Tax Matters

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The team at JMP Advisors is pleased to bring to you a gist of some of the significant developments in the direct tax space during February 2021:

Income tax rulings

➢ Compensation received against Letter of Intent (LOI) taxed under Capital Gains

- Shailendra Bhandari (Mumbai ITAT) (ITA No.6528/M/2018)

The taxpayer had entered into a LOI from the builder company. It gave him the right to occupy flats constructed by a builder company. Later, due to cancellation of the LOI, he received a compensation along with a refund of the original money invested. The taxpayer claimed a capital loss, taking into consideration indexed cost of acquisition, which was disputed by the AO.

ITAT observed that a LOI is equivalent to an agreement as it creates a right in the hands of the taxpayer. Though, the department contended that the LOI was in contravention of the provisions of the Maharashtra Ownership Flats (Regulation of the promotion of construction, sale, management and transfer) Act, 1963 (MOFA), the ITAT ruled that provisions of MOFA do not have impact on the taxability of an income. Relying on judicial precendent set by the Hon'ble Bombay HC in the case of Vijay Flexible Containers, it was held that LOI is a capital asset and the taxpayer's claim of capital loss was allowed.

JMP Insights: *It is an established principle that the phrase 'property of any kind' in section 2(14) is wide enough to include assets that create rights like letters of intent, right in immovable property etc. The present case highlights another important element that whether or not an instrument or agreement is in compliance with other laws and regulations, it would not impact the taxation of income arising from it.*

➢ Amount of sum is immaterial in deciding head of income for taxation and circulars by CBDT must be followed by AO.

- United Spirits Limited (Bangalore ITAT) (ITA No.1923/Bang/2018)

In the given case, the taxpayer had held investment in its foreign subsidiary incorporated in British Virgin Islands. It was intended to consolidate various investments into the subsidiary and not to trade in the shares of the subsidiary. Upon sale of shares of the subsidiary, the AO contended that the profit should be taxed as business profits merely because the amount gained was 'astronomical'.

The Mumbai ITAT observed that the taxpayer had held the investment for more than 12 months and had disclosed the shares held in subsidiary as investments in its financial statements and not as stock-in-trade. Further, it was pointed out that the CBDT has issued circular 4/2007 and 6/2016 to distinguish between shares held as investments and shares held as stock-in-trade. The AO did not rely on parameters listed by CBDT and used only the amount of gain in his approach. In view of the mentioned facts, taxpayer's claim of taxing the gain as LTCG was accepted.

- **Compensation received for pre-closure of a manufacturing contract is a capital receipt**

  - Sai Mirra Innopharm Private Limited. (Chennai ITAT) (ITA No. 3454/CHNY/2019)

The taxpayer had entered into a contract manufacturing agreement with Dr. Reddy's Laboratories Ltd. for manufacturing drugs for 10 years. The contract was later terminated by Dr. Reddy's before completion of the contract period for business reasons.The taxpayer received a sum as compensation for loss of investment in manufacturing facilities and loss of profit in business. The dispute was whether the sum is a capital receipt or taxable as Business income under section 28(ii)(e) or section 28(va)(a).

ITAT observed that sub-clause (e) of section 28(ii) was inserted w.e.f 01 April 2019 and accordingly it will not be applicable in the given case as the relevant AY is AY 2007-08. Section 28(va)(a) deals with compensation received for carrying out or not carrying out any activity in relation to any know-how, patent, copyright, trade-mark, license, etc. ITAT observed that the taxpayer does not have any such intangible asset. Accordingly, it was held that the sum received does not fall under that category. Lastly, it was concluded that compensation paid for breach of contract and failure to honour commitment is capital in nature.

- **Flat booking is equivalent to 'construction' of a house within the stipulated period of three years**

  - Harminder Kaur v. ITO (Delhi ITAT) (ITA No.2656/Del./2017)

Delhi ITAT held that booking of flat is equivalent to construction of house and deduction under section 54 is available if such investment is made within three years from transfer of the original asset.

The claim of deduction under section 54 was denied on the following grounds: (i) flat booking was not 'construction' as Circular no. 471 and circular no. 672 are applicable only on allotment by Delhi Development Authority and not private builders (ii) Taxpayer had not obtained possession of the flat within 3 years (iii) capital gain had neither been invested in purchase or construction of residential house within the stipulated period, nor deposited in capital gain scheme account within limit provided Sec.139(1);

Relying on the Delhi HC ruling in R L Sood and Jaipur ITAT ruling in Rampraksh Miyan Bazaz, and referring to the CBDT circular No. 672 and 471, the Delhi ITAT held that booking of flat with private builder was also considered as case of construction for the purpose of section.54. As regards Revenue's contention of non-possession of flat, ITAT remarked that 'the prime requirement is investment in new residential house within the prescribed period. The Delhi ITAT rejected the contention that since investment was not made within due date u/s 139(1), deduction should be denied. Relying on the Karnataka HC ruling in Fathima Bai and Punjab and Haryana HC ruling in Jagtar Singh Chawla, the Delhi ITAT held that exemption u/s 54 can be availed if the full amount of capital gain is utilized within time limit under section 139(4).

Design services provided held taxable if linked to project office in India

- Technip France SAS (AAR 1413 of 2012)

The AAR has ruled that basic engineering and design services, including off-shore advisory services, are taxable in India if the provision of such services is linked to the project office in India.

The taxpayer was awarded a contract for providing off-shore and on-shore engineering and design service to an Indian company for setting up a plant in India. The taxpayer's wholly owned subsidiary in India was also involved in the project right from the initial bidding process. Since, the employees of Indian subsidiary were carrying out the work of the parent company, it was established that the taxpayer had a PE in India from the date of the contract.

In case of off-shore supply of equipment, it was observed that sale was completed by the taxpayer outside India and the project office in India did not play any role in this sale. Accordingly, relying on the decision of the Hon'ble SC in the case of Ishikawajima Harima Heavy Industries Ltd, the AAR held that such income will not be taxable in India as the income did not accrue or arise in India.

In connection with taxability of the offshore services, the AAR observed that the taxpayer was required to furnish all design information to the Indian company for approval. The contract also provided for formal design verification meeting to approve the design services. Thus, the AAR held that the services were 'made available' and even the narrower definition of FTS as per MFN clause was satisfied. It was further observed that all such services were provided directly as well as with the involvement of project office in India and will accordingly be taxed as business income of the PE.

JMP Insights: It is vital to note that if the employees of the wholly owned Indian subsidiary are carrying out work of its parent company, it may be considered as fixed place PE of the parent company. Further, in case of a composite contract and where an taxpayer has a PE, it may become difficult to bifurcate between services which were provided only by the taxpayer and services which were provided only by its PE. Therefore, it is important to note that even minute ambiguities can have impact on tax cost for an enterprise.

- **LoB clause is applicable for extending treaty benefit to Singapore-based Investment Co. on share-sale.**

    - BG Asia Pacific Holding Pte. Limited (AAR No. 1376 & 1377 of 2012)

Taxpayer, a subsidiary of BG North Sea Holding Limited, UK, was a tax resident of Singapore. It acted as the regional headquarters for the BG Group. Significant investments of the group in India, Singapore, Egypt, Thailand and Trinidad were held through the Taxpayer.

As a part of its business restructuring process, the Taxpayer proposed to sell its entire shareholding in GGCL (Indian listed company) to GSPC Distribution Network Limited (another Indian company) in 2013 under a private arrangement to be completed outside the stock exchange as an "off-market" sale transaction.

While deciding on the taxability of capital gains on the sale of shares of the Indian listed company, the AAR observed that the shares of the Indian listed company were acquired 6 years prior to introduction of tax exemption provisions of Article 13(4). The Group's decision to divest non-core business interest was not limited to India but was also extended to investments in Brazil and Italy, as a part of the business restructuring exercise. It could, thus, not be said that the business affairs were arranged with a primary purpose of availing treaty benefits.

The AAR rejected the contention that the taxpayer's group investment holding was not a bonafide business activity. The AAR placed reliance on the SC decision in Vodafone and Andhra Pradesh HC ruling in Sanofi to hold that investment in itself is a legitimate, established and globally well recognised business. It was noted that the taxpayer had continuous but a real business as evidenced by its audited accounts. The AAR therefore held that all the ingredients of shell/conduit company as prescribed in Article 3.2 of the Protocol are found missing.

The AAR further observed that the condition for total annual expenditure of at least SGD 200,000 in the contracting state for 24 months preceding the date of capital gains was met. The AAR referred to the Tax Residency Certificate (TRC), certificate issued by Tax Authority of Singapore certifying the total expenditure for the purpose of Limitation of Benefits ('LoB') clause and submissions summarising the dividend income, administrative expenses and payroll cost as per audited accounts for past 10 years. It observed that the administrative expenses in all the years was more than the prescribed limit stipulated in Article 3.3 of the Protocol to the India – Singapore Tax Treaty ('Tax Treaty'). The Revenue contended that the statutory expenses should not be considered as operational expenditure as the company may incur statutory expense such as director's fee, filing fee, etc. but still may not carry on any business. The Revenue further contended that the administrative expenses should also be excluded. The AAR observed that the employee recharge was part of such administrative recharge and thus it had to be considered as operational expense, immaterial of whether it was incurred directly or through subsidiary.

The AAR held that there was nothing in the LoB clause to suggest that its intention was to curb the use of holding companies, not having any bona fide business activity in India/Singapore, from getting any treaty benefits. There was no such condition that the benefit of Article 13(4) will not be available to holding companies. The AAR observed that the Tax Treaty and the Protocol cannot be read beyond what is provided therein and the contention of the Revenue that the company earning only dividend income is liable to be treated as a shell company under the Protocol is found to be preposterous.

Based on the above, the AAR ruled that the capital gains arising on sale of shares of the Indian listed company is not taxable in India as the conditions of Limitation of Benefit clause stipulated in Article 3 of the Third Protocol to Tax Treaty were satisfied and the Taxpayer was eligible to avail exemption under Article 13(4) of the Tax Treaty.

Notifications and Circulars

➢ Faceless Penalty Scheme, 2021 (Notification No. 03/2021)

The Central Board for Direct taxes (CBDT) vide Notification No. 3 of 2021 dated January 12, 2021, has notified the 'Faceless Penalty Scheme' for conducting penalty proceedings under the Act in a faceless manner. The said scheme is in alignment with the Faceless Assessment Scheme and the Faceless Appeal Scheme.

For the overall structure and functioning of the Faceless Penalty Scheme, the CBDT has set up a National Faceless Penalty Centre (NFPC), Regional Faceless Penalty Centres (RFPC), Penalty Units (PU) and Penalty Review Units (PRU). Post Faceless Penalty Scheme being notified, the CBDT issued an order directing units set up under Faceless Assessment Scheme 2019 to act as the NFPC/RFPC/PU/PRU.

All the penalty proceedings under the Scheme would be conducted entirely through an electronic mode without any physical interaction between the taxpayer and the Income-tax Department and all exchange of communication between the NFPC and the taxpayer as well as all internal communications between NPPC, NFAC, RFPC, PU and PRU will be strictly through electronic mode. Specific circumstances will be prescribed where a personal hearing (through video conferencing mode) may be conducted.

JMP Insights – *This is a welcome move. The overall structure and functioning of the Faceless Penalty Scheme is more or less in lines with the Faceless Assessment Schemes introduced earlier.*

The CBDT vide its order dated Order F.No. 187/4/2021-ITA-I dated 20 January 2021 has clarified that below mentioned proceedings shall not be disposed by the NFAC / NeAC:

i. Penalty proceedings in cases assigned to Central Charges;
ii. Penalty proceedings in cases assigned to International Tax Charges; and
iii. Penalty proceedings arising in TDS charges.

➢ Clarification of spending of Corporate Social Responsibility (CSR) funds on COVID-19 vaccination (General Circular No. 01/2021)

On 23 March, 2020, the Ministry of Corporate Affairs (MCA), (vide General Circular No.10/2020), had clarified that spending on CSR Funds for COVID 19 is an eligible CSR activity.

The MCA on 13 January, 2021 has further clarified that spending of CSR funds for carrying out awareness campaigns/programmes or public outrage campaigns on COVID-19 vaccination programme is also an eligible CSR activity.

➢ Amendment to the Maharashtra Stamp Act.

The Government of Maharashtra has by the Maharashtra Stamp (Amendment and Validation) Ordinance 2021 ('Ordinance') amended Article 6 (Agreement Relating to Deposit of Title Deeds, Pawn, Pledge or Hypothecation) and Article 40 (Mortgage Deed) of Schedule I of the Maharashtra Stamp Act, 1958 (Maharashtra Stamp Act).

The Ordinance has increased the stamp duty payable on an agreement relating to deposit of title deeds, pawn, pledge or hypothecation where the amount secured exceeds INR 5 lakh (~ USD 6849) from 0.2% to 0.3% subject to the existing cap of INR 10 lakhs (~USD 13,689).

The Ordinance has reduced the stamp duty on a mortgage deed, where possession of the subject property is not given or agreed to be given, from 0.5% to 0.3% subject to the existing cap of INR 10 lakhs (~USD 13,689).

DID YOU KNOW?

The CBDT has launched an automated dedicated e-portal on the e-filing website of the Income Tax Department to receive and process complaints of tax evasion, foreign undisclosed assets as well as complaints regarding benami properties. This e-portal is yet another initiative of the Income Tax Department to bring about enhanced ease of interaction with the Department, while strengthening its resolve towards e-governance.

Should you wish to discuss any of the above issues in detail or understand the applicability to your specific situation, please feel free to reach out to us on coe@jmpadvisors.in.

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