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 June 2024:

Income tax rulings

- **GAAR - SAAR applicability to be determined on a case-to-case basis**

  - Ayodhya Rami Reddy Alla vs Principal Commissioner of Income Tax[1]

The taxpayer is an individual. Ramky Estate and Farms Limited ('REFL'), an Indian company, issued 7.64 crore equity shares to taxpayer and 5.56 crore equity shares to another group company Oxford Ayyapa Consulting Services Private Limited ('OASCPL') through private placement in February 2019. The taxpayer later purchased those 5.56 crore shares from OASCPL. REFL issued bonus shares in March 2019 in the ratio of 1:5. Subsequently, in March 2019, the taxpayer sold the 5.56 crore equity shares to another group company, Advisory Services Private Limited ('ADR')[2] resulting in a Short Term Capital Loss ('STCL'). The STCL was offset by the taxpayer against Long Term Capital Gains ('LTCG') from another transaction in the Return of Income ('ROI') filed for FY 2018-19.

The Tax Officer ('TO') sought to treat the transaction as an Impermissible Avoidance Arrangement ('IAA') and issued a notice, calling for the objection from the taxpayer.

Concerning the above notice, the taxpayer filed a writ petition with the Telangana High Court ('HC'). The taxpayer argued that the transaction was governed by bonus stripping provisions under Section 94(8) of the Income Tax Act, 1961 ('the Act') and not under GAAR provisions. The taxpayer also referred to the Shome Committee[3] recommendations of not invoking GAAR if SAAR is applicable.

The TO argued that showcause proceedings cannot be challenged by writ jurisdiction without clear jurisdictional issues and the objections should be raised with them. The TO contended that several transactions in a short time period was executed by the individual and group companies, without having necessary funds, suggested tax avoidance. Other transactions of the group companies included inter-corporate deposits and advances write-off, all indicating round-tripping of funds with no commercial substance and intent to evade taxes.

[1] WRIT PETITION NOS. 46510 AND 46467 OF 2022

[2] Funds were provided by OASCPL to ADR

[3] Prior to introduction of GAAR provisions, the Government had constituted an expert committee headed by Dr. Parthasarathi Shome to undertake the consultation with the stakeholders, and finalise the GAAR guidelines and a roadmap for the implementation.

The HC stated that the Supreme Court ('SC') and various High Courts have repeatedly held that specific provisions will prevail when it is enacted after general provisions. However, since that's not the case here, the taxpayer's argument that specific provisions should take precedence was dismissed. The HC held that the GAAR provisions have an overriding effect on other provisions of the Act as they begin with a non-obstante clause. Further, the HC held that the taxpayer's contention that the bonus stripping (i.e., SAAR) provisions should prevail over GAAR was flawed as the taxpayer had himself stated that, for the year under consideration, SAAR did not cover bonus stripping of equity shares. Moreover, the HC observed that the Shome Committee report relates to international transactions, generally not domestic ones.

Basis the evidence and arguments on record, the HC held that the entire arrangement did not have any commercial substance and was executed with the sole purpose of avoiding taxes. Accordingly, the provisions of GAAR are applicable, thereby dismissing the writ petition.

JMP Insights *- The ruling provides some clarity on the applicability of GAAR provisions. However, the facts of the case were such that the HC held that the transaction amounted to a colourable device and that the provisions of GAAR would apply. It is likely that the principles emerging from this ruling in the context of SAAR vs GAAR may come up for discussion before the Supreme Court in coming future.*

- **One-time voluntary payment relating to the Employee Stock Options Plan by the employer is not considered as a perquisite for employee**

  - Sanjay Baweja v. Deputy Commissioner of Income Tax[4]

The taxpayer is an ex-employee of Flipkart Internet Private Limited ('FIPL'), a wholly-owned subsidiary of Flipkart Marketplace Private Limited ('FMPL'). FMPL is the wholly-owned subsidiary of Flipkart Pvt. Ltd., Singapore ('FPS'). During the term of his employment, the FPS had rolled out an Employee Stock Option Plan ('ESOP') called Flipkart Stock Option Plan ('FSOP'), wherein, the FPS granted certain stock options to eligible persons, including employees of its subsidiaries. As per the FSOP, the taxpayer was granted stock options with a vesting period of 4 years. Due to the announcement of the disinvestment of one of its wholly-owned subsidiaries, PhonePe, subsequent actions such as dividends and buy-backs, all resulted in the decline in the value of these stock options. Consequently, the taxpayer received communication from FPS stating his eligibility for a one-time compensation to cover the loss in the value of the stock options held on a particular date. Further, the said compensation will be subject to withholding tax.

Upon receipt of the FPS communication, the taxpayer preferred an application under Section 197 of the Act seeking a NIL withholding certificate for deduction of tax at source by FPS. The taxpayer submitted that the payment from FPS does not constitute income under Section 2(24) of the Act and he would report it as exempt in his ROI. The TO passed the order rejecting the taxpayer's application stating that the amount received would be considered as a perquisite

[4] W.P. (C) NO. 11155 OF 2023

under Section 17(2)(vi) of the Act under the head Salaries and hence taxable under Section 192 of the Act.

The taxpayer preferred a writ petition before the Delhi HC. The taxpayer argued that ESOPs are taxable only in two contingencies –

i) when the employee exercises his option; and
ii) when the shares are sold by an employee

In the taxpayer's case, the stock options were held by him and were not exercised. Further, the one-time voluntary payment made by FPS was not linked to employment with FIPL and hence, cannot be considered taxable under the head Salaries. The HC observed that the compensation was one-time voluntary payment made by FPS to all option holders in lieu of the disinvestment of PhonePe business. It was not related to the exercise of options by the taxpayer. Further, the HC also observed that as per Explanation (c) to Section 17(2)(vi) of the Act, the value of stock options to be considered as perquisite is dependent upon the exercise of options. The compensation was a voluntary payment and not for transfer by way of any obligation as the taxpayer had not exercised his right under FSOP. In light of the above observations, the HC set aside the order of the TO rejecting the NIL WHT application of the tax payer.

JMP Insights - *This ruling underscores the distinction between voluntary payments and employment-linked perquisites on stock options. This ruling also highlights that the manner or nature of payment would not determine the taxability of such transaction.*

- **Income earned as Guarantee charges taxable as other income under Article 23(3) of India - UK DTAA**

  - Johnson Matthey Public Limited Company vs Commissioner of Income Tax, International Taxation[5]

The taxpayer is a company engaged in the business of manufacturing speciality chemicals and is a tax resident of the United Kingdom. The taxpayer has several subsidiaries across the world including in India. The India subsidiaries are Johnson Matthey India Private Limited and Johnson Matthey Chemicals India Private Limited. The Indian subsidiaries had availed credit facilities from overseas branches of foreign banks. The taxpayer received guarantee charges of INR 1.49 crore from Indian subsidiaries for the guarantee provided in respect of credit facilities extended by banks to those subsidiaries. The said charges were received by the taxpayer as per the terms entered with those subsidiaries under the Intra Group Agreement ('IGA').

The taxpayer regarded this amount to be taxable as interest under Article 12 of the India-UK Double Taxation Avoidance Agreement ('DTAA'). During the assessment proceedings, the TO determined the guarantee charges as liable to be taxed under Article 23(3) of the DTAA as 'other income'. The Dispute Resolution Panel confirmed the order of the TO.

[5] IT APPEAL 727 of 2018

The taxpayer filed an appeal with the Delhi Tribunal ('Tribunal'). The Tribunal stressed the importance of considering the context of payments to determine if they qualify as interest for tax purposes. The term "interest" should be viewed in the context of loan transactions, with payments related to the parties involved in the agreement. The Tribunal held that guarantee charges, accrued to the taxpayer in India due to loan transactions occurring in India. It also held that guarantee charges did not constitute business income under the DTAA, considering the purpose of the IGA. Therefore, the Tribunal upheld that these charges were liable to be taxed as 'other income' under Article 23(3) of the DTAA.

The taxpayer further appealed to the Delhi HC. The taxpayer argued that guarantee charges were payment for bearing the risk of default by the Indian subsidiaries. The risk was borne by the taxpayer outside India, making the income exempt under Section 5(2) of the Act. It was further contended that the guarantee charges received would also not be taxable under Explanation 1(a) of Section 9(1)(i) of the Act. The HC held that the taxpayer received guarantee charges for providing assurances to its Indian subsidiaries, not as interest since the taxpayer was not a party to the loan agreement. The IGA did not permit claims against the subsidiaries.

The HC placed reliance on the SC judgements[6] and emphasized that accrual of income does not require actual receipt, but rather the existence of a right to receive it. This principle was clarified by referencing the meanings of "accrue" and "arise" as distinct from "receive". The fact that guarantee charges may be used to meet liabilities to overseas financial institutions is irrelevant in determining whether income has accrued in India. In light of the above, the HC concluded that the guarantee charges, based on the IGA, determined the right to receive the charges. Whether these charges could be considered business income under the tax treaty was left open as the question was not framed by the taxpayer.

JMP Insights *- This ruling highlights the importance of careful consideration of the nature of cross-border transactions and the specific clauses of relevant tax treaties. This ruling also emphasises that the focus is on whether income has arisen or accrued.*

- **Disallowance under section 40(a)(i) is unwarranted if amended provisions, although retrospective, were not in place at the time of making payment**

  - Titan Company Ltd. vs The Assistant Commissioner of Income Tax, Circle III (2), Chennai[7]

Titan Company Ltd. ('taxpayer'), a domestic company, engaged in the business of manufacturing, trading and servicing of watches, jewellery and clocks.

During FY 2008-09, FY 2010-11 and FY 2011-12[8], the taxpayer availed professional and consultancy services from various foreign parties for its operations in the United States ('US')

[6] E.D.Sasson & Co. Ltd. vs CIT [1954] 26 ITR 27 (SC), Seth Pushalal Mansinghka (P.) Ltd vs. CIT [1967 SCC OnLine SC 222], Tuticorin Alkali Chemicals & Fertilizers Ltd. v. CIT (1997) 6 SCC 117

[7] ITA Nos.: 518, 505, 506 & 507/CHNY/2018

[8] The ruling includes other issues but we have discussed only the critical issue of disallowance under Section 40(a)(i) of the Act.

and the United Kingdom ('UK'). The taxpayer incurred foreign currency expenses for professional and consultancy services without deducting tax under Section 195 of the Act') as the services were provided for US/UK operations and not in India. The TO considered these specialized technical services as originating from India, leading to the disallowance of payments to non-resident consultancy firms under Section 40(a)(i) of the Act.

The taxpayer filed an appeal with the Commissioner of Income-tax Appeals [CIT(A)] wherein CIT(A) upheld the decision of the TO, classifying the services as fees for technical services ('FTS') taxable in India.

The taxpayer filed an appeal before the Chennai Tribunal ('Tribunal'). The taxpayer stated that the services were used outside India, so no income taxable in India accrued to non-residents. Hence, the disallowance under Section 40(a)(i) was unwarranted as the payments were not taxable under the India-US/India-UK DTAA. The Tribunal observed that Finance Act, 2010 substituted Explanation to section 9(2) of the Act to specifically provide that the services are not required to be rendered in India. The Tribunal further noted that though the amendment was made with retrospective effect from 01.06.1976, it is a settled legal position that taxpayer cannot be made liable for non-deduction of tax at source when the provisions requiring tax deduction were not on the statute book when the payment was made. Further, the Tribunal observed that the services did not satisfy the "make available" test under the India-US/India-UK DTAA. Accordingly, the Tribunal held that the taxpayer is not required to deduct taxes on payments made to foreign parties for services rendered outside India for FY 2008-09. For FY 2010-11 and FY 2011-12, further examination was needed in light of the amendment brought out in Explanation to Section 9(2) of the Act, and the matter was restored to the TO.

JMP Insights - *The ruling underscores the importance of adhering to tax regulations and fulfilling tax deduction obligations to avoid potential disallowances. Taxpayers should exercise due diligence in assessing the applicability of requirements to deduct taxes based on the source of income and the nature of services provided.*

DID YOU KNOW?

India and USA have agreed to extend the Transitional Approach on Equalisation Levy ('EL') on e-commerce supply of services until 30 June 2024, in line with the approach adopted between USA and five countries.

In October 2021, India and USA, along with 134 other OECD/G20 members, reached an agreement on a two-pillar solution to tax challenges from digitalization of the economy.

Under a transitional approach, effective 1 April 2020, India is levying an EL of 2% on amounts received/receivable by a non-resident e-commerce operator from e-commerce supply of services. This approach was to continue until March 2024 or till the implementation of Pillar One whichever is earlier.

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 below award:

- Tax Expert of the Year in India – Advisory Excellence Annual 2024 Award.

We are proud to receive this accolade and endeavor 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.

JMP Advisors has been consistently recognized as a leading Tax firm in India, *inter alia,* in the International Tax Review (Euromoney) World Tax Directory for all successive years since incorporation, including the 2024 Directory.