ambiguity in interpretation of the Explanation, the following interpretations may come in support of the taxpayers:

- By placing reliance on the ruling in the case of *KP Varghese*[38], the SC observed that since the Explanation was introduced with the intent of plugging a loophole i.e. misuse of Section 43B, bona fide transactions of actual payments are not meant to be affected by it.
- A retrospective provision which was meant for the removal of doubts, could not be presumed to be retrospective if it altered or changed the law as it earlier stood. Thus, in this case, the Explanation should be considered as only explaining the purport of Section 43B and not adding any new condition to it. In this regard, SC placed reliance on its own ruling in the case of *Sedco Forex International Drill*[39].
- Any ambiguity in the language of the Explanation should be resolved in favour of the taxpayer. For this, the SC placed reliance on ruling in the case of Cape Brandy Syndicate, which was subsequently followed in the case of *Vodafone International Holdings BV.*[40]

Given the above, the SC set aside the ruling of the HC and decided the matter in favour of the Assessee.

Significant Takeaways

The SC ruling interpreting the provision along with the Explanation can be seen as a welcome ruling for taxpayers. The observations made by the SC in this case would be beneficial for taxpayers in the long run for interpreting tax provisions in their entirety.

Aside from the beneficial interpretation given the by SC, it has also upheld the privity of contract between the lenders and borrowers. Thus, where the parties had reached an agreement on extinguishing the interest liability with issue of debentures, the tax authorities need not have pierced the veil to rewrite the transaction. Further, where such transactions are bona fide and genuine, the interest of the parties should not be impacted.

The SC also reiterated the important principle in interpretation of retrospective provisions, which are brought forth for 'removal of doubts', to not have the impact of altering or changing the law as it earlier stood. The SC ruling also made an impact in distinguishing the term 'debentures' from 'loan' or 'borrowing' from 'debenture'.

The ruling may benefit a number of corporates looking to restructure their interest liabilities into payment by securities.

> **"SC holds that discharge of interest through issuance of debentures is eligible for deduction under Section 43B."**

[38] KP Varghese v. ITO (1981) 131 ITR 597 (SC).
[39] Sedco Forex International Drill v. CIT [2005] 279 ITR 310 (SC).
[40] Vodafone International Holdings BV v. UOI [2012] 34 ITR 1 (SC).

Section 14A not applicable where own funds available exceeded the investments

In the case of ***South Indian Bank Ltd.***[41], the SC held that where investments are made from mix funds, consisting of both borrowed capital and own funds, a disallowance under Section 14A of IT Act in respect of expenditure incurred for earning tax-free income is not warranted, provided the own funds exceeded the investment amount. The SC further held that there is no statutory obligation on a taxpayer to maintain separate accounts in respect of its funds i.e. interest-free funds and borrowed funds.

Facts

South Indian Bank Ltd. ("**Assessee**") a scheduled bank, made investments in certain securities resulting in interest and dividend income which were tax exempt under the IT Act. The Assessee made the said investments from a pool of mixed funds, consisting of interest-bearing borrowed funds and as well as its own funds. The Assessee did not maintain separate accounts for investment yielding interest-free income.

During the assessment, the AO held that in the absence of separate accounts, it was not possible to determine the actual expenditure incurred by the Assessee in respect of its exempt income. Accordingly, the AO proportionately disallowed the interest expenditure attributable to investments used to earn tax free income, under Section 14A of the IT Act, which provides for disallowance of expenditure incurred to earn exempt income. The taxpayer unsuccessfully appealed the order of the AO before the CIT(A). Subsequently, it approached the ITAT, which granted relief.

The ITAT observed that the Assessee had surplus funds from which investments could be made and hence deleted the disallowance made by the AO. However, the aforesaid decision of the ITAT was reversed by the HC. Aggrieved by the order of the HC, the Assessee filed an SLP before the SC.

Issue

Whether proportionate disallowance of interest paid by the banks is called for under Section 14A of IT Act for investments made in securities that yield tax-free income to Assessee, when it had own funds which were more than the investments made?

Arguments

The Assessee argued that the quantum of interest-free funds available to it was substantially more than its investments yielding interest-free income. Therefore, such interest expense claimed by the Assessee should not be considered towards such investments for the purpose of disallowance under Section 14A of IT Act.

The Assessee further contended that where investments are made out of a mixed fund, it should be left to the taxpayer to pick any part of the funds needed for a particular investment and the IRA should not be allowed to appropriate the funds on its own. In this regard, the Assessee placed its reliance in the decisions made in cases of *Reliance Industries Ltd*[42], *HDFC Bank Ltd.*[43], *Suzlon Energy Ltd.*[44], *Microlabs Ltd.*[45] and *Max India Ltd.*[46]. It must be noted that on similar facts, the SC and the corresponding HCs had ruled in favour of the taxpayer.

The IRA argued that due to Assessee's failure to maintain separate accounts, it was not possible to determine the actual expenditure incurred by the Assessee in respect of its exempt income. Accordingly, proportionate disallowance had to be made as per Section 14A of IT Act.

The IRA also contended that the Assessee had a statutory obligation to maintain separate accounts and placed reliance on the decision of *Honda Siel Power Products Ltd.*[47], wherein it was held that the taxpayer was responsible to fully disclose all material facts in a given case.

Decision

The SC held that where investments in securities were made out of mix funds (i.e. interest-bearing funds and own funds) and the Assessee had non-interest-bearing funds which were more than the investments made in tax- free securities, then in such cases, the Assessee has the right of appropriation as well as to assert its right to determine what part of the fund it should use for a particular investment. It was permissible for the IRA to make estimation of a proportionate figure. Accordingly, no disallowance should be made under Section 14A of the IT Act.

The SC rejected the argument of the IRA that separate accounts were required to be maintained by the taxpayer and held that though there was an obligation on the taxpayer to disclose

[41] South Indian Bank Ltd. Vs. Commissioner of Income Tax [Civil Appeal No. 9606 of 2011].
[42] Commissioner of Income Tax (Large Tax Payer Unit) Vs. Reliance Industries Ltd3 (2019) 410 ITR 466 SC/ (2019) 20 SCC 478.
[43] HDFC Bank Ltd. Vs. Deputy Commissioner of Income Tax (2016) 383 ITR 529 (Bom) / 2016 SCC Online Bom 1109.
[44] CIT Vs. Suzlon Energy Ltd (2013) 354 ITR 630 (Guj)/ 2013 SCC Online Guj 8613.
[45] CIT Vs. Microlabs Ltd (2016) 383 ITR 490 (Karn)/ 2016 SCC Online Kar 8490.
[46] CIT Vs. Max India Ltd. (2016) 388 ITR 81 (P & H) / 2016 SCC Online P&H 6788.
[47] Honda Siel Power Products Ltd. Vs. DCIT [(2012) 12 SCC 762].

material facts at the time of filing of its return, that does not tantamount to an obligation on the taxpayer to also maintain separate accounts for different funds. The SC placed reliance on the decision of *Reliance Industries Ltd (supra)* where it was held that since interest-free funds available to the taxpayer were sufficient to meet its investments, it will be presumed that investments were made from such interest-free funds. The SC distinguished its ruling in the case of *S.A. Builders*[48], rendered in the context of disallowance of interest expenditure, in relation to funds lent to sister concerns as an interest-free loan. The SC observed that the said ruling was rendered on different set of facts where the taxpayer had given interest-free loans to sister concerns whereas in the present case the Assessee had made investments in bonds/ securities. Hence, it held that the said case should not have a bearing per se on the present case even though the said ruling was pending consideration before a larger bench of the SC in the case of *Tulip Star Hotels Ltd*[49].

The SC also observed that as per CBDT Circular No. 18/2015 dated November 11, 2015, all securities held by a bank, other than securities held for maintaining Statutory Liquidity Ratio (SLR), are in the nature of stocks in trade as they pertain to its banking business and hence yield business income. The SC observed that it was not the contention of the IRA that the securities held by the Assessee pertained to the securities held for SLR purposes or did not constitute business income for the purpose of disallowance under Section 14A of the IT Act.

Therefore, the SC held that a nexus was not established between the expenditure sought to be disallowed by the IRA and the exempt income of the Assessee. Hence, it held that a disallowance under Section 14A of the IT Act was not warranted in the case of the Assessee.

Significant Takeaway

With the abolition of dividend distribution tax in the hands of the company, the dividend payable to its shareholders by a company is now taxable in the hands of the respective shareholders. Hence, as far as such dividend income is concerned, it is no longer exempt in the hands of the shareholders and hence, any expenditure in relation to it would not attract the provisions of Section 14A of IT Act.

However, the aforesaid ruling in respect of Section 14A of IT Act will continue to be beneficial to all the pending litigation involving exempt dividend income and any disallowance of expenditure in relation thereto and also in the case of other exempt income. It provides a much-needed clarity on disallowance of expenditure under Section 14A of IT Act, where own funds are more than its borrowed funds, it is open to the taxpayer to contend that its investments have been made out of its own funds, rather than its borrowed funds, to avoid any disallowance of expenditure under Section 14A of IT Act.

> **“ Disallowance of expenses under Section 14A not warranted where assessee has sufficient interest-free funds to cover its investments generating exempt income. ”**

[48] S.A. Builders Ltd. Vs. Commissioner of Income-tax (Appeals), Chandigarh [(2007) 1 SCC 781]/ [2007] 158 Taxman 74 (SC).
[49] Additional Commissioner of Income-tax Vs. Tulip Star Hotels Ltd. [2012] 21 taxmann.com 97 (SC).

A loan or advance extended by a company to its shareholder in return for a benefit derived by the company would not constitute deemed dividend

In the case of ***N.S. Narendra***[50], the Karnataka HC held that the loan or advance received by a shareholder from a company to purchase a property did not amount to deemed dividend under Section 2(22)(e) of the IT Act, since the company had derived benefit from the shareholder i.e. the shareholder had provided his personal property as a collateral to the banks for loans obtained by the company.

Facts

N.S. Narendra ("**Assessee**") was the managing director of an Indian company. ("**the Company**"). The Assessee had given certain personal properties as collateral security and even provided his personal guarantee to some banks and financial institutions on behalf of the Company for the purpose of obtaining loans in furtherance of the business of the Company.

During the year under consideration, the Company extended an advance to the Assessee for purchasing a property. This advance was extended in recognition of his contribution to the business of the Company and it was disclosed as a recoverable advance in the books of the Company.

During the assessment proceedings, the AO made an addition for deemed dividend in hands of the Assessee under Section 2(22)(e) of the IT Act on account of advance received by the Assessee from the Company, in which he was a substantial shareholder.

The Assessee appealed against the order of the AO, wherein the CIT(A) deleted the addition made by the AO and held that the advance received by the Assessee cannot be treated as deemed dividend under Section (2)(22)(e) of the IT Act as it was not for the benefit of the Assessee whereas the Company had derived benefit from the loan it availed for its business. Subsequently, the IRA unsuccessfully appealed before the ITAT. Thereafter, the IRA filed an appeal before the Karnataka HC.

Issue

GivWhether the amount advanced by the Company to Assessee, who is its shareholder, in return for his contribution to the Company's business would constitute deemed dividend under Section (2)(22)(e) of the IT Act?

Arguments

The IRA laid emphasis on the provisions of Section 2(22)(e) of IT Act and contended that the said provision clearly provides that all loans or advances made by a company to its shareholder should be taxed as deemed dividend in the hands of the shareholders (to the extent of accumulated profits in the books of a company). Thus, the IRA argued that since the ingredients of Section 2(22)(e) of IT Act were duly satisfied, the advance paid to the Assessee should be taxed as deemed dividend.

The Assessee contended that the impugned advance was given by the Company only in lieu of the advantage conferred upon it by the Assessee. This claim was substantiated by the Assessee by furnishing necessary details before the CIT(A). Therefore, it was argued that the advances were merely given for the business purposes of the Company and should not be considered as deemed dividend under Section 2(22)(e) of the IT Act. Reliance was also placed by the Assessee in the case of *Pradip Kumar Malhotra*[51] wherein on similar facts, the Calcutta HC held that advance given by a company to its shareholder in return for an advantage conferred upon it by the shareholder by way of mortgaging his property to obtain a loan for the company, would not constitute deemed dividend under Section 2(22)(e) of IT Act.

The Assessee also placed reliance on rulings in the case of *Jamuna Vernekar,*[52] *Bagmane Constructions (P.) Ltd.*[53], *Creative Dyeing & Printing (P.) Ltd.*[54] and *Ambassador Travels (P.) Ltd.*[55] wherein similar observations were made.

Decision

The HC analysed the provisions of Section 2(22)(e) of the IT Act and held that the implication of the said provision in the hands of a shareholder was based on whether or not such loan or advance was received by a shareholder on account of him being a beneficial owner of shares of a company. However, if such loans or advances were received for any other reason (including where certain benefit was derived by the company from such loans) then the said scenarios would not fall within the ambit of Section 2(22)(e) of IT Act.

In this regard, the HC relied upon the ruling of the Calcutta HC in the case of *Pradip Kumar Malhotra (supra)* wherein it held that the phrase *'by way of advance or loan'* used in Section 2(22)(e) of IT Act should be construed to mean those advances or loans

[50] Commissioner of Income Tax, Bangalore v. N.S. Narendra [ITA No. 92 of 2015](Karnataka HC).
[51] 338 ITR 538 (Cal.), [2011] 15 taxmann.com 66.
[52] ITA No. 43 of 2013 (Karnataka HC).
[53] 231 Taxman 260 (Karnataka HC).
[54] 318 ITR 476 (Delhi)/ [2009] 184 Taxman 483.
[55] [2009] 318 ITR 376 (Delhi), [2008] 173 Taxman 407.

which a shareholder enjoys on account of being a beneficial owner of shares. However, if such a loan or advance was given as a consequence of certain consideration received by a company from its shareholders that was beneficial to the company, then such an advance or loan cannot be treated as deemed dividend. Further, the HC made a reference to certain other rulings as well such as *Jamuna Vernekar (supra), Creative Dyeing and Printing (P.) Ltd. (supra) and Bagmane Constructions (P.) Ltd. (supra)* which also held that the term "loans or advances" used in Section 2(22)(e) of IT Act does not include within its ambit an amount given to a shareholder in return for an advantage or amount given by him during the course of various business transactions of a company for instance, a trade advance between a company and its shareholder etc.

The HC appreciated the fact that appropriate records had been furnished by the Assessee before the lower authorities to establish that the advance was given by the company in lieu of the benefit accruing to it. Therefore, the HC upheld the order passed by the ITAT and held that the amount given to the Assessee by the Company did not constitute deemed dividend under Section 2(22)(e) of IT Act.

Significant Takeaway

The decision of the HC is in line with the previous judicial precedents on the issue. It would be relevant to note that in the case of *Bagmane Constructions (P.) Ltd. (supra)*, the court while discussing the provisions of Section 2(22)(e) of IT Act, held that the principle of purposive interpretation should be applied. If the said provision is given a literal interpretation, then as per the language of the said provision, it would lead to absurd results (like covering trade advances within its ambit).

While dwelling into the intention of the provision, the HC also held that the facts of each case would have to be analysed in light of the intentions of the legislature behind introducing such provision. Similarly, in the case of *Ambassador Travels (P.) Ltd. (supra),* the Delhi HC applied similar principles and held that the amounts considered by the AO were nowhere in the nature of deemed dividend as they were actually pertaining to normal business transactions between a company and its shareholder entities in relation to their tourism business.

It would be pertinent for the taxpayers to ensure that sufficient documentation and records are maintained to establish the true object behind giving a loan or an advance to a shareholder. All such transactions are vetted from a tax perspective.

> **"Amount given by a company to its shareholder in return for a benefit derived by the company does not constitute deemed dividend u/s 2(22)(e) of IT Act."**

CASE LAW UPDATES- DIRECT TAX ROUTINE

SC ruled out interest under Section 234B on failure to pay advance tax when the income is subject to TDS

In ***Mitsubishi Corporation & Others***[56]**,** the SC held that the interest on failure to pay advance tax should not be levied on receipts, which was subject to withholding of tax and the payers have failed to withhold the necessary taxes. The Court took note of the amendment made in 2012 and held that the same cannot be applied to cases that fell prior to Financial Year ("**FY**") 2012-13.

Facts

M/s Mitsubishi Corporation ("**Assessee**"), a non-resident company incorporated in Japan, was engaged in trading of carbon crude oil, LPG, ferrous products, minerals, etc. through its liaison offices in India. The AO held that activities carried out in India constituted business connection/ permanent establishment for the Assessee in India. The AO concluded the assessment by making additions, wherein interest was also levied for failure to pay advance taxes under Section 234B of the IT Act.

The Assessee agreed with the primary allegation of the AO that its activities constituted permanent establishment in India, but it challenged the decision to levy interest under Section 234B of the IT Act. While the first appellate authority had decided the issue against the Assessee, the second appellate authority, the ITAT, decided the issue in favour of the Assessee. The ITAT held that the Assessee was not liable for payment of interest under Section 234B of the IT Act since it was the duty of the payor to withhold taxes at source. It further noted that the Assessee cannot be penalised for the failure of the payer to withhold taxes.

The IRA challenged the judgment before the HC, which upheld the decision of ITAT. The IRA carried the matter before the SC.

Issues

Whether the Assessee was liable to pay interest for failure to pay advance tax in respect of income, wherein the taxes ought to have been deducted at source?

Arguments

The IRA contended that there are two modes of recovery of taxes i.e. one directly from the taxpayers and the other from the payer who had an obligation to withhold taxes. However, the same cannot be interpreted to mean that the primary taxpayer would be absolved of its obligation to pay tax if the payor had failed in its obligation to withhold taxes. For this purpose, it relied on Section 191 of the IT Act, which states that in cases where the payor failed to withhold taxes, the requisite income-tax should be paid by the payee directly. Accordingly, it contended that it is the primary obligation of the Taxpayer to pay requisite taxes, including advance tax, and that interest for such failure to pay such advance tax is automatic under Section 234B of the IT Act.

The Assessee contended that Section 234B is a consequential provision and that the manner of computation of advance tax has been provided in Section 209. Section 209 (d) stipulates that the taxes which are 'deductible or collectible at source' should be reduced from the computation of advance tax. In this regard,

[56] Director of Income Tax v. Mitsubishi & Others TS-869-SC-2021.

it relied on the Bombay HC ruling in *NGC Network,*[57] and Uttarakhand HC ruling in *Tide Water Marine.*[58]

The IRA, however, contended that the provisions of Section 209 and 234B are independent of each other and that the obligation of the payee to pay advance tax was independent of the obligation of the payer to deduct tax at source. In this regard, it relied upon the definition of 'assessed tax' provided in Explanation 1 to Section 234B (1), which states that tax on the total income is reduced by 'any tax deducted or collected at source' for the purposes of levying interest under Section 234B. It was the argument of the IRA that only when the taxes are deducted/collected, the same can be reduced for computation of interest on advance but not in cases where payor had failed to withhold taxes.

Decision

SC observed that according to Section 195 of the IT Act, the payor is required to deduct income-tax at source in respect of all the payments that are made to non-resident companies that are chargeable to tax in India. The SC further observed that dispute relating to the interpretation of words 'would be deductible or collectible' in Section 209(1)(d) of the Act was resolved by the amendment made to the Finance Act, 2012. The amendment stated that the taxes deductible/collectible should not be reduced from the computation of advance taxes if the payor had failed to deduct/collect the requisite taxes.

Accordingly, it held that post FY 2012-13, by virtue of the amendment made through Finance Act 2012, the taxpayers would be liable to pay interest on the failure to pay advance taxes, even in cases where the payments were subject to withholding of taxes, but the payor had failed to deduct such taxes. However, in respect of cases, which fell prior to 2012-13, it held that the Assessee cannot be subject to payment of interest for failure to pay advance taxes.

Significant Takeways

The IRA used to levy interest under Section 234B of the IT Act automatically for almost all the assessments concluded by it, disregarding the fact that Section 209(1)(d) specifically stated that taxes deductible/collectible by the payors should be reduced for the purposes of computation of advance taxes payable by the payee. While it had impacted both residents and non-residents, it had created a major controversy for non-residents wherein the payor was obliged to withhold the entire taxes payable by the payees and deposit them to the credit of the Indian Government.

It should also be appreciated that multiple views were possible before the amendment made in FY 2012-13. on one hand, Section 209 stated that taxes deductible (not deducted) should be reduced for the computation of advance taxes, on the other, Section 234B stated that interest should be computed for failure to pay advance taxes by reducing the taxes actually deducted from the total income. There were many decisions by the ITATs and the HCs[59], which had decided the issue in favour of the taxpayers. Through this instant case, controversy was put to rest by categorically holding that prior to FY 2012-13, the payee taxpayers cannot be held liable for the failure to pay advance taxes if there was an obligation on the payer to withhold the taxes. This decision will bring much-needed relief, especially to the non-resident taxpayers.

As noted by the SC, this position has changed from FY 2012-13 in view of the amendment brought through the Finance Act 2012. The amendment had explicitly stated that for the purposes of computation of advance taxes, the taxes that were actually deducted/collected should only be reduced.

> **"Prior to 2012, no interest to be levied on failure to pay advance tax, when payment was subject to TDS."**

[57] Director of Income-Tax (International Taxation) v. NGC Network Asia LLC [2009] 313 ITR 187.
[58] Commissioner of Income-Tax v. Tide Water Marine International Inc [2009] 309 ITR 85.
[59] CIT v. Tide Water Marine Inc. (2009) 309 ITR 85; DIT v. NGC Network Asia LLC (supra); CIT v SEDCO Forex International Drilling Co. Ltd (supra); CIT v. Madras Fertilizers Ltd. (supra).

Hospital charging fees at par with other hospitals and remunerating doctors at a certain percentage based on net receipts held to be non-charitable and ineligible for exemption.

In the case of ***Ashwini Sahakari Rugnalaya & Research Centre***[60], the SC denied the claim for tax exemption under Section 10(23C)(via) of IT Act as it charged patients at par with other hospitals. Further, basis the facts of the case, the SC observed that it cannot be established that the activities of the hospital were being carried on solely for charitable purposes.

Facts

Ashwini Sahakari Rugnalaya & Research Centre ("**Assessee**") was a co-operative society providing medical and surgical amenities to citizens at reasonable charges and claiming exemption under Section 10(23C)(via) of IT Act on the ground that it carried on its activities for charitable purposes. However, the Chief Commissioner of Income Tax ("**CCIT**") denied exemption to the Assessee under Section 10(23C)(via) of IT Act stating that the medical expenses charged by the Assessee from its patients were at par with other hospitals and hence it was not carrying on its activities for charitable purposes.

The Assessee filed a writ petition before the Bombay High Court ("**Bombay HC**") against such an order passed by the CCIT. The Assessee contended that its facts were similar to that of another hospital namely, Dhanraj Giraji Hospital, which was allowed exemption under Section 10(23C)(via) of the IT Act. The Assessee also stated that in a letter to the CCIT, it had inquired how the tax authorities arrived at a conclusion that its charges were at par with other hospitals, however, no information was furnished to the Assessee.

The Bombay HC dismissed the writ petition filed by the Assessee by stating that it had failed to show how it was engaged in carrying out charitable activities for obtaining exemption under Section 10(23C)(via) of IT Act. It observed that the Assessee neither furnished any details to show its case was similar to Dhanraj Giraji Hospital nor did it provide the details of its charges in comparison with other hospitals to refute the allegations of the IRA. Hence, the Bombay HC upheld the observations made by the CCIT in its order that the Assessee was charging its patients an amount that was at par with other commercial hospitals, and hence, was not *per se* carrying out any charitable activity or providing any additional benefit to the citizens. Further, it also upheld other reasons for rejection of exemption given by the CCIT in its order, particularly that the doctors working at the hospital of the Assessee were getting remunerated at a certain percentage based on net receipts of the Assessee even if they were not working in that particular department.

The Assessee filed an appeal in SC against such order passed by the Bombay HC.

Issue

Whether the Assessee should be denied exemption under Section 10(23C)(via) of the IT Act as it was charging its patients an amount that was at par with other hospitals and remunerating doctors at a certain percentage based on its net receipts?

Arguments

The Assessee stated that it had been granted benefit of the exemption under Section 10(23C)(via) of IT Act for the last ten (10) years and hence, it should be granted exemption for the years under consideration. The Assessee also argued that earning profits *per se* does not imply that it was no longer eligible for exemption under Section 10(23C)(via) of the IT Act. Rejecting IRA's contentions that the its charges were at par with other hospitals, the Assessee argued that these observations were baseless and the IRA did not disclose any details in this regard when a letter was filed by the Assessee to enquire about the basis for these observations.

Whereas it was argued by the IRA that the Assessee was not carrying on any charitable activity for the purpose of obtaining exemption under Section 10(23C)(via) of IT Act. The IRA stated that the Assessee failed to substantiate the charitable nature of its activities as it was charging at par with other commercial hospitals and not giving any concessional or free treatment to its patients. Further, the IRA argued that the Assessee was remunerating doctors at a certain percentage based on the net receipts of its out-patient department ("**OPD**") and in-patient department ("**IPD**") even if they were not engaged in performing connected tasks.

Decision

The SC observed that merely because the tax exemption under Section 10(23C)(via) of IT Act was granted to the Assessee in preceding ten years, it does not translate into automatic entitlement for exemption in the present case as well for the years under consideration.

[60] Ashwini Sahakari Rugnalaya & Research Centre Vs. Chief Commissioner of Income Tax & Ors. [Civil Appeal No. 3453 of 2007].

The SC also observed that it had been alleged by the IRA that the fees collected by the Assessee from its patients were at par with other commercial hospitals. The Assessee submitted that the IRA did not furnish the necessary details in this regard to substantiate such claims. The SC also observed that while objecting to the claims of the IRA, the Assessee itself did not submit any response or counter affidavit regarding its fees or their comparison with other hospitals. However, the SC observed that it would have remitted the matter back for verification of such claims made by the IRA in its order on this issue had this been the only reason for denial of tax exemption to the Assessee.

The SC went on to observe that there was another reason emanating from the facts and circumstances which was sufficient to deny the exemption to the Assessee under Section 10(23C)(via) of the IT Act. The SC stated the Assessee had admitted in its writ petition filed before the Bombay HC that the remuneration paid by it to its doctors was at a certain percentage based on the net receipts from outpatients from OPD and IPD. Further, such remunerations were paid to the doctors whether or not they performed the connected tasks in that department. On this basis, the SC upheld the order of the Bombay HC that the Assessee was not carrying out any charitable activity for the purpose of exemption under Section 10(23C)(via) of IT Act.

Hence, the SC dismissed the civil appeal filed by the Assessee against the order passed by the Bombay HC. However, the SC made a specific observation in its order that the Assessee may apply for exemption in the subsequent AYs in case it rectifies its current position.

Significant Takeaways

In the case of the Assessee, the SC has for the purposes of claim of tax exemption under Section 10(23C)(via) of IT Act by charitable organisations, brought the entire focus to the fact that the remuneration being paid by the Assessee to its doctors is based on a certain percentage of its net receipts and that it is charging at par with other commercial hospitals. While there was always a burden of proof on charitable organisations to substantiate and justify the '*charitable*' nature of its activities, the SC, in a way, came up with a new proposition for substantiating the claim of exemption which deviates from the principles already laid down by several judgments i.e. comparison with other institutions and distribution of a portion of profits amongst doctors.

For the purpose of claiming tax exemption under Section 10(23C)(via) of IT Act for a hospital or an institution providing treatment to patients, it is necessary that its activities are charitable in nature and not for the purpose of earning profits. It has been held in various judgments that merely because a hospital or institution is earning profit on its activities, that by itself will not attract denial of exemption. Its claim for tax exemption will attract disqualification only if a hospital or institution has an objective of earning profit. The Hon'ble SC in the case of *Queen's Educational Society*[61] held that it was necessary to ascertain, taking into account all the facts and circumstances of a case, whether the dominant object of the activity is profit-making or carrying out a charitable purpose.

In addition to the above, it may be appreciated that if a hospital or an institution is to be properly maintained and good facilities are to be provided to the patients or users, the medical practitioners at a hospital/ employees cannot be expected to work for free or on charitable basis. Further, unless some surplus is created, it would be difficult for any institution to maintain and upgrade its facilities as per the requirements.. Hence, generating income by itself does not imply that a hospital or an institution is not running for charitable purposes. In-fact, the relevant test would be for what purpose the surplus or the profits earned are being applied. Reliance in this regard may be placed on a ruling of the Bombay HC in the case of *Shushrusha Citizens Co-operative Hospital Ltd.*[62].

In a way, the SC has given a new colour to the concept of profit-making vs charitable objective and going forward this could pose new problems for the existing charitable institutions. Hence, the existing charitable institutions claiming tax exemption should take note of the decision and be cautious and they would need to strategise to meet the new proposition to avoid any allegation by the IRA to deny their tax exemption status.

> **"Hospital charging fees at par with other hospitals and remunerating doctors at a certain percentage based on its net receipts held as not carrying out charitable activities."**

[61] Queen's Educational Society v. CIT [2015] 55 taxmann.com 255 (SC) /231 Taxman 286/372 ITR 699.
[62] Shushrusha Citizens Co-operative Hospital Ltd. Vs. Chief Commissioner of Income-tax, Mumbai [WP No. 949 of 2011/ [2018] 91 taxmann.com 136 (Bombay)].

CASE LAW UPDATES- INDIRECT TAX

Taxpayer would be eligible to claim refund of unutilised input tax credit only for goods in case of inverted duty structure

In the case of ***VKC Footsteps India Pvt. Ltd.***[63], the Hon'ble SC held that exclusion of refund of tax paid on 'input service' as part of the refund of unutilised ITC in case of inverted duty structure was vires to Section 54(3)of CGST Act and Rule 89(5) of CGST Rules.

Facts

VKC Footsteps India Pvt. Ltd. ("**Respondent**") was engaged in the manufacture and supply of footwear which attracted the levy of GST at an effective rate of 5%. The respondent procured input services such as work services, goods transport agency services, etc. and inputs such as synthetic leather, PU polyol, etc. for use in manufacture. Most of these inputs and input services were eligible for GST at the effective rates of 12% and 18%, respectively and the Respondent availed the ITC of the same. Since the rate of GST paid on such procurements was higher than the rate of GST payable on the outward supply of footwear, there was an accumulation of unutilised ITC in the electronic credit ledger of the Respondent. As the GST legislation provided refund of unutilised ITC of goods in case of inverted duty structure, the Respondent challenged the validity of Rule 89(5) of the CGST Rules to the extent it denied refund of unutilised ITC on input services. The Gujarat HC held the provision to be ultra vires as it denied refund of unutilised ITC on input services.

However, the Madras HC in *Transtonnelstroy Afcons Joint Venture v. Union of India, 2020-VIL-459-MAD*, upheld Rule 89(5) of CGST Rules stating that a refund was a statutory right and it is a valid exercise of power to restrict refund only to a class of taxpayer. There was no necessity to adopt the interpretative device of reading down to save the constitutionality of Section 54(3)(ii) of the CGST Act. Section 54(3)(ii) of the CGST Act was the source of restriction placed by Rule 89 (5) of the CGST Rules.

Accordingly, the IRA ("**Petitioner**") approached the SC on account of divergence between the views of the Gujarat HC on the one hand, and the Madras HC on the other.

Issue

i. Whether the term 'input' used in Section 54(3) of the CGST Act includes both goods and services?

ii. Whether the Rule 89(5) of the CGST Rules was ultra vires to the extent it denied refund of unutilised ITC on input services?

Arguments

The Petitioner contended that the refund of taxes was neither a fundamental right nor a constitutional right. The Constitution only guarantees that the levy should be legal and that the collection should be in accordance with the law. Refund was always a matter of a statutory prescription and could be regulated by the statute subject to conditions and limitations.

The Petitioner also contended that the GST legislation treats goods, services, input (goods) and input services distinctly. It is a settled position of law that discriminatory treatment under tax laws is not *per se* invalid. It was invalid only when equals were

[63] UOI v. VKC Footsteps India Pvt. Ltd., TS-472-SC-2021- GST.

treated unequally. The Petitioner submitted that ITC was not a matter of right and the burden of proof was on the assessee to establish a claim for a concession or benefit. The Petitioner also relied on earlier jurisprudence which had observed that ITC was a form of concession provided by the legislature and would be made available subject to conditions.[64] The proviso (ii) of Section 54(3) of CGST Act restricts inverted duty structure to only goods as the rate structure for goods was very dynamic vis-à-vis services. Where input services were also considered for determining inverted duty structure, the refund would have been available to every taxpayer.

On the other hand, the Respondent contended that GST is a destination-based consumption tax providing for seamless flow of ITC. However, in case of inverted duty structure, it was an anomaly which conflicted with the fundamental principles of GST. The provision pertaining to inverted duty structure for refund ensures that different tax rates do not result in alterations to the guiding principles of GST.

The Respondent relied on Section 54(3) of CGST Act, which provides for refund of "any unutilised input tax credit". The quantum of refund was provided by the main part of Section 54(3) which stipulates the refund of any unutilised ITC on input goods as well as on input services.

The refund formula prescribed in Rule 89(5) for pro-rata determination of amount of credit relatable to the inverted duty structure vis-à-vis total turnover, restricted the refund to ITC on input goods by denying it on input services. Accordingly, it was ultra vires to the GST legislations as delegate legislations were required to be within the ambit of act.

The Respondent also submitted that the formula prescribes the ratio of proportionate turnover only to ITC availed on input goods. Whereas, after arriving at the proportionate value, the entire amount of tax paid on output supplies was deducted. Thus, the formula inaccurately assumes that output tax would only be paid from ITC availed on input goods.

Moreover, it asserted that the rule was ultra vires to Section 54(3) of CGST Act as it restricted the computation of refund only by taking into account the credit availed on input goods. 'Input tax' was specifically defined under the CGST Act to mean tax charged on supply of goods or services or both made to a registered person. Thus, the use of the word "any" would include all ITC i.e. even ITC on input services. Therefore, "input tax credit" used in Section 54(3) of CGST Act would include ITC on both inputs and input services.

The Petitioner also argued that Section 54(3) of CGST Act would not enable the Central Government/ executive to frame/ enact rules as it did not use the phrase "as may be prescribed". The said provision was a complete code in itself as it provided for entitlement to refund, its quantum and the cases in which the refund was to be granted, and there was no purpose to enact any rules in its regard.

Decision

The SC held that exclusion of refund of tax paid on 'input service' as part of the refund of unutilised ITC was in line with the provisions of Section 54(3) of the CGST Act. The SC observed that refund was a matter of statutory prescription and the Parliament was entitled to make laws regarding the

[64] Jayam and Co. v. Assistant Commissioner and Anr., [2016] 15 SCC 125 [SC] (Supreme Court).

circumstances in which a refund can be claimed. There was neither a constitutional guarantee nor a statutory entitlement to refund, thus goods and services could be treated differently on matters related to refund. In the instant case, the Parliament has confined that a refund would be admissible only where the unutilised ITC has accumulated on account of the rate of tax on inputs being higher than the rate of tax on output supplies.

The SC also affirmed that where the rules have not transgressed a provision of the statute, the authority who has enacted the rules cannot be deprived of its authority to exercise the rule-making power. The review of Section 164 of CGST Act, clearly provides that that the powers were not restricted to only those sections which grant specific authority to frame rules. The purpose of the formula in Rule 89(5) of CGST Rules was to give effect to Section 54(3)(ii) of CGST Act which makes a distinction between input goods and input services for grant of refund. The formula was not required to be struck down merely for giving effect to the same.

The SC also stated that it cannot step into the shoes of legislature to redraft the provision and formula. The anomalies, if any, can only be seen by the GST Council, which is the designated authority in this regard. Thus, it urged the GST council to reconsider the formula and take a policy decision regarding the same.

Significant Takeaways

The aforementioned ruling clearly disrupts the great relief that was available to a lot of players after the Gujarat HC had rectified the differential treatment created between input, input services and capital goods. A lot of players had huge capital blockage in the form of unutilised ITC of input services, which would continue to impact the operational cost for business.

While the SC has asked the GST Council to look at the anomaly, the taxpayers are left in complete state of confusion and there is a high possibility that refund claim for prior period would be rejected if any positive law is implemented prospectively.

> **“ Rule 89(5) of the CGST Rules was vires to the extent it denied refund of unutilised ITC on input services. ”**

Rule 86-A CGST Rules creates a limited lien and does not appropriate any amount

In the case of ***RM Dairy***[65], the Hon'ble Allahabad HC interpreted the Rule 86-A of CGST Rules. The ambit and purpose of rule 86A was inherently different and independent of recovery provisions. The lien was required to be created equivalent to the amount that would be sufficient to cover the input tax that, according to the IRA, had either been fraudulently availed or the taxpayer was not eligible to avail.

Facts

RM Dairy ("**Appellant**") had purchased certain supplies from M/s Darsh Dairy & Food Products, Agra. ITC on such purchase was availed by the Appellant. An investigation against Appellant was underway in terms of Section 74 of the CGST Act read UP GST Act for fraudulent availment of ITC.

The IRA believed that M/s Darsh Dairy & Food Products, Agra was non-existent at the disclosed place of business, thus the ITC was fraudulently availed. Accordingly, the IRA department passed an order under Rule 86A of the CGST Rules to block ITC that was over and above the amount of ITC available on the date of order.

Aggrieved by the same, the Appellants filed a writ petition against the order before the Allahabad HC.

Issue

Whether the respondent had jurisdiction or authority to block ITC over and above any amount that may have been actually available on the date of the order?

Arguments

The Appellant, by relying on Rule 86A of the CGST Rules, submitted that it requires the IRA department to record a positive 'reason to believe' that ITC had been fraudulently availed or the petitioner was wholly ineligible to avail the same. The department's action was wholly without jurisdiction as the Petitioner was eligible to avail ITC and had not committed fraud.

The Appellant also contended that since the proceedings under Section 74 was underway, no amount was recoverable from the petitioner as the demand has not been crystallised. The CGST Act evidently provides for the manner in which tax dues may be ascertained and recovered. The settled principle of law would be violated where the manner of recovery was different than the procedure prescribed under the legislation. The order passed by department was completely premature. Moreover, the provision does not allow blocking of ITC over and above the amount that was available in the electronic credit ledger on the date of the order.

The Respondent on the other hand, contended that actions were in line with the procedure prescribed under the legislation. The order was within the jurisdiction which allowed blocking of ITC in case of fraudulent availment of ITC or availment of ineligible ITC.

Decision

The HC did a detailed analysis of provisions of Rule 86A of the CGST Rules and held that the provision creates a lien in favour of the IRA by blocking utilisation of an amount equivalent to fraudulently availed ITC or ineligible ITC.

The HC emphasised that the ambit and purpose of the Rule 86A was inherently unlike and independent of the recovery provisions. The legislature has specifically chosen the words 'not allow debit'. In other words, the provision creates a lien for amount that would be held back and be not allowed for utilization by the assessee towards discharge of its liabilities on the outward tax or towards refund. The term ITC used in Rule 86-A cannot be read as actual ITC available on the date of the order passed under that Rule. The position is strengthened by relying on the term 'available' which is used to refer a time in the past when the taxpayer allegedly availed ITC either fraudulently or was not eligible to avail.

In the instant case, the IRA alleged fraudulent utilisation of ITC and availment of ineligible ITC. The term 'ineligible' has been clarified to include a transaction performed with a registered dealer who may be found to be non-existent. The IRA's allegation is that M/s Darsh Dairy & Food Products, Agra products was found to be non-existent at the disclosed place of business.

Therefore, as the petitioner did not have the requisite ITC in electronic ledger, any ITC earned in future upto the tune of INR7,06,66,700.00/-, would be retained by way of a lien in favour of the IRA. The IRA is not allowed to appropriate it as per this rule. Any kind of adjustment or appropriation would occur only as per recovery provision after finalisation of an adjudication order.

[65] R.M. Dairy Products LLP v. State of Uttar Pradesh, [2021] 129 taxmann.com 37 (Allahabad).

Significant Takeaways

The aforementioned decision is the first decision interpreting Rule 86A of the CGST Rules. The HC has clearly articulated that the IRA cannot undertake any kind of adjustment or appropriation of ITC under this rule. The rule has limited application for creating lien over ITC.

The decision would accordingly curtail any misuse of Rule 86A of the CGST rule by the IRA. The decision also safeguards the interest of taxpayer who would not be troubled by the IRA where it blocked any higher amount of ITC that was present in the electronic credit ledger on the date of passing order under said rule.

> **“ Rule 86A of CGST Rules safeguards the interest of IRA and does not provide for actual recovery/ appropriation. ”**

SEZs are eligible to claim refund of GST paid to its supplier

In the case of ***Platinum Holdings Pvt. Ltd.***[66], the Hon'ble Madras HC held that Section 54 of CGST Act and Rule 89 of CGST Rules provide that refund can be claimed by 'any person'. An SEZ unit was also eligible to claim refund of CGST, SGST or IGST erroneously remitted on supplies effected to it.

Facts

Platinum Holdings Pvt. Ltd. ("**Petitioner**") had procured goods and services from various suppliers for the development of its SEZ unit. The supplier to the Petitioner issued invoices which included components of CGST, SGST and IGST, even when the transactions were zero- rated. Despite not being liable to pay GST portion to the suppliers, the Petitioner settled the invoices in full including the tax. Subsequently, the Petitioner filed an application for refund of the taxes erroneously remitted on various dates.

A showcause notice was issued to the Petitioner alleging that only a supplier of services would be entitled to claim refund and not the SEZ unit under Section 54 of the CGST Act and Rule 89 of CGST Rules. The IRA ("**Respondent**") passed an order denying the refund of CGST, SGST, IGST. The order was affirmed by the appellate authority.

Aggrieved by the same, the Petitioner approached the HC by filing a writ petition.

Issue

Whether a SEZ unit is eligible to claim refund under the CGST Act?

Arguments

The Petitioner asserted that in terms of Section 54 of the CGST Act, there was no restriction regarding the person who could make an application for refund. The provision specifically states "any person" and not only "suppliers". Further, Clause (g) of the Explanation to Section 54, dealing with relevant date for filing of an application for refund, contemplates a scenario where application was filed by person other than supplier. In the instant scenario, the supplies received by the Petitioner were zero rated and the Petitioner had remitted tax to the suppliers. Thus, there was no embargo on a SEZ unit for claiming refund.

On the other hand, the Respondent asserted that second proviso to Rule 89(1) of the CGST Rules provide that in case of zero-rated supplies to SEZ, the supplier was required to file an application of refund. The Respondent also contended that it would be difficult for the IRA to examine and determine the eligibility of any other entity to claim refund other than for a supplier. Thus, Section 54 (4) casts an onerous burden upon the applicant to provide all documentary evidence along with the application seeking refund.

Decision

The HC emphasised that there was no restriction that only a supplier can claim refund. In other words, the provision for refund under the GST legislation permits any person to seek a refund of taxes paid under the provisions of the legislations, subject to absence of unjust enrichment. Even the language of Rule 89 of CGST Rules begin with the phrase "any person", which was in line with Section 54 of the CGST Rules.

The Respondent has incorrectly assumed the word "only" in the second proviso to Rule 89 of the CGST Rules. The HC relied on the settled position that there can be no insertion of a word or phrase in a statutory provision. Therefore, no restrictions can be introduced by having such interpretation. Mere mention of the supplier (a type of person who can make a refund application) in proviso would not automatically exclude all other persons.

In the current case, while the zero-rated supplies were not subject to the levy of taxes, the Petitioner had paid the tax to the supplier erroneously. As there is no restriction for any entity to claim refund, the Petitioner's SEZ unit can also claim the refund subject to satisfaction of all the conditions and the fact that the supplier has not claimed any refund.

Significant Takeaway

It is very common for the suppliers located in Domestic Tariff Area to charge GST in invoice as they don't want to undertake the procedural compliances necessary to claim the refund or supply the goods/services without the payment of GST. Thus, the SEZ unit and developers were forced to pay GST in order to procure goods and services from certain suppliers. The aforementioned decision is a breakthrough decision for both developers and the units located in SEZ region that were facing difficulty in claiming refund.

Hopefully, the additional GST which was increasing the cost of operation for units could now be minimised by claiming refund.

> **"There is no embargo in SEZ unit claiming refund of GST."**

[66] Platinum Holdings Pvt. Ltd. v. Additional Commissioner of GST & Central Excise, TS-527-HC(MAD)-2021-GST.

REGULATORY DIRECT TAX UPDATES

CBDT guidelines on taxability of transfer of assets by a partnership firm to its partners on its dissolution or reconstitution

The IT Act provided for capital gains tax in the hands of the specified entity on distribution of capital asset to partners on dissolution or otherwise, till FY 2019-20. The FMV of capital asset on the date of distribution was deemed as sale consideration in the hands of specified entity. Further, based on judicial precedent, assuming that instead of capital asset, money was distributed to partners in excess of their capital account balance in connection with their retirement, such excess was not chargeable to tax either in the hands of specified entity or partner.

Finance Act 2021 has brought in a fresh set of provisions for taxation in the hands of specified entities, for receipts in the hands of partner, with effect from FY 2020-21. Thus, Section 9B of the IT Act provides that if a partner receives any capital asset or stock in trade or both during the FY, from a specified entity, in connection with dissolution or reconstitution of such specified entity, then the specified entity shall be deemed as the transferor of such capital asset or stock in trade or both, in such FY. Further, any profits or gains arising from the deemed transfer shall be deemed as income of the specified entity. Further, Section 45(4) of the IT Act was also amended to provide that where a specified person receives any money or capital asset or both from a specified entity, in connection with reconstitution of such specified entity, then any profits or gains arising from such receipts shall be chargeable to tax as income of the specified entity, as capital gains. The section levies capital gains on realization by the partner in excess of their capital account balance, in connection with such reconstitution.

In furtherance of the above-mentioned provisions, the CBDT has issued a circular[67] prescribing guidelines with respect to the taxability on account of distribution of assets by a partnership firm to its partners on its distribution or reconstitution. Further, the CBDT has also notified[68] rules with respect to method of determination of period of holding of capital assets in certain cases. In addition, the CBDT has introduced Rule 8AB with respect to attribution of income taxable under Section 45(4) of IT Act in the hands of the specified entity.

Under the attribution amount to be taxed under Section 45(4), the rules provide that the said amount is to be attributed to the remaining capital assets of the specified entity, so that when such capital assets are transferred in future, the amount attributed to such capital assets gets reduced from the full value of consideration, and to that extent, the specified entity does not pay tax on the same amount. Further, Section 48 of the IT Act only applies to capital assets which are not forming block of assets. For capital assets forming block of assets, Section 43(6)(c) determines the written down value ("**WDV**") of the block of assets and Section 50 determines the capital gains arising from such assets. However, there was lack of clarity on whether the amount taxed under Section 45(4) could also be attributed to the capital assets forming block of assets. Thus, while the IT Act provided for attribution only to capital assets of the specified entity that did not form part of capital assets, to remove difficulty in situations where capital gains chargeable under Section 45(4) related to increase in value of block of assets of the specified entity, the guidelines issued by CBDT have provided

[67] Circular No, 14/2021, dated 02 July 2021.
[68] CBDT Notification No. 76/ 2021, dated 02 July 2021.

relief. The guidelines have clarified that the reference to capital asset includes a capital asset forming part of block of assets.

The mechanism specified under the guidelines is in the manner provided as below:

- Under the IT Act, the monies payable on transfer of asset forming part of block of assets is to be reduced from the WDV for the purpose of computing depreciation. If the entire block of assets ceases to exist upon transfer, or, if sale consideration on account of disposal of any asset forming part of block of assets is higher than WDV, the resultant gains are chargeable as capital gains arising from the transfer of short-term capital asset in hands of the specified entity.
- As per the guidelines, at the time of transfer by the specified entity of capital asset forming part of block of assets in future, post reconstitution, capital gains charged under Section 45(4) that have been attributed to depreciable capital asset shall be reduced from monies payable/ sale consideration and only such net amount shall be considered for reduction from WDV, or for chargeability as short-term capital gains.

The guidelines have also provided several examples for applicability of Section 9B and Section 45(4).

CBDT notifies rules to compute WDV of goodwill

Prior to Finance Act, 2021, taxpayers claimed depreciation on goodwill by placing reliance on decisions such as ***Smifs Securities Limited***[69]. However, the Finance Act, 2021, amended the IT Act to exclude goodwill from the ambit of depreciable assets. In order to address the impact of such amendments on the Written Down Value ("**WDV**") of intangible assets, the IT Act was amended to empower the CBDT to prescribe rules for computing capital gains and WDV of such goodwill on which depreciation has already been obtained by the taxpayer.

The CBDT *vide* Notification[70] dated July 7, 2021, inserted Rule 8AC to provide a mechanism for computation of capital gains and WDV of block of assets containing goodwill, on which depreciation has been claimed prior to FY 2020-21.

The said rule inter alia provides that the WDV of goodwill, forming a part of block of intangible asset or being the only asset in the block, would be determined as per the methods prescribed under Section 43(6) of the IT Act. Further, it is also provides that where the WDV of goodwill is more than aggregate of opening WDV of block of intangible asset and the actual cost of any intangible asset acquired in FY 2020-21, then the excess shall be deemed to be short term capital gain in the hands of the taxpayer. However, where the goodwill is the only asset in the block of intangible assets as on March 31, 2020, and the block of asset ceases to exit henceforth, then there would be no capital gains or loss. Rule 8AC also provides that capital gains on transfer of goodwill from FY 2020-21 would be calculated as per the provisions applicable to non-depreciable assets.

This computation mechanism was awaited ever since the amendment of IT Act *vide* Finance Act, 2021, and provides much-needed clarity to the taxpayers who are impacted by the aforementioned amendments.

CBDT notifies rules providing income attribution mechanism for tax exemption for specified funds

The CBDT has issued a Notification[71] dated August 09, 2021 to insert Rule 21AI and Rule 21AJ in the IT Rules. While Rule 21AI of the IT Rules prescribes the method of calculating exempt income of a specified fund for the purposes of Section 10(4D) of the IT Act, Rule 21AJ of the IT Rules deals with determining the income of a specified fund attributable to units held by a non-resident taxable under Section 115AD of the IT Act.

The changes have been summarised below:

Rule 21AI of the IT Rules - Exempt income of a specified fund for the purposes of Section 10(4D) of the IT Act:

Section 10(4D) of the IT Act was inserted by Finance Act, 2019 w.e.f. April 1, 2020, in order to grant exemption to 'specified funds' on income from transfer of capital asset specified under Section 47(viiab) of the IT Act, on a recognised stock exchange of an IFSC where consideration is paid/ payable in convertible foreign exchange.

While the specified funds initially included Category III AIF located in IFSC that were regulated by SEBI and the exemption was restricted to income attributable to units held by non-residents, the scope was extended by Finance Act, 2021, to include the investment division of offshore banking unit that has a Category I FPI license, upon satisfaction of prescribed conditions.

However, rules for determination of such income of the specified funds were not prescribed so far.

The Notification has now inserted Rule 21AI to prescribe the detailed calculation methodology to determine the income

[69] CIT v. SMIFS Securities Ltd (2012) 348 ITR 302 (SC).
[70] Notification, G.S.R. 472(E), [No. 77/2021/F. No. 370142/23/2021-Tpl.
[71] Notification No. 90/2021/ F. No. 370142/20/2021-TPL dated August 09, 2021.

attributable to units held by non-resident which may be claimed as exempt upon satisfaction of prescribed conditions. The formula determines the proportion of income attributable to non-resident unitholders by dividing the proportion of daily assets under management ("**AUM**") of specified funds *held by non-resident unitholders* to the *aggregate* daily AUM.

The Notification also prescribes that the information for the above exemption is to be filed in Form 10IG at the time of filing of ROI for the relevant AY. The said form contains break-up of each item of income for all securities separately.

Rule 21AJ of the IT Rules - Income of a specified fund attributable to units held by a non-resident taxable under Section 115AD of the IT Act:

Section 115AD of the IT Act provides beneficial tax rates to FPIs on incomes earned from securities in India. Its scope had been enhanced by Taxation and Other Laws (Relaxation and Amendment of Certain Provisions) Act, 2020 in September 2020 by the introduction of Section 115AD(1A) of the IT Act to provide beneficial tax rates to income attributable to units of specified funds (as defined in Section 10(4D) of the IT Act) held by non-residents.

However, rules for determination of such income of the specified funds were not prescribed so far.

The Notification has now inserted Rule 21AJ to prescribe the manner of computation of income of specified fund which may be claimed as exempt. The formula determines the exempt income by dividing the income arising from the transfer of the security or income received in respect of the security by the ratio of aggregate of daily AUM *held by non-resident unit holders* to the *total* AUM. In case of income arising from transfer of the security, the above calculation shall be required from the date of acquisition of the security to the date of transfer of such security. However, in case of income in respect of the securities, the above calculation shall be required to be done as on the date of receipt of such income.

The Notification also prescribes that the information for the above exemption is to be filed in Form 10IH at the time of filing of ROI for the relevant AY. The said form contains break-up of each item of income for all securities separately.

Calculation of taxable interest relating to contribution to a provident fund or recognized provided fund exceeding specified limit

The Finance Ac 2021 has amended Section 10(11) and Section 10(12) to provide that exemption shall not be available for the interest income accrued during the previous year on the recognised and statutory provident fund in the account of the person to the extent it relates to the contribution made by the employees in excess of INR 2,50,000 in the previous year. However, if such person has contributed to a fund in which the the employer has not made any contribution, then a limit of INR 2,50,000 shall be increased to INR 5,00,000. The amount of such interest income shall be computed as per the prescribed rules.

The CBDT has now notified Rule 9D to calculate the taxable portion of interest pertaining to the contribution made to a statutory or a recognized provident fund in excess of the threshold limit of INR 2.5 lakh or INR 5 lakhs as the case may be. It provides that separate accounts within the provident fund account shall be maintained during the previous year 2021-22 and onwards for the taxable and non-taxable contribution made by the person.

CBDT notifies new Rule 10RB for computation of tax relief with respect to MAT liability

Vide the Finance Act, 2021, a new clause 2D was inserted in Section 115JB of the IT Act in order to provide relief to an assessee in case of an increase in his book profits in the relevant year due to the outcome of an Advance Pricing Agreement ("**APA**") entered into by an assessee under Section 92CC of IT Act or due to a secondary adjustment in his case under Section 92CE of IT Act. As per the provisions of clause 2D of Section 115JB of IT Act, the AO shall recompute the book profits of an assessee of past years and compute the MAT liability arising in the hands of an assessee in the relevant year accordingly, where an application is filed before him by an assessee in this regard.

In respect of the above, a new rule i.e. Rule 10RB has recently been introduced in the IT Rules *vide* Income Tax (23rd Amendment), Rules, 2021 *vide* CBDT Notification[72] No. 92 of 2021 dated August 10, 2021, providing the manner of computation of relief in MAT payable by an assessee as per the above under Section 115JB of IT Act.

In this regard, Rule 10RB provides that the MAT payable by an assessee under the provisions of Section 115JB of IT Act shall be reduced by the following amount:

(A-B)-(D-C), where

'A' = tax payable by the assessee on book profits of the relevant previous year including the past income on account of an APA or a secondary adjustment as referred to above

[72] Notification No. 92/2021/F. No.370142/21/2021-TPL (Part).

'B' = tax payable by the assessee on book profits of the relevant previous year after reducing such past income from the book profits

'C' = tax payable by the assessee on book profits of past year or years to which such past income belongs

'D' = tax payable by the assessee on book profits of past year or years as referred to in item C above after increasing the book profits with the relevant past income of such years

It has also been provided that in case a negative value is derived as per the above calculation, the amount of relief as computed above shall be deemed to be zero.

In order to claim a relief under Section 115JB(2D) of IT Act, the assessee is required to file an application vide a new form notified for this purpose i.e. in Form 3CEEA electronically. It has also been provided that the tax credit available to an assessee under Section 115JAA of IT Act shall be reduced by the amount of relief calculated under this provision.

CBDT notifies Rules 11UE & Rule 11UF for withdrawal of retrospective application of indirect transfer

Taxation Laws (Amendment) Act, 2021 nullified the retrospective effect of the amendment made in Section 9 of the IT Act *vide* the Finance Act, 2012. The Finance Act, 2012 inserted Explanation 5 in Section 9 (1)(i) of the IT Act to incorporate retrospectively indirect transfer of shares. The Taxation Laws (Amendment) Act, 2021 prescribed nullification of any retrospective demand raised for such offshore indirect transfer on fulfilment of certain conditions.

In respect of the above, two new rules i.e. Rule 11UE and Rule 11UF have recently been introduced in the IT Rules *vide* Income Tax (31st Amendment) Rules, 2021 *vide* CBDT Notification No. 118 of 2021 dated October 1, 2021.[73] The Rules provide that taxpayers wishing to opt for this amendment should file an application and submit a corporate action i.e. Board Resolution along with the application within 45 day.

The Rule 11UE and 11UF address persons in whose case a specified order had been passed or made, as the case may be, and such person would be known as 'Declarant'.

The Rules also define the term 'interested parties' to mean

- All the companies or entities in the entire chain of holding of the Declarant till the ultimate holding company.
- Any person to whom the Declarant has transferred any of its claims under any award, judgment, or court order pertaining to relevant orders or under the relevant orders or granted any rights.
- Any person other than the person mentioned in sub-clauses (i) and (ii), in whose favour any interest has seen created or assigned by the Declarant or under any law or rules made thereunder with respect to any of the relevant orders.

The Declarant shall furnish an undertaking in Form No. 1 and shall append the undertakings from all interested parties in Part M of the Annexure to the undertaking in Form 1 and furnish all the attachments required to be furnished.

The Declarant would have to fulfil conditions prescribed under Rule 11UE (2) of the IT Rules. The Rule 11UE (2) of the IT Rules states the corporate actions that the Declarant and all the interested parties are required to fulfill. These are as follows:

- Withdraw and terminate without any recourse: all the appeals, applications, petitions, proceedings, proceedings for arbitration, conciliation, mediation and any other proceedings to enforce or pursue attachments in respect of any order against India.
- Waive all rights and claims of any nature against the Republic of India in connection with the relevant orders.
- Irrevocably waive any right to seek or pursue any claim issues in favour of the Declarant or any of the interested parties.
- Irrevocably waive all right to seek any costs, attorney's fees, court's fee expenses, damages, judgments, orders, compensation in relation to taxation of income referred to in 5th and 6th proviso to Explanation 5 to Section 9(1)(i) of the IT Act.
- Indemnify, defend and hold harmless the Republic of India and Indian affiliates from all costs, expenses at any time after the date of furnishing the undertaking in Form No. 1 by the Declarant.
- Refrain from facilitating, procuring, encouraging or otherwise assisting any person (including but not limited to related party[3] or interested party) from bringing any proceedings or claim of any kind related to any relevant order(s) or any award/judgment/other relief against the Republic of India/Indian affiliates in connection with any relevant order(s).

[73] CBDT Notification No. 118/2021 [F. No. 370142/47/2021-TPL]/GSR 713(E).

- Notify by a public notice or press release that by signing the undertaking in Form 1 or Part M of the Annexure to the undertaking in Form 1, from any claims arising out of or relating to the relevant orders or any related award no longer subsist. Such person or entity issuing the public notice has signed an undertaking that includes an indemnity against any claims brought against Republic of India. Further copy of such public notice shall be furnished to Republic of India by that declarant and all interested parties.

The execution, delivery and performance of the undertaking in Form 1 submitted by the Declarant, undertakings from all the interested parties in Part M of the annexure to the undertaking in Form 1 and indemnity bond by the Declarant and interested parties in Part N of the annexure to the undertaking in Form 1 shall be duly authorised by all necessary requirements under the applicable law to be furnished by the Declarant.

Requirement	Rule
The Declarant is required to submit an undertaking to the jurisdictional Principal Commissioner or Commissioner.	Rule 11UF (1)
Declarant would be, - Granted a certificate in Form 2 accepting such undertaking; or - Such undertaking would be rejected after giving an opportunity of being heard.	Rule 11UF(2)
The Declarant, along with the interested parties, has to fulfil conditions specified in Rule 11UE (2) of the IT Rules and file an intimation to this effect.	Rule 11UF(3) and Rule 11UF(4)
After receipt of intimation in Form 3, an order shall be passed.	Rule 11UF(9)

REGULATORY INDIRECT TAX UPDATES

Amendments pertaining to annual return under the GST Legislation

a. CBIC *vide* Notification No. 31/2021 – Central Tax dated July 31, 2021, has exempted taxpayers having annual aggregate turnover of upto INR 2 crores from the requirement of furnishing annual return for FY 2020-21.

b. A registered person is not required to get his accounts audited by a Chartered Accountant or a Cost Accountant and submit copy of audit annual accounts, reconciliation statement as provision Section 35 (5) of the CGST Act has been omitted.

c. A registered person has to furnish an annual return which may include a self-certified reconciliation statement, reconciling the value of supplies declared in the return furnished for the financial year, with the audited annual financial statement for every financial year electronically in terms of amended Section 44 of the CGST Act.

Clarification under GST legislations

a. Refund of tax paid under wrong head: CBIC *vide* Circular No. 162/18/2021- GST dated September 25, 2021, clarified that a registered person who has paid the CGST/ SGST instead of IGST (or vice versa), would be refunded the taxes wrongly paid after payment of correct taxes. This refund of wrong payment of taxes under Section 77(1) of the CGST Act and Section 19(1) of the IGST Act would be available irrespective of whether such erroneous payment is found by the taxpayer himself or by the tax officer in any proceeding.

   A refund can be claimed before the expiry of two years from the date of payment of tax under the correct head.

b. Merely establishment decoded: CBIC *vide* Circular No. 161/17/2021- GST dated September 20, 2021, clarified that supply of services by a subsidiary/ sister concern/ group concern, etc. of a foreign company, which is incorporated in India, to the establishments of the said foreign company located outside India, would not be barred for the refund of GST for being considered as export of services as they are separate legal entities. It would not be considered as "merely establishments of a distinct person in accordance with Explanation 1 in Section 8".

c. Refund is restricted on goods subject to export duty: Those goods which are actually subjected to export duty i.e., goods on which some export duty has to be paid at the time of export will be covered under the restriction imposed under Section 54(3) to avail refund of accumulated ITC. Goods, which are not subject to any export duty and in respect of which either NIL rate is specified in Second Schedule to the Customs Tariff Act, 1975 or which are fully exempted from payment of export duty by virtue of any customs notification or which are not covered under Second Schedule to the Customs Tariff Act, 1975, would not be covered by the restriction imposed under the first proviso to Section 54(3) of the CGST Act for the purpose of availment of refund of accumulated ITC

d. Delinking of debit note from invoice: *Vide* Circular No. 160/16/2021-GST dated September 20, 2021, it has been clarified that the date of issuance of debit note (not the date of underlying invoice) shall determine the relevant financial year for the purpose of determining last date to avail ITC for such debit note for availment of ITC on or after January 01, 2021. (Section 16(4) of the CGST Act).

e. No requirement of physical invoice in case of e-invoice for transport of goods: CBIC has clarified that there is no need to carry the physical copy of tax invoice in cases where e- invoice has been generated by the supplier as per Rule 48(4) of the CGST Rules. The proper officer can verify the transaction by checking the Quick Response (QR) code having an embedded Invoice Reference Number (IRN) electronically.

Electronic Duty Credit Ledger Regulations, 2021

Vide Notification No. 75/2021-Customs (N.T.) dated September 23, 2021, the CBIC has notified Electronic Duty Credit Ledger Regulations, 2021 detailing the procedure of issuance of e-scrips at time of export of goods, registration of scrips, usage, transfer, validity and suspension/cancelation of e-scrips.

Amendment to FTP and HBP

Notification No. 33/2015-2020, dated September 28, 2021, and Public Notice 25/2015-2020, dated September 28, 2021, notified the following major amendments to the FTP and HBP:

a. To ensure policy continuity, the current FTP and HBP has been extended till March 31, 2022.

b. The list of eligible services for FY 2019-20 has been announced and the rate of incentives has been fixed at 5% and 3% for specified services. However, the maximum entitlement per IEC code has been restricted to INR 5 crore.[74]

   Last date for making an application for claiming SEIS scrips has been fixed to December 31, 2021. No late cut fee has been imposed for filing application for FY 2019-20.

c. The validity period of a Duty Credit Scrip issued on or after September 16, 2021, shall be 12 months from the date of issue for scrip-based schemes.[75]

d. Exemption from the payment of IGST and Compensation Cess on imports made under Advance Authorisations / EPCG Scheme and by EOUs, etc., has been extended up to March 31, 2022.

e. Similarly, where the period to make export is expiring between August 01, 2020, and July 31, 2021, for Advance Authorisation and EPCG Authorisation, extension has been provided without requirement to discharge any composition fees or requirement of 5% additional export obligation on balance exports.[76]

[74] Notification No. 29/ 2015-2020 (DGFT) dated September 23, 2021.
[75] Notification No. 26/ 2015-2020 (DGFT) dated September 16, 2021.
[76] Notification No. 28/2015-2020 (DGFT) dated September 23, 2021.

GLOSSARY

ABBREVIATION	MEANING
AAR	Hon'ble Authority for Advance Rulings
AAAR	Hon'ble Appellate Authority for Advance Rulings
ACIT	Learned Assistant Commissioner of Income Tax
AE	Associated Enterprises
AO	Learned Assessing Officer
APA	Advance Pricing Agreement
AY	Assessment Year
Customs Act	Customs Act, 1962
CbC	Country by Country Reporting
CBDT	Central Board of Direct Taxes
CBEC	Central Board of Excise and Customs
CCR	CENVAT Credit Rules, 2004
CEA	Central Excise Act, 1944
CENVAT	Central Value Added Tax
CESTAT	Hon'ble Customs, Excise and Service Tax Appellate Tribunal
CETA	Central Excise Tariff Act, 1985
CGST	Central Goods and Service Tax
CGST Act	Central Goods and Service Tax Act, 2017
CGST Rules	Central Goods and Service Tax Rules, 2017
CIT	Learned Commissioner of Income Tax
CIT(A)	Learned Commissioner of Income Tax (Appeal)
CRISIL	Credit Rating Information Services of India Limited
CST	Central Sales Tax
CST Act	Central Sales Tax Act, 1956
CT Act	Custom Tariff Act, 1975
CVD	Countervailing Duty
DCIT	Learned Deputy Commissioner of Income Tax
DIT	Learned Director of Income Tax
DGFT	Directorate General of Foreign Trade

GLOSSARY

ABBREVIATION	MEANING
DRP	Dispute Resolution Panel
DTAA	Double Taxation Avoidance Agreement
EL	Equalisation Levy
EPCG	Export Promotion Capital Goods
FMV	Fair Market Value
FTP	Foreign Trade Policy
FTS	Fees for Technical Services
FY	Financial Year
GAAR	General Anti-Avoidance Rules
GST	Goods and Services Tax
GST Compensation Act	Goods and Services Tax (Compensation to States) Act, 2017
HC	Hon'ble High Court
IBC	Insolvency and Bankruptcy Code, 2016
IFSC	International Financial Services Centre
IGST	Integrated Goods and Services Tax
IGST Act	Integrated Goods and Services Tax Act, 2017
INR	Indian Rupees
IRA	Indian Revenue Authorities
IT Act	Income-tax Act, 1961
ITAT	Hon'ble Income Tax Appellate Tribunal
ITC	Input Tax Credit
ITO	Income Tax Officer
IT Rules	Income-tax Rules, 1962
Ltd.	Limited
MAP	Mutual Agreement Procedure
MAT	Minimum Alternate Tax
MLI	Multilateral Convention to Implement Tax Treaty related measures to prevent Base Erosion and Profit Shifting
MoU	Memorandum of Understanding

GLOSSARY

ABBREVIATION	MEANING
MRP	Maximum Retail Price
NAA	National Anti-profiteering Authority
NCLT	National Company Law Tribunal
OECD	Organisation for Economic Co-operation and Development
PAN	Permanent Account Number
PCIT	Learned Principal Commissioner of Income Tax
PE	Permanent Establishment
Pvt.	Private
PY	Previous Year
R&D	Research and Development
RBI	Reserve Bank of India
SC	Hon'ble Supreme Court
SEBI	Security Exchange Board of India
SEZ	Special Economic Zone
SGST	State Goods and Services Tax
SGST Act	State Goods and Services Tax Act, 2017
SLP	Special Leave Petition
ST Rules	Service Tax Rules, 1994
TCS	Tax Collected at Source
TDS	Tax Deducted at Source
TPO	Transfer Pricing Officer
TRC	Tax Residency Certificate
UK	United Kingdom
USA	United States of America
UTGST	Union Territory Goods and Services Tax
UTGST Act	Union Territory Goods and Services Tax Act, 2017
VAT	Value Added Tax
VAT Tribunal	Hon'ble VAT Tribunal

List of Contributors

S. R. Patnaik
Partner (Head – Taxation)

Thangadurai V. P.
Principal Associate

Reema Arya
Consultant

Bipluv Jhingan
Senior Associate

Akshara Shukla
Senior Associate

Shivam Garg
Senior Associate

Rashi Gupta
Associate

Shrish Gautam
Associate

Cyril Amarchand Mangaldas
Advocates & Solicitors

100 years of legacy | **750+** Lawyers | **Over 150** Partners

Peninsula Chambers, Peninsula Corporate Park, GK Marg, Lower Parel, Mumbai – 400 013, India
T +91 22 2496 4455 **F** +91 22 2496 3666 **E** cam.mumbai@cyrilshroff.com **W** www.cyrilshroff.com
Presence in Mumbai | Delhi-NCR | Bengaluru | Ahmedabad | Hyderabad | Chennai | GIFT City | Singapore