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 May 2021:

Income tax rulings

- **Most Favoured Nation clause invoked to allow withholding at a rate lower than that specified in the DTAA**

  - Concentrix Services Netherlands B.V. and Optum Global Solutions International B.V. (Delhi HC)

  The Hon'ble Delhi High Court ('HC') allowed the taxpayer's writ petition and directed the tax department to issue a certificate permitting tax to be withheld on dividend paid to a Dutch taxpayer by its Indian subsidiary, at a lower rate of 5% by applying the Most Favoured Nation ('MFN') clause as provided in the Protocol to the India – Netherlands Double Tax Avoidance Agreement (DTAA). The HC has placed significant reliance on the decree issued by the Dutch authorities wherein Netherlands has adopted the position that the lower rate of tax in the India-Slovenia tax treaty will be applicable to the India-Netherlands treaty on the date when Slovenia became a member of the OECD, i.e., from 21 July 2010. The HC observed that DTAAs are negotiated by diplomats and while interpreting DTAAs, the rules for interpretation of domestic laws need not be applied.

  ***JMP Insights:**. This is a welcome decision by the Delhi HC where it has affirmed that the Protocol to the India-Netherlands DTAA forms an integral part of the DTAA and no separate notification is required to apply the MFN clause in the Protocol. Taxpayers based in other countries where the DTAA has a similar MFN clause such as France, Sweden, Switzerland and Hungary among a few, may also be able to rely on this decision and avail a lower withholding tax rate of 5% on dividend income.*

- **Taxpayer's Writ Petition admitted against faceless assessment order issued in contravention of principles of natural justice**

  - Manickan Ravichandran [WP(C) No.9350/2021)]

  The Hon'ble Kerala HC admitted the Writ Petition filed by the taxpayer against the Faceless Assessment order passed without giving an opportunity of being heard to the taxpayer. In rendering this judgment, the HC took cognizance of the fact that the assessment order was passed without considering either the taxpayer's request for granting additional time or the response submitted by the taxpayer to the Shown Cause Notice ('SCN'). The HC further held that the assessment order issued to the taxpayer *prima facie* suffered from perversity as well as non-compliance with the principles of natural justice.

JMP Insights: *Recently, in the case of B.L. Gupta Construction Private Limited, the Delhi HC has also admitted the taxpayer's writ petition filed on a similar issue where the Faceless Assessment order was passed before the expiry of the time limit provided to the taxpayer for submitting its response and thereby, not providing the taxpayer with an opportunity of being heard. Recently, a few other High Courts have also, on similar facts, admitted the Writ Petitions filed by the taxpayers.*

- **Failure to pay tax not to necessarily attract criminal liability**

  - Forzza Projects Private Limited (Kerala HC) (Crl.MC.No.5669 OF 2020(G))

The Hon'ble Kerala HC held that failure to pay the amount of tax at the time of filing the return, which was subsequently paid with interest, does not satisfy the legal requirement of constituting an 'offence' in order to attract criminal liability.

In rendering this decision, the HC relied on the ruling delivered by the Hon'ble Supreme Court in the case of Prem Dass (AIR 1999 SC 1079) and observed that there should be concealment of income to attract the provisions for criminal liability. Merely failing to pay tax on time does not mean that the source of the income was concealed or there was intention to evade tax. The SC further observed that the presumption of culpable mental state can be applied only when the basic requirements for constituting an offence are established.

- **Depreciation may be allowed on non-compete fee; surplus credited to general reserve on amalgamation not to be included in business income**

  - Areva T & D India Ltd (Madras HC) (ITA No. 194 of 2021)

The two significant issues under consideration in this ruling were depreciation on non-compete fee and inclusion of surplus arising on amalgamation in the scope of business income.

On the first issue, the Hon'ble Madras HC allowed depreciation on non-compete fee paid by the taxpayer's sister concern (but claimed by the taxpayer since the sister concern was taken over by the taxpayer) for acquiring a business, based on the fact that a similar claim by the sister concern was allowed in earlier years and that the tax officer was bound to remain consistent with earlier decisions. In rendering this judgment, the HC distinguished on facts the ruling of the Hon'ble Delhi HC in the case of Sharp Business Systems v. CIT (254 CTR 233) relied upon by the Revenue.

On the second issue, the HC ruled that the excess of net book value of assets taken over in amalgamation as compared to the consideration and credited to the capital reserve, is not taxable under section 28(iv) of the Income-tax Act, 1961 (the Act) as it did not arise from any business of the taxpayer. The HC relied on the decision of the Supreme Court in the case of Mahindra & Mahindra Ltd (404 ITR 1) where it was held that in order to be taxed under section 28(iv) of the Act, the income must arise from business or profession

and the benefit received must be in any form other than money. The HC held that the surplus has arisen out of amalgamation which is not the business activity of the taxpayer and therefore, cannot be said to arise from business.

JMP Insights: *The HC has distinguished contrary rulings on depreciation on non-compete fees. This ruling is in line with past rulings where Courts have held non-compete fees as being in the nature of an enduring benefit and hence, covered under the scope of 'business or commercial rights of a similar nature', eligible for depreciation. The Court also held that the Revenue authorities should not deviate from the view adopted in an earlier year.*

- **Setting up a business is different from commencement of business**

  - Miele India Pvt. Ltd. (Delhi HC) (ITA 144/2020 & & CM Nos.7635-36/2020)

The issue in this ruling involved allowability of deduction for advertising and pre-operative expenses before the commencement of business.

The Hon'ble Delhi HC upheld the taxpayer's contention that there is a difference between setting up a business and commencing a business. The HC appreciated that prior to the setting up of its retail store, the taxpayer had completed several legal formalities, onboarded employees and made some purchases. Further, the taxpayer did not have any online presence and intended to sell goods only through retail store. The taxpayer had taken steps to set up a business in earlier years and once a business has been set up, expenses should be allowed as a deduction. Hence, the Revenue's contention that since the retail store was set up only on 29 October 2009, the business commenced on that date was incorrect.

JMP Insights: *A very important distinction between setting up a business and commencement of a business has been drawn in the ruling. Once a business is set up and reasonable steps are taken to start the business, expenses incurred for the business may be treated as deductible.*

- **Section 56(2)(viib) not to apply to excess of net assets over consideration paid on amalgamation**

  - Ozone India Ltd (Ahmedabad ITAT) (IT.A. Nos. 2081/Ahd/2018)

The Hon'ble Ahmedabad Tribunal held that the provisions of Section 56(2)(viib) of the Act do not apply to the capital reserve created out of excess of net assets acquired on amalgamation over and above the consideration paid by the taxpayer. In arriving at its decision, the Tribunal took into consideration the Memorandum Explaining Finance Bill, 2012 and CBDT Circular 3/2012 dated 12 June 2012 for introduction of Section 56(2)(viib) of the Act which stated that this provision, is a measure to tax hefty or excessive share premium received by private companies on issue of shares without carrying underlying value to support such premium and thereby enriching itself without paying taxes

legitimately due to them. The Tribunal therefore, observed that these provisions were never intended to apply to amalgamations.

Further, the Tribunal held that the provisions of Section 56(2)(viib) of the Act would not be applicable to this transaction since taxpayer has not charged premium and shares were issued at face value. The Tribunal relied on the ruling of the Hon'ble Supreme Court in the case of Mother India Refrigeration (P) Ltd. (1985) 155 ITR 711 where it was held that legal fictions are only for a definite purpose and they are limited to the purpose for which they are created and should not be extended beyond the legitimate field. The Tribunal held that in cases of amalgamation there is a tripartite agreement between the amalgamated company, amalgamating company and shareholders of amalgamating company and such agreements are not contemplated in the deeming clause in question. The provisions of Section 56(2)(viib) of the Act are applicable only to bilateral transactions viz. issue of shares by company to subscribers.

***JMP Insights:**. This is a welcome judgement as there is no clarification for taxability of such type of transactions under Section 56(2)(viib) of the Act. The issue of shares by the amalgamated company to the shareholders of amalgamating company in pursuance of a scheme of amalgamation which has been accorded legal approval by the Court should not be considered as being within the ambit of Section 56(2)(viib) of the Act.*

- **Withholding tax not to apply to provisions where the income has not accrued**

  - Toyota Kirloskar Motor (P) Ltd (Karnataka HC) (ITA No. 245 of 2018)

The Hon'ble Karnataka HC ruled that the taxpayer had no obligation to withhold tax on provisions for expenses made during the year and reversed during the same year. The HC further ruled that the provisions of withholding can be applied only when an income accrues or is paid. Relying on the ruling delivered by the Hon'ble Supreme Court in the case of Shoorji Vallabh Das (46 ITR 144), the HC held that income tax can be levied only when there is an accrual or a receipt of income in the hands of the recipient.

In the given case, the taxpayer made provisions for marketing and general expenses at the end of every year, although the invoices for these provisions were not received by the taxpayer. Expenses were being recorded against the provision as and when the invoices were received, and the taxpayer deducted and paid tax on these invoices along with interest. The remaining amount of unutilised provision was not claimed as a deduction in accordance with section 40(a)(i) and 40(a)(ia) of the Act. Based on these facts, the HC ruled that a provisional accounting entry does not give rise to income in the hands of any person and in the absence of any income accruing to anyone, the liability to deduct tax could not be imposed on the taxpayer.

***JMP Insights:** The issue of applicability of withholding tax on provisions is a contentious issue and there have been several contrary Court rulings on this matter. In this connection, attention is drawn to the Explanation in the withholding tax provisions in the Act which mentions that withholding will be required even if the income is credited to any 'Suspense account' or to any other account by the taxpayer. In such a case, the credit will*

be deemed to be a credit of income to the account of the payee. However, this argument does not appear to have been taken up in the hearing.

Notifications and Circulars

- **Threshold notified for Significant Economic Presence (Notification No. 41/2021)**

Provisions relating to Significant Economic Presence ('SEP') have come into effect from 1 April 2021. As per the said provisions, a non-resident having a SEP in India would be considered as having a business connection in India and accordingly, income from the business connection would be deemed to accrue or arise in India and hence, subject to tax in India. SEP has been defined to mean:

a. Transactions by a non-resident in respect of any goods, services or property with any person resident in India including provision of download of data or software in India, if the aggregate payments from such transactions exceed the *prescribed* amount;

b. Systematic and continuous soliciting of business activities or engaging in interaction with a *prescribed* number of users in India.

A new Rule 11UC has been introduced in the Income-tax Rules, 1962 to prescribe the thresholds in this regard. As per the abovementioned notification, the threshold for the aggregate payments in clause (a) above is INR 20 million and the number of uses in clause (b) above is 300,000. Some confusion may be caused by the fact that while under the Act, the provisions relating to SEP come into effect from 1 April 2021, the new Rule 11UC of the Income-tax Rules, 1962 comes into effect from 1 April 2022.

JMP Insights: *The SEP provisions would bring within their ambit various overseas companies which do not have a physical presence in India, but still carry out transactions with any person(s) in India. However, a non-resident may still take shelter under the DTAAs since India's existing DTAAs contain the concept of Permanent Establishment (comparatively having a more restricted scope) to tax business profits of a non-resident, and the inclusion of SEP in the Act will not be read into the DTAAs. Having said this, it also needs to be analysed (regardless of the SEP provisions) whether or not, the transactions would be subjected to Equalisation Levy in India, in which case, the relevant amount which is chargeable to Equalisation Levy would be exempt from tax.*

- **Extension of due dates for certain compliances**

Various timelines including those for filing an appeal to the Commissioner of Income tax (Appeals), filing objections to Dispute Resolution Panel (DRP), and submitting the return in response to notice for reopening, which were due on or after 1 April 2021, have been extended to 31 May 2021.

Belated returns and revised returns pertaining to FY 2019-20, which were due on or before 31 March 2021 may be filed before 31 May 2021.

Further, the due date for payment and filing of return-cum-challan statement for withholding tax liabilities under section 194-IA (on transfer of certain immovable property), 194-IB (payment of rent by individuals) and 194M (payment by individuals under a contract, for commission, fees for professional services) has been extended from 30 April 2021 to 31 May 2021.

DID YOU KNOW?

On 20 April 2021, the CBDT prescribed the format, procedure, and guidelines for submission of Statement of Financial Transactions (SFT) by the reporting entities for dividend and interest income which would be reflected in the prefilled income tax returns of the recipients of such income.

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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About JMP Advisors

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JMP Advisors offers advice in international taxation, domestic taxation, transfer pricing, mergers and acquisitions, Goods and Services Tax (GST), business laws and exchange control regulations and foreign investment consulting. We specialize in fiscal strategy and policy foresight and are trusted advisors to high net worth families. Our team at JMP Advisors takes pride in being the best at what matters most to clients-technical expertise, innovative solutions, consistent, high quality service, reliability, and ease of doing business.

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