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 July 2021:

Income tax rulings

- **Advance given to the Managing Director ('MD') in return for providing collateral security and personal guarantee towards loan taken by M/s. Firepro Systems Pvt Ltd ('the Company') not taxable as deemed dividend**

  - N. S. Narendra (Karnataka High Court) [I.T.A. No. 92 of 2015]

The taxpayer, MD of the Company had given personal guarantee and collateral security of personal properties on behalf of the Company for availing loan for furtherance of the business of the Company. The Company utilised the loan for meeting its capital requirements. The Company in turn paid certain amount to the taxpayer for purchasing an apartment for himself which was disclosed under recoverable advances in the accounts of the Company.

The tax officer treated the advance given to the taxpayer as deemed dividend under section 2(22)(e) of the Income-tax Act,1961 ('the Act'). As per section 2(22)(e) of the Act, if a Company gives any advance or loan to a shareholder holding more than 10% of the voting power, then the amount given to the shareholder will be considered as deemed dividend and taxed in the hands of the shareholder.

Relying on the ruling of Hon'ble Calcutta High Court ('HC') in the case of Pradip Kumar Malhotra v. CIT [(2011) 64 DTR 378 (Cal)], the Karnataka HC held that the phrase "by *way of advance or loan*" as mentioned in section 2(22)(e) of the Act must be construed to mean those advances or loans which a shareholder enjoys simply on account of being the beneficial owner of shares. However, if such loan or advance is given to the shareholder in return for an advantage conferred by him upon the Company, the loan or advance cannot be said to be deemed dividend under the Act.

The HC further noted that a similar view was taken by the coordinate benches in Jamuna Vernekar v. DCIT in ITA No. 43/2013 (KAR.), Bagmane Constructions Private Limited v. CIT [(2015) 277 CTR 338 (KAR.)], CIT v. Creative Dyeing and Printing P. Ltd [(2009) 218 ITR 476 (DEL.)].

Thus, advance given by the Company to the shareholder in return of the benefits derived by the Company from the shareholder cannot be treated as deemed dividend under the Act.

- **Tax Payer not allowed to make fresh claim of a deduction or allowance in an assessment under section 153A of the Act**

  - GMR Infrastructure Limited (Karnataka HC) [ITA No.1036 of 2017]

The taxpayer, a company engaged in promotion of infrastructure developments, had filed the return of income declaring loss under the normal provisions of the Act. The return of income was accepted by the tax department and an intimation was issued under section 143(1) of the Act. The taxpayer noticed that there was a short grant of withholding tax credit, and it filed a rectification application against the intimation. The rectification order was passed granting a refund to the taxpayer.

Thereafter, the tax officer initiated search and seizure operations against the taxpayer and made some disallowances to the loss return filed by the taxpayer. One of the disallowances pertained to expenditure incurred to earn exempt income under section 14A of the Act. The tax officer had worked out the disallowance under section 14A of the Act on the basis of Rule 8D of the Income-tax Rules, 1962 ('the Rules'). As against this disallowance, the taxpayer contended that while filing the return of income, it had suo moto disallowed an amount under section 14A of the Act on the basis of disallowances made in the past, in absence of any precedents.

The Karnataka HC confirmed the disallowances made by the tax officer placing reliance upon the ruling of Rajasthan HC in Jai Steel (India), Jodhpur [(2013) 36 taxmann.com 523 (Rajasthan)]. The HC held that the assessment or reassessment made in pursuance to search proceedings, is not a "de novo" assessment i.e. the assessment is not made afresh. It held that the taxpayer cannot be allowed to claim any deduction which it had not claimed in the original assessment proceedings which in the given case got concluded when the intimation was issued under section 143(1) of the Act.

- **Corrigendum to valuation report forms part of the original valuation report**

  - M/s. I Brands Beverages Pvt Ltd (Bangalore ITAT) [ITA No.882/Bang/2019]

The taxpayer, a private unlisted company, issued shares at a premium. As per section 56(2)(viib) of the Act, if a private unlisted company issues shares for a consideration higher than the face value of shares, then the consideration in excess of the Fair Market Value ('FMV') is liable to tax in the hands of the company. In the given case, shares having face value of INR 10 per share were issued at INR 374.95 per share. The issue price was determined by the company on the basis of a valuation report obtained by a chartered accountant. However, the tax officer observed that as per the financial projections of the company, the FMV of the shares was INR 37.49 per share.

The taxpayer submitted a corrigendum to the original valuation report citing that there was an error in the schedule annexed to the original valuation report. The taxpayer argued that the corrigendum issued by the valuer must be read in conjunction with the original valuation report. The tax officer expressed the view that the corrigendum issued by the valuer is an afterthought of the taxpayer. The tax officer also expressed the view that the valuation report cannot be changed as per the whims and fancies of the taxpayer. The Commissioner of Income Tax (Appeals) [‘CIT(A)’] refused to admit the additional evidence.

The Bangalore ITAT accepted the corrigendum furnished by the taxpayer, since the same was issued to correct the error in arriving at the FMV of shares. It held that the original report and corrigendum shall constitute full report and the same needs to be examined by the tax officer. Accordingly, the ITAT directed the tax officer to take into account full report i.e. original report along with the corrigendum.

***JMP Insights**: Under section 250(4) of the Act, the CIT(A) is empowered to make such further inquiry as he thinks fit and such power being quasi-judicial power, it should be incumbent on him to exercise it if the facts and circumstances justify. In certain circumstances, it may be possible to argue that if some evidence is necessary to examine the claim of a tax payer, it should be admitted by the CIT(A).*

- **Pre-commencement expenditure allowed as deduction in case of newly set up Insurance company**

    - Maruti Insurance Broking (P.) Limited (Delhi HC) [(2021) 127 taxmann.com 685 (Delhi)]

The taxpayer was incorporated on 24 November 2010 as a Joint Venture Company to conduct the business of soliciting and procuring life and/or general insurance. It filed an application with Insurance Regulatory and Development Authority (‘IRDA’) for issuance of a direct broker’s license on 1 December 2010. The taxpayer received the license from IRDA on 2 February 2012 i.e. in Financial Year (‘FY’) 2011-12.

The taxpayer filed the return of income for FY 2011-12 claiming a deduction for business expenses incurred before the issue of license by IRDA. The tax officer while completing the assessment concluded that since the IRDA issued the license on 2 February 2012, the taxpayer could not have set up business before that date. Therefore, the tax officer held that the entire business expenditure before the issuance of the license to be disallowed and capitalized as pre-operative expenses.

On appeal before the Delhi HC, the taxpayer held that it had acquired the necessary wherewithal and physical infrastructure for carrying on its business. It was only waiting for the IRDA approval for commencement of business. Post the incorporation, the company had opened a bank account, entered into an agreement for deputing employees, gave necessary training to the employees, executed operating lease agreements and set up offices at 29 different locations across the country.

The Delhi HC considered the submission of both the taxpayer and revenue and analysed the difference between date of setting up of business and date of commencement. It stated that the expression “setting up of business” merely means that the taxpayer is ready to conduct business and that the connotation does not mean the business has commenced. It also observed that the taxpayer had filed a loss return in FY 2010-11 and had taken the stand that the business was set up in that year. The return of income for FY 2010-11 was accepted by the tax department without any disallowance.

Finally, relying on the above facts and various judicial pronouncements of the Hon'ble Supreme Court ('SC') and HC and distinguishing the Delhi High Court case of Marvel Polymers (P.) Ltd v. CIT [2007] 165 TAXMAN 618 (Delhi), the Delhi HC ruled in favour of the taxpayer and mentioned that in the instant case the IRDA took more than a year to issue the licence even though the taxpayer was ready to commence the business. This approach destroys business efficacy and is not countenanced by the law.

***JMP Insights**: The ruling has highlighted the point that it is not necessary for a company to commence business, it is adequate if the business has been set up in order to claim the expenditure.*

Expenditure relating to a business which is yet to be set-up (other than certain preliminary expenses which are specifically allowed under section 35D of the Act) cannot be allowed as a deduction. Whether a particular business is set-up or not is a question of fact and each case has to be evaluated separately.

- **Notice issued to taxpayer at the address available in PAN database is valid**

  - Rajmannar Ramaswamy (Madras HC) [W.P.No.33803 of 2018 & W.M.P.No.39259 of 2018]

The taxpayer is a non-resident individual, having no income in India except for bank interest on which tax was deducted at source. He had not furnished any return of income in India for the last 15 years.

A notice was issued to the tax payer under section 148 of the Act for FY 2009-10. The tax payer filed a writ petition to quash the reassessment notice issued challenging the jurisdictional validity of the notice and that there was no income escaping assessment as the only income, being bank interest, was also subjected to deduction of tax at source.

The taxpayer contended that the notice was served to him beyond the period of limitation i.e. 31 March 2017 and the notice was not served at the correct address.

The tax officer submitted that the notice was served on the last available address as updated in the Permanent Account Number ('PAN') records. Thus, in case of any change in address, it was the duty of the taxpayer to inform this to the tax department and update the PAN records. Further, the tax officer contended that the date of dispatch of notice from the tax department should be considered while assessing as to whether the notice is issued within prescribed time. It is not necessary that the notice should be served on the taxpayer within the due date.

The HC relied upon the SC ruling in the case of PCIT v. IVen Interactive Limited in Civil Appeal No.8132 of 2019 dated 18.10.2019 wherein it has been held that mere mentioning of the new address in the return of income without specifically intimating the tax officer with respect to change of address and without getting the PAN database changed is not sufficient. In absence of any specific intimation to the tax officer with respect to change in address, the tax officer would be justified in sending the notice at the available address mentioned in the PAN database. Further, the HC also noticed the fact that writ petition filed was pre-mature as the required procedures as laid down by the SC in the case of GKN Driveshaft India Ltd. v. ITO reported in 259 ITR 19 (SC) were also not completed. The HC accordingly held that the petition is devoid of merits and dismissed the petition.

***JMP Insights**: With the introduction of faceless assessments, every notice or order or any other electronic communication has to be delivered to the taxpayer by placing it in the taxpayer's registered account or to his email address or to his Mobile App and followed by a real time alert via short messaging service, email or update on Mobile App. In light of this, it is important for the taxpayers to update their contact details accurately on the income tax website*.

It is also advisable for the taxpayers to ensure that their records in the PAN database is updated with the correct contact information.

Income tax notifications, circulars and guidelines

- **Central Board of Direct Taxes ('CBDT') notifies Rules and issues guidelines for taxing a partnership firm, Association Of Person ('AOP') or Body Of Individuals ('BOI') in case of its reconstitution or dissolution.**

The Finance Act, 2021 revamped the entire scheme of taxation of reconstitution of a partnership firm, AOP, BOI (together referred as specified entity) by introducing new section 9B under the Act as well as substituting the existing section 45(4) of the Act. It also made consequential amendment in section 48 of the Act.

As per section 9B of the Act, if a specified person i.e. a partner of a partnership firm or member of AOP or BOI receives during the FY any capital asset or stock in trade or both from a specified entity in connection with the dissolution or reconstitution of such specified entity, then the transaction will be deemed to be transfer of capital asset or stock in trade or both, as the case may be, in the FY of its receipt by the specified person. Accordingly, such deemed transfer shall be chargeable to income tax as business income or capital gains of such specified entity respectively. In case if the transfer is chargeable as capital gains, the profits or gains in such cases will be determined as per the formula prescribed in section 45(4) of the Act.

Section 48(iii) of the Act which provides for the mode of computation of capital gains, provides that for transactions governed by section 45(4) of the Act, the computation methodology shall be prescribed by the CBDT.

The CBDT vide Notification No. 76/2021 dated 2 July 2021 has now prescribed Rule 8AB as well as amended Rule 8AA of the Rules prescribing the manner of attribution of capital gains chargeable under section 45(4) of the Act, to the capital assets remaining with the specified entity subsequent to the reconstitution. Further, with a view to address the concern of the various stakeholders, CBDT also issued a Circular No. 14 of 2021 dated 2 July 2021 laying down guidelines for taxing the specified entity in terms of section 9B and section 45(4) of the Act.

***JMP Insights**: The above Rule and guidelines provide clarity to taxpayers in understanding the methodology for attribution of income and determination of capital gains in the hands of the specified entity.*

However, it is to be noted that both the Rule and the guidelines are issued in July 2021 whereas section 9B of the Act and amended section 45(4) of the Act are effective from 1 April 2021. There appears to be a lack of clarity on whether the taxpayers can rely on the Rule and the guidelines in the interim period.

- **Rule notified for computing the Written Down Value ('WDV') and the resultant capital gains on goodwill**

With a view to overturn the SC's ruling in case of Smifs Securities Limited, Civil Appeal No. 5961 of 2012 and thereby denying depreciation on goodwill, the Finance Act, 2021 brought about various amendments in the Act. The rationale behind this amendment is that goodwill, in general, is not a depreciable asset and in fact depending upon how the business runs, goodwill may see appreciation or in the alternative no depreciation to its value.

With goodwill no longer entitled for depreciation, the WDV of intangible assets would be impacted and that the taxpayer would need to recompute the WDV. To address this, the CBDT has issued a notification inserting new Rule 8AC in the Rules. Rule 8AC provides for the computation methodology for WDV of block of assets and Short Term Capital Gains ('STCG'), where goodwill is a part of such block and depreciation has been obtained in the FY prior to FY commencing from 1 April 2020.

Determination of WDV of block of assets:

(i) Where goodwill of the business or profession is one of the assets in the block:

The WDV of intangible block of asset as on 1 April 2020 needs to be reduced by standalone WDV of goodwill computed as difference between the actual cost of goodwill and depreciation allowable on such goodwill up to 31 March 2020.

(ii) Where goodwill of the business or profession is the only asset in the block:

The WDV of the block of assets in the immediately preceding previous year as reduced by the depreciation actually allowed in respect of that block of assets in relation to the said preceding year and as further adjusted by,

(a) the increase or the reduction (not being increase on account of acquisition of goodwill of a business or profession) for purchase of asset or sale of asset;

(b) the reduction by an amount which is equal to the actual cost of the goodwill falling within that block as decreased by the amount of depreciation that would have been allowable to the taxpayer for such goodwill for any assessment year commencing on or after the 1st day of April, 1988 as if the goodwill was the only asset in the relevant block of assets.

Capital gains:

Where the standalone WDV of goodwill is higher than aggregate of the opening WDV of the entire intangible block of assets and actual cost of any intangible asset acquired in FY 2020-21, then the excess shall be deemed to be short term capital gain for FY 2020-21.

It is clarified that there will not be any capital gains or loss where the goodwill was the only asset forming part of intangible block of asset as on 31 March 2020 and such block of asset ceases to exist due to reduction of WDV of goodwill.

Given that goodwill would cease to be part of block of intangible assets from FY 2020-21 and no depreciation would be allowable, the capital gains or loss on transfer of such goodwill shall be determined in the manner as if the goodwill is non-depreciable capital asset. For such cases, the cost of acquisition shall be the tax WDV as on 31 March 2020.

***JMP Insights**: The above Rule would remove several ambiguities in calculating the WDV of block of assets and the capital gains.*

DID YOU KNOW?

The Employees' Provident Fund Organization ('EPFO') has made it mandatory to link the Aadhaar numbers with the Provident Fund Universal Account Number ('UAN') before 1 September 2021 to avail uninterrupted services of the EPFO.

While it has become mandatory to link the Aadhaar numbers with the UAN, it is still not clear on how will this apply to International Workers who are not required to obtain an Aadhaar number.

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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