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 2024:

Income tax rulings

➢ **Premium on redemption of debentures taxable as interest under Income from Other Sources**

- Khushaal C Thackersey v Assistant Commissioner of Income Tax [1]

Background

Hindoostan Spinning & Weaving Mills Ltd ('HSWML'), a listed company in India was declared a sick unit. As a part of an approved rehabilitation scheme, two companies of the group issued 0% secured Redeemable Non-Convertible Debentures ('NCD') to the banks and other creditors against their outstanding loans. These NCDs were issued at face value in two series i.e. NCD-I and NCD-II. Due to pressure from banks to redeem the debentures before maturity, the taxpayer, a director in HSWML, purchased the NCDs from the bank at a price higher than their face value.

During the year under consideration, the NCDs were redeemed at a premium. The taxpayer, an individual, considered the difference between the redemption proceeds and the purchase price as Long Term Capital Gains and claimed deductions (under Sections 54EC and 54F) from the taxable capital gains by investing the capital gains in a residential property and specified bonds.

However, the Revenue Authorities considered the difference between the redemption proceeds and the purchase price of NCDs as Income from Other Sources and disallowed the deductions claimed by the taxpayer.

Before the Mumbai Tribunal, the taxpayer contended that the Revenue Authorities were not empowered to assess any new source of income. In support of this, the taxpayer relied on the decisions of the Delhi High Court in the case of *Union Tyres* [2]and *Sardari Lal.*[3]

On merits, the taxpayer contended that the redemption of debentures results in a transfer of capital asset as it is an extinguishment of rights. In support of its claim, the taxpayer relied on the following:

- Section 50AA under which the gains from the transfer of Market Linked Debentures ('MLD') are treated as Short Term Capital Gains;

[1] ITA 3679/2015 (Mumbai Tribunal)
[2] 240 ITR 556
[3] 102 Taxmann 595

- Non-availability of indexation benefit for debentures (fourth proviso to Section 48), which implies that the law considers debentures as a capital asset;

- Decision in the case of *Mrs. Perviz Wang Chuk basi* [4] where redemption of a capital investment Bond upon maturity was held as a transfer of a capital asset.

Decision of Mumbai Tribunal

The Tribunal held that the Revenue Authorities did not assess any new sources of income but only recharacterized the head of the income under which it was offered to tax by the taxpayer.

Further, the Tribunal observed that there is no dispute with regard to the fact that debentures fall in the category of 'capital asset'. However, the NCDs held by the taxpayer were materially different from MLDs. Interest payable on MLD is not determined at the time of issuance but is based on the performance of the underlying market index. In the case of MLDs, interest may not be payable every year and it may be payable in lumpsum at the end of its tenure.

The case laws referred to by the taxpayer related to taxation of preference shares or equity shares, which are materially different from debentures. A debenture holder is not an owner like in the case of an equity shareholder. A debenture holder is a financial creditor. So, the redemption of debentures by the company amounts to the repayment of debt not resulting in the extinguishment of any rights.

When it comes to deep discount bonds, the face value of a bond is discounted by applying a particular interest rate, so that the maturity proceeds are equal to the face value. In the case of NCDs, they are redeemable at a premium which is determined by applying a specific interest rate. The discount and premium amounts essentially represent the 'interest' amount only. The companies issuing both types of bonds and debentures claim the discount/premium on redemption as interest income/expenditure.

The premium paid at the time of the redemption of debentures thus taxable as interest under the head Income from Other Sources. Since this is interest, there is no deduction available under section 54F & section 54EC of the Income-tax Act, 1961 ('the Act').

***JMP Insights** – This judgment highlights the importance of substance over form. The nature of the transaction defines the taxability of the transaction and not the formal structure. Though the taxpayer purchased debentures and redeemed them at a gain, it was held to be repayment of debt with a premium, not a sale of a capital asset. The judgment clarifies that the redemption of debentures does not trigger capital gains as there is no 'transfer' of a capital asset. It emphasizes that debenture redemption represents debt realization rather than the extinguishment of rights. It highlights that the premium paid upon debenture redemption should be classified as interest income, while capital gains may occur if such instruments are transferred to a third party before maturity.*

[4] 102 ITD 123

- **Transactions on assignments of loan between SBI and NBFC not subject to tax withholding**

  - State Bank of India ('SBI') v Deputy Commissioner of Income Tax

The taxpayer is a Public Sector bank. It purchased loans from Non-Banking Financial Companies ('NBFCs') through the Direct Assignment route. In these transactions, the taxpayer purchased a significant portion (say 90%-95%) of the loan portfolios of NBFCs, while the remaining portion (say 5%-10%) is retained by the NBFCs. Tripartite agreements were executed between the NBFCs (assignors), the taxpayer (assignee), and trusteeship companies (assignee representatives) to facilitate these transactions.

Under these agreements, NBFCs retained a part of the interest income received from borrowers. This retained interest was higher than the portion of the loans which were retained by the NBFCs, which became the focal point of dispute. The Revenue contended that interest which is in excess of the retained portion of the loan was subject to tax withholding under section 194A (for interest payments) of the Act and the taxpayer had defaulted in withholding tax. Therefore, the taxpayer should be considered as an 'assessee-in-default' under Section 201/201A of the Act.

The taxpayer contended that since it did not borrow any funds or incur any debt from NBFCs, there was no obligation to withhold tax under section 194A. The tax officer held that the taxpayer should have received the interest associated with the loan assigned to the taxpayer. Retention of interest in excess of the retained portion of loan by the NBFCs is considered as the payment by the taxpayer to NBFC and that should be subject to tax withholding. Separately, NBFCs provided certain technical services like maintenance/development of loan portfolios to the taxpayer. The tax officer alternatively considered the excess interest as the payment for these services, liable to tax withholding under section 194J (on professional fees) of the Act.

The CIT(A) partly allowed the appeal and held that the retained interest was subject to withholding based on the relationship between the taxpayer and NBFCs. If the relationship was principal to principal, then withholding tax should be done under Section 194J for professional fees. If the relationship was of a principal and agent, then withholding tax should be done under Section 194H for brokerage or commission.

The issue before the Mumbai Tribunal was whether the interest retained by the NBFCs could be categorized as 'interest', subject to withholding of tax under Section 194A, 'fees for professional or technical services' subject to withholding of tax under Section 194J, or 'commission/brokerage' subject to tax withholding under Section 194H.

Decision of Mumbai Tribunal

The Tribunal held that since the taxpayer had not borrowed any funds or incurred debt from NBFCs, the interest retained in excess of the portion of loan couldn't be classified as 'interest' under section 2(28A) of the Act. Therefore, taxpayer wasn't liable to withhold tax under section 194A.

The Tribunal noted that the taxpayer and NBFCs had entered into separate tripartite service agreements for various services, with specific service fees agreed. Therefore, the Tribunal held that the interest retained in excess of the portion of loan couldn't be considered fees for services rendered under these agreements.

The Tribunal further found no evidence which suggested that NBFCs acted on behalf of the taxpayer in loan transactions as an agent, negating the possibility of categorising the retained interest as 'commission or brokerage'.

The Tribunal ruled in favour of the taxpayer and held that the taxpayer wasn't liable to withhold tax under sections 194A, 194J, or 194H of the Act.

***JMP Insights** – The Tribunal's decision highlighted the importance of in-depth examination of the nature of transactions and agreements between parties to determine tax withholding obligation. The Tribunal focused on the substance of the transaction and went on to analyse its true nature.*

- **UK-based law firm is eligible for the Tax Treaty benefit**

  - Herbert Smith Free LLP vs Deputy Commissioner of Income Tax[5]

The taxpayer is a UK-based Limited Liability Partnership ('LLP') of solicitors, with a majority of its partners being tax residents of the UK. It rendered legal services worldwide, including to its clients in India.

During FY 2013-14, it did not maintain any office in India and rendered legal services to Indian clients through its partners and employees, primarily from outside India (with only occasional visits to India).

As per the UK tax laws, the LLP is treated as a Fiscally Transparent Entity ('FTE') and taxes are recovered from partners in the UK with reference to profits of the LLP.

During the scrutiny for FY 2013-14, the Tax Officer contended that the whole of the receipts from the Indian clients are taxable as Fee for Technical Services ('FTS') under the Act. The Tax Officer was of the view that unless an entity is 'liable' to tax in the UK, it does not fall within the purview of a 'resident' within the meaning of Article 4(1) of the India-UK Double Tax Avoidance Agreement ('DTAA'). Since an LLP is not liable for taxation in UK, it is not eligible for benefits under the DTAA.

Decision of Delhi Tribunal

The facts of the case are identical to those of FY 2011-12 and 2012-13 in taxpayer's own case wherein the Tribunal had held that:

[5] ITA No. 3994/Del/2017

- the taxpayer is entitled to the benefit of India-UK DTAA on the portion of its India sourced income, which is taxed in the UK in the hands of its UK tax resident partners.

- the eligibility of an FTE to avail of the benefits of DTAA is to be affirmed on the basis that the income of the partnership firm has been taxed in the foreign state in the hands of its partners.

- income received by taxpayers from the provision of legal services under Indian engagements does not fall within the meaning of FTS as per Article 13 of the DTAA, since it did not make available inter-alia any technical knowledge, experience, skills, know-how or process. The income received was therefore, taxable as Business income. Since the taxpayer did not have a Permanent Establishment ('PE') in India, no income was taxable in India (Article 5 read with Article 7 of the DTAA).

- Further, the balance portion of the Indian sourced income (i.e., income to the extent of profit share relating to partners who are tax residents of countries other than the UK) be taxed as FTS under the Act.

The Delhi Tribunal observed that under the UK domestic tax laws, LLPs and partners are treated as a taxable unit and appropriation of tax liability amongst the partners is merely a mechanism for levy of tax on the taxable unit. The LLP is liable to tax on its profits in the UK and the recovery of tax is done through its partners.

Therefore, the Tribunal held that as long as the entity's income is taxed in the concerned jurisdiction, either in the hands of partners or the LLP, the relevant DTAA benefits should be available to the taxpayer.

Further, the Tribunal relied on the Mumbai Tribunal ruling in the case of Linklaters LLP, which agreed with a similar approach. In this case, it was discussed that a protocol amending the DTAA was concluded on 30.10.2012, and the effective date was 27.12.2013. The modified Article 4 provides that DTAA benefits apply to income derived by a partnership firm to the extent such income is taxed in the UK in the hands of its partners. Before this amendment, the position was that a partnership that is an FTE is not liable to tax and cannot be a resident for purposes of the DTAA. The decision of the Mumbai Tribunal in the Linklaters case pertained to years before the amendment and indirectly ruled that the amendment is applicable on a retroactive basis. Further, no contrary decision has been produced by the Revenue. The canons of judicial discipline come into play and the decision in the case of Linklaters LLP decision (supra) on this issue could not be ignored.

JMP Insights *– This ruling provides clarity on the tax treatment of income earned by a foreign LLP especially where the LLP is considered to be a fiscally transparent entity.*

- **Mandatory nature of CSR expenditure does not warrant its disallowance under section 80G**

  - Interglobe Technology Quotient Private Limited vs Assistant Commissioner of Income Tax[6]

The taxpayer is a private limited company engaged in the business of export of data processing services. During FY 2019-20, the taxpayer made certain donations and claimed a deduction under section 80G of the Act. The said donations were made towards Corporate Social Responsibility ('CSR') which were suo-moto disallowed by the taxpayer under section 37(1) of the Act.

During the scrutiny for FY 2019-20, the Tax Officer disallowed the claim of deduction under section 80G of the Act. The Tax Officer was of the view that the donations have been made to meet the statutory requirement of the provisions of Companies Act, 2013 and were accordingly not a voluntary donation for which a deduction can be allowed under section 80G of the Act.

On appeal, the Delhi Tribunal highlighted that the Act specifically states that sums donated towards 'Swatch Bharath Kosh' and 'Clean Ganga Fund' spent as a part of CSR are not eligible for a deduction under section 80G of the Act. As a result, only donations to these two specific Funds are not allowed as a deduction under section 80G of the Act, if such payments are made towards the discharge of the CSR obligation of the taxpayer. Donations for the other entries are noticeably unrestricted. The Tribunal observed that the payments covered by section 80G(2) of the Act and paid in accordance with the CSR are not intended to be prohibited by the legislation.

The Tribunal relied on the decision of Mumbai Bench of the Tribunal in the case of *Synergia Lifesciences Pvt Ltd*[7], wherein it was held that the denial of CSR expenditure under Section 37(1) of the Act does not exclude the claim of deduction under Section 80G of the Act. The Tribunal determined that there is no restriction in the Act that expenditure when disallowed for CSR cannot be considered under section 80G of the Act. The Tribunal further observed that CSR expenditure is an application of income and therefore, it continues to form part of the total income of the taxpayer. Further, Section 80G which forms part of Chapter VI A comes into play only after the gross total income has been computed by applying the computation provisions under the Act, including the Explanation 2 to section 37(1) of the Act. Therefore, there is no co-relation between disallowance as per section 37(1) and claim of deduction under section 80G of the Act. The Tribunal further observed that both donations and CSR expenditure by their very nature, are without any reciprocal commitment from the recipient of the donation. Therefore, the Tribunal held that if the taxpayer meets the conditions of section 80G of the Act, it should be entitled to claim deduction under section 80G of the Act for donations made as part of the CSR.

JMP Insights – *This ruling serves to elucidate the criteria for qualifying deductions in respect of donations made to various institutions, including those made as a part of CSR expenditure.*

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[6] ITA No. 95/Del/2024
[7] ITA No. 938/Mum/2023

DID YOU KNOW?

CBDT has issued a Notification 48/2024 amending the Income-tax Rules, 1962 relating to TDS compliance.

The notification modifies Form No. 27Q for TDS on non-resident payments. The form now requires taxpayers to indicate a "P" if a lower rate of tax or no deduction of tax applies under section 197A(1F) of the Act in respect of classes of notified persons. This change is effective 1 July 2024.

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.

JMP Advisors has recently received the following Awards for its outstanding services:

- Tax Expert of the Year Award at The Lawyer International – Legal 100 – 2024 Awards
- Tax Advisory Expert of the Year in India – 2024 by Global Advisory Experts
- Tax Expert of the Year – India at the Corporate America Today – Annual Awards 2024

We are proud to receive these accolades and endeavour to continue providing high quality services to our clients!

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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 also 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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