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 March 2023:

Income tax rulings

➢ Loss on sale of non-performing NCDs by the AMC allowable business loss

- Deutsche Asset Management India P. Ltd v Asst CIT[1]

The taxpayer is a SEBI registered Asset Management Company ('AMC') for Deutsche Mutual Fund ('Fund') from October 2002 and acts as an investment manager to the Fund.

For FY 2010-11, the tax officer made the following adjustments to the income offered to tax in the return of income namely:

i. Disallowance of business loss on sale of investments and treating it as a Short-Term Capital Loss;
ii. Addition to income on account of reversal of stale cheque liabilities; and
iii. Disallowance of expenses due to non-deduction of withholding tax.

Disallowance of business loss

The taxpayer is the asset manager for all the schemes of Deutsche Mutual Fund ('DMF') and was managing one such scheme of 'DWS Money Plus Fund', which had made an investment in the unsecured Non-Convertible Debentures ('NCDs') of Vishal Retail Ltd. The investment in NCDs turned into a Non Performing Asset ('NPA') as per the SEBI Circular dated 18 September 2000 due to a default on the part of the issuer company. During the tax year, the taxpayer purchased the NCDs from DMF at their book value for INR 228.10 million and sold the same to TPG Group at INR 200 million. The taxpayer claimed the resultant loss as its business loss. However, the Revenue alleged it to be a short term capital loss as the purchase of NCDs from DMF was shown by the taxpayer as investment.

The Tribunal held that since DMF was a money market oriented fund, negative returns from the non-performing NCDs would have adverse consequences on the AMC as well. The AMC is considered responsible for the nature and type of investments made by the Fund. Any non-performing investments reflect on the capabilities and obligations of the AMC. The Tribunal relied on the Supreme Court ('SC') ruling in case of *Birla Cotton Spinning and Weaving Ltd*[2] wherein it was held that expenses incurred for the preservation and protection of the taxpayer's business were allowed as revenue

[1] I.T.A No 2599/Mum/2017 (Mumbai Tribunal)
[2] CIT v Birla Cotton Spinning and Weaving Ltd 82 ITR 166

expenditure. Merely, disclosing the NCDs under the head of investments does not lead to a conclusive decision that any loss of sale of investment is purely a capital loss.

Stale cheque liabilities

The Commissioner of Income Tax (Appeals) had partially allowed the deduction of expenditure and added the liability to the income of the year under section 41(1) of the Income-tax Act, 1961 ('the Act') on the ground that since the liability was standing in the books for more than 5 years, it is not free from doubt as to its genuineness. The Tribunal, however, deleted the addition of liability to the income since the taxpayer established that the amount was offered to tax in the subsequent year 2016-17.

Disallowance of expenses in absence of withholding of tax

The Tribunal held that brokerage paid on securities are outside the scope of section 194H of the Act by virtue of explanation (i) and therefore not subject to withholding tax. For non-deduction of tax on expenses claimed to be reimbursements, the Tribunal directed the taxpayer to file the details of such expenditure before the tax officer to determine the nature of expenses as reimbursements or otherwise.

JMP Insights *– The Tribunal has relied on the SC ruling in case of Birla Cotton stating that decisions taken for commercial consideration and business exigency cannot be held to be not for business purposes. Further, disclosing the purchase of NCDs under investments does not lead to a conclusive decision that any loss of sale of NCDs is purely on capital account. There are contrary decisions treating such losses as capital losses and not as business losses.*

- **Receipt of listed equity shares of an Indian company as a gift neither taxable as business income nor as income from other sources**

  - Direct Media Distribution Ventures Pvt Ltd.[3]

Issue 1: -

As a part of corporate restructuring, the taxpayer, an unlisted Indian company had received equity shares of an Indian group company which was listed on a recognized stock exchange in India from another group company as a gift. The tax officer was of the view that the same is taxable as income from other sources. Alternatively, the same can also be taxed as business income.

Held 1: -

The Mumbai Tribunal observed that receipt of equity shares by way of gift represents a capital receipt in the hands of the taxpayer. A capital receipt cannot be taxed unless there are specific provisions to tax such kind of receipts. Section 56(2)(viia) of the Act taxes an unlisted Indian company for receiving equity shares of an unlisted Indian company without

[3] ITA No. 2715/Mum/2018 & ITA No. 3084/Mum/2018

any consideration or by way of gift. In the instant case, since the equity shares are received as gift are of a listed Indian company, the provisions of section 56(2)(viia) of the Act are not applicable. Section 56(2)(x) of the Act taxes an unlisted Indian company for receiving equity shares of even a listed Indian company if the same are received by way of gift. Section 56(2)(x) however is applicable from 1 April 2017 i.e. the year 2017-18 and onwards but the relevant year in question is the year 2011-12 and hence the rigors of section 56(2)(x) won't apply to the facts of the instant case. Section 28(iv) of the Act taxes the value of any benefit or perquisite only if the same arises from business or exercise of profession. The equity shares received as gift do not arise out of business dealing and accordingly, such a receipt cannot be taxed as business income in the hands of the taxpayer as per section 28(iv) of the Act.

Issue 2: -

The taxpayer had issued equity shares to its holding company at a premium. The tax officer alleging that the same transaction is unexplained cash credit under section 68 of the Act and accordingly made an addition to the total income of the taxpayer.

Further, the tax officer also alleged that the premium charged is not justified as the company has negative earnings per share and losses and hence the price at which the shares are issued does not corresponds to the fair value of the shares and hence the provisions of section 56(2)(viib) of the Act gets attracted.

Held 2: -

Section 56(2)(viib) of the Act taxes an unlisted company if it issues its shares at a price which is higher than the fair market value i.e. the difference between the issue price and the fair market value is taxable as income from other sources in the hands of such unlisted company. However, section 56(2)(viib) of the Act was brought in statute from FY 2012-13 and hence the same is not relevant in the instant case as the relevant FY in the given case is FY 2011-12.

The Mumbai Tribunal noted that the taxpayer had proved beyond doubt as to the identity of the subscriber of the shares, creditworthiness of the subscriber of shares and the genuineness of the transaction and therefore, the Mumbai Tribunal deleted the addition of unexplained cash credit under section 68 of the Act.

***JMP Insights** – This judgement highlights that the law as on the date of the transaction needs to be read into and any subsequent amendment in law cannot alter the taxability of the taxpayer.*

- **Determination of controlling interest is required in case of transfer of controlling stake between two associated enterprises**

  - Palmer Investment Group Ltd.[4]

The taxpayer, a British Virgin Island ('BVI') resident company and a wholly owned subsidiary of a listed company in India ('I Co'). The taxpayer owned certain equity shares of I Co. The taxpayer along with other group companies of I Co entered into a Share Purchase Agreement ('SPA') with a Netherlands based company ('N Co') which was signed on 9 November 2012. Subsequent, to signing of the SPA, N Co acquired certain shares of I Co from the Indian stock exchanges thereby acquiring N Co controlling stake in I Co i.e. more than 26% of the voting power of I Co.

Section 92A(2)(a) of the Income-tax Act, 1961 ('the Act') states that two enterprises shall be deemed to be associated enterprises ('AEs') <u>if, at any time during the year, one enterprise holds, directly or indirectly</u>, shares carrying not less than 26% of the voting power in the other enterprise.

The Bangalore Tribunal held that N Co and I Co are AEs, since during the relevant year, N Co hold more than 26% shares of I Co. As the taxpayer was a wholly owned subsidiary of I Co, AE of I Co is also the AE of the taxpayer. Therefore, it was held that the transfer pricing provisions are applicable in the given facts of the case.

The Bangalore Tribunal noted certain clauses of SPA which gave the intent of N Co to acquire a controlling stake in I Co. Further, taxpayer and other group companies of I Co would transfer their stake in I Co to N Co. N Co is purchasing shares as a going concern and it is not a case of mere investment by N Co in shares of I Co. The Bangalore Tribunal held that where controlling stake is sold, addition on account of control premium is justified by relying upon the Mumbai Tribunal decision in case of Lanxess India (P.) Ltd[5].

The taxpayer had made an open offer to comply with the Substantial Acquisition of Shares and Takeovers Regulations as required by the Capital Market Regulator in India. The taxpayer argued that the open offer price should be considered as the arm's length price which was dismissed by the Bangalore Tribunal wherein it held that the Regulations do not regulate the price to be negotiated between the buyer and seller of shares. The open offer price is only to safeguard the interest of general shareholders. Hence, the open offer price cannot be regarded as the arm's length price. The transfer pricing officer adopted the discounted cash flow method and arrive at a transfer price which appears to be reasonable since if controlling premium of 30% to 50% (as recommended by Phillip Sounders Jr PHD report) is added to the transfer price, then the price as arrived will be within the range of the transfer price as computed by the transfer pricing officer and hence the Bangalore Tribunal held that no interference is called for as regards the transfer price as computed by the transfer pricing officer.

[4] ITA No. 2929/Bang/2018 & ITA No. 2930/Bang/2018
[5] (2013) 36 taxmann.com 350 (Mum-Trib)

The taxpayer argued that the price at which the taxpayer has sold the shares of I Co to N Co is the same price at which the other group companies sold the shares of I Co to N Co which is accepted by the transfer pricing officer. Therefore, the price at which the taxpayer transferred the shares of I Co also should be accepted by considering it to be an independent or uncontrolled transaction. The SPA was entered into between the Trustees of I Co Benefit Trust and certain subsidiaries of I Co including the taxpayer with N Co to transfer their investment in shares of I Co. It was one agreement and thus price at which other group companies sold their shares of I Co to N Co cannot be considered to be the arm's length price entered between independent parties. For this, reliance was placed upon the Chennai Tribunal decision in case of Ascendas India P Ltd[6] wherein it has been held that transactions between independent parties ordinally is not effected through one agreement and the price at which shares have been transferred was based on a single agreement and therefore one part of that agreement would be an uncontrolled transaction, for comparing it with the other part, is not tenable.

The SPA was entered into for transfer of 25.1% of shares of I Co. If non-AEs had entered into a similar arrangement, they would not have agreed to transfer the shares at the market price as prevailing on the date of transaction in the Indian stock exchanges as here transfer of control is also involved. The Bangalore Tribunal held that the action of the transfer pricing officer making the addition to the transfer price was justified and the contention of the taxpayer was dismissed.

JMP Insights *– This judgement highlights several important principles. Firstly, the mechanics for a transaction plays an important role. In this peculiar case, the transaction between unrelated parties was deemed to be transactions between AEs since I Co and N Co became AEs and since the taxpayer was wholly owned subsidiary of I Co, it became AE of N Co. In normal parlance, taxpayer and N Co were not related until the controlling stake was acquired in I Co. Secondly, the arm's length price is different from fair market value of shares listed on Indian stock exchanges. Where there is a transfer of controlling stake, control premium needs to be factored in while computing the arm's length price as transfer of shares held as investor is different than transfer of shares held as a controller since in the latter not only shares are parted but the control is also parted with the buyer. Therefore, a reasonable consideration for transfer of control apart from the market price that needs to be added for the transfer of shares.*

[6] [2013] 33 taxmann.com 295

- **Tax recovery in absence of specific findings on director's negligence or misfeasance, not sustainable**

  - Geeta P Kamat (Writ petition No 3159 of 2019)[7]

Section 179 of the Act, inter-alia, envisages that the where any tax demand from a private company in respect of any income of any previous year cannot be recovered then every person who was a director of the private company at any time during the relevant previous year shall be jointly and severally liable for the payment of such tax unless he proves that the non-recovery cannot be attributed to any gross neglect, misfeasance or breach of duty on his part in relation to the affairs of the company.

The taxpayer was a director of a private limited company. Since the private limited company of which she was a managing director was not traceable at the available address and bank accounts attached were not sufficient to recover the tax dues, the tax officer issued a notice to the taxpayer under section 179 of the Act, seeking to recover tax dues in her capacity as a director of the company. Based on the minutes of the company's Board meetings, the tax officer treated the taxpayer to be a working director of the company bestowed with many important responsibilities in order to run day-to-day affairs of the company.

The Bombay HC relied on the decision in the case of *Maganbhai Hansrajbhai Patel*[8] *and Ram Prakash Singeshwar Rungta & Ors.*[9], wherein it was held that no order could have been made under section 179(1) of the Act for recovering the dues from the director in absence of any findings that non-recovery of tax due from the company can be attributable to any gross-negligence on the part of the director-petitioner. The Bombay HC further observed that the material put on record by the taxpayer clearly suggested the lack of financial control and lack of decision-making powers of the taxpayer. As the taxpayer had a very limited role to play in the company which sufficiently discharged the burden cast upon her in terms of section 179, the Bombay HC absolved her of the liability of the company.

JMP Insights *– Once the petitioner has discharged the initial burden under section 179, it is Revenue's responsibility to show as to how a gross neglect, misfeasance or breach of duty would be attributable to the petitioner. As the tax department failed to establish such gross neglect, misfeasance or breach of duty by the taxpayer, the Bombay HC ruled in the taxpayer's favour.*

[7] Geeta P Kamat [TS-75-HC-2023(BOM)]

[8] [2013] 353 ITR 567 (Guj.)

[9] [2015] 370 ITR 641 (Guj)

Circular

- **Consequences of PAN becoming inoperative as per the newly substituted Rule 114AAA**

  The Central Board of Direct Taxes ('CBDT'), vide Circular No. 03 of 2023 dated 28 March 2023, has hereby clarified that any person who fails to intimate the Aadhar Number in accordance with section 139AA read with rule 114AAA shall face the following consequences as a result of PAN becoming inoperative:

  - Refund of any tax under the Income Tax Act shall not be made due to him.
  - Interest shall not be payable on any refund due to the taxpayer until the PAN becomes operative.
  - Tax shall be deducted at source at such higher rates under Section 206AA.
  - Tax shall be collected at source at such higher rates under section 206CC.

  These consequences shall take effect from 1 July 2023 and continue till PAN becomes operative. A fee of INR 1,000 shall continue to apply to make the PAN operative.

  The above consequences shall not be applicable to persons exempt from intimating Aadhar Number under the Act.

DID YOU KNOW?

- SEBI had issued a circular prescribing the requirements for nomination/opting out of nomination for individual MF unitholders by 31 March 2023 failing which folios shall be frozen for debits. Based on representations received from market participants, SEBI issued a circular on 28 March 2023 postponing the provisions regarding freezing of folios with effect from 30 September 2023.

- The CBDT vide a notification has extended the relaxation given to non-residents not having a PAN and not required to have a PAN from statutory compliance of filing electronic form 10F to claim the treaty benefits from 31 March 2023 to 30 September 2023.

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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