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 October 2023:

Income tax rulings

- **Mere existence of MFN clause in the treaty is not sufficient to avail benefit of lower rate or scope of withholding tax**

  - Nestle SA[1] vs. AO, New Delhi (Supreme Court)

The taxpayer, a Swiss based multinational company had deducted tax at a lower rate on dividend payments made to its shareholders by availing the benefit of Most-Favoured Nation ('MFN') clause existing in the treaty signed between India ('India / contracting state') and Switzerland ('other state').

Before the Honourable Supreme Court ('SC'), the taxpayer relied on the Delhi High Court ('HC') ruling in the case of Steria India[2] and Concentrix Services[3] wherein it was held that when a treaty is notified, the protocol, which is an integral part of that treaty, automatically gets operationalised. Further, it held that where the protocol contains an MFN clause, there is no point for a separate notification to incorporate the beneficial provisions of the treaties signed with the third state. As regards the time of applicability of MFN clause, the Delhi HC held that the benefit of the MFN clause can be applied to treaties entered into by India and third states which are members of Organisation for Economic Co-operation and Development ('OECD') as on date of applying the MFN clause, even though such third states were not members of the OECD at the time of entering into treaty with India.

The two important issues for discussion before the SC were -

- Whether the MFN clause in the treaties was to be interpreted in a manner to allow restrictions on tax rates and scopes of income agreed between India and third state before it become a member of OECD.

- Whether the benefit of the restricted rate or restricted scope would automatically be available by the virtue of the MFN clause being present as part of the treaty.

On the first issue, the SC held that the third state should be a member of OECD on the date of the treaty entering into force with India and not on any subsequent date.

On the second issue, the SC observed based on detailed discussion and as per past practice followed by the CBDT for implementation of the MFN clause, that the benefit of a more restrictive tax rate or restricted scope in the treaty with a third state would be available via the MFN clause only if it were specifically notified by the Central Government. Therefore, a more restrictive tax rate or restricted scope of income in a treaty with a third state would not be automatically available to the contracting state.

[1] Civil Appeal No.1420/2023
[2] 72 taxmann.com 1/Delhi/2016
[3] 127 taxmann.com 43/Delhi/2021

JMP Insights - *The above judgement signifies the importance of a notification under section 90(1) of the Income tax Act, 1961 ('the Act') in the implementation of a treaty and its Protocol. This could potentially give rise to a significant tax demand together with interest on the taxpayers who had offered income to tax on the basis of lower rate of a tax or a restricted scope pursuant to the MFN clause.*

It is important to note that in the absence of an appropriate notification in relation to changes that are triggered pursuant to the MFN clause in the treaties, the benefit of the MFN clause may not be available to non-resident taxpayers. This may lead to unfavourable consequences in the area of foreign investments and may be possibly regarded as not fulfilling treaty obligations by India.

- **SC holds variable component of license fee payable by telecom operators as 'capital in nature'**

  - CIT Delhi vs. Bharti Hexacom Ltd[4] (SC)

The taxpayer was engaged in the business of establishing, maintaining and operating telecommunication services and had procured licenses in different telecom circles. The license agreement was executed in 1994.

Subsequently, the National Telecom Policy of 1994 was substituted by the New Telecom Policy of 1999, wherein, the existing operators were required to pay a one time entry fee and additionally, a variable license fee each year computed as a percentage share of Annual Gross Revenue.

The taxpayer, in the Return of Income filed for Assessment Year ('AY') 2003-04, claimed the variable license fee amount as revenue expenditure. However, the tax officer held the same to be capital in nature and to be amortised over the license period in accordance with section 35ABB of the Act.

The Delhi HC, while passing its judgement divided the license fee into 2 periods, i.e., license fees paid at the time of entry to be capital in nature and the variable component payable to be revenue in nature.

In passing its judgement, the SC observed the various tests laid down by SC from time to time for classification of expenses into revenue or capital in nature.

- In case of Empire Jute Co.[5] the SC interpreted capital expenditure to bring into existence an asset for the enduring benefit of the trade.

- In case of Assam Bengal Cement[6], the SC held that where expenditure is made for initial outlay or extension of business or substantial replacement of equipment, it would be capital in nature.

- In case of Alembic Chemical Work[7], it was held that each case is to be judged in the context of business necessity or expediency. Where the subsequent payments are towards a purpose which is identifiably distinct from the original obligation of the taxpayer, the same would constitute revenue expenditure. However, where each of the successive

[4] CIVIL APPEAL NO(S). 11128 OF 2016 (SC)
[5] Empire Jute Co. vs. CIT, [1980] 124 ITR 1 (SC)
[6] Assam Bengal Cement Co. Ltd. vs. CIT, [1955] 27 ITR 34 (SC)
[7] Alembic Chemical Works Co. Ltd vs. CIT (1989) 3 SCC 329 (SC)

instalments relate to the same obligation or purpose, the cumulative expenditure would be capital in nature.

Payment towards royalty distinguished by SC

The SC differentiated the variable license fee vis-à-vis payment for royalty. It observed that:

- Acquisition of a right would mean purchase of an asset for an enduring advantage of the purchaser, meaning thereby that the ownership of the said rights vests with the purchaser.

- On the other hand, payment of royalty is to use the right or asset for a stipulated duration. It is only the 'right to use' that is obtained by the taxpayer. The right or the asset continues to vest with the owner of such right or asset.

The SC distinguished the various case laws relied by the taxpayer and has affirmed that in order to qualify as royalty, the payments must not have a nexus with the acquisition of a capital asset.

The SC held that the nature of two payments would be distinct only when the periodic payments have no nexus with the original obligation of the taxpayer. In the present case, the variable license fee paid relates to the same obligation i.e., payment as consideration for right to establish, maintain and operate telecommunication services as a whole. Hence, the cumulative expenditure would have to be held to be capital in nature.

JMP Insights *– The classification of expense between revenue and capital has to be considered in relation to the facts of each case and the true nature of the payment has to be ascertained considering the nature of the original obligation.*

The expenditure incurred needs to be characterised in the context of business necessity or expediency. What is relevant is the nature of the obligation and whether successive payments made in instalments have nexus with the original obligation of the taxpayer. In the present case, each of the successive payments relate to the same obligation, and accordingly, should be classified as capital in nature.

Further, the nature of payment being made for the same purpose cannot have a different characterization merely because of change in the manner or measure of payment. The nomenclature and manner of payment is irrelevant. Where the payment is intrinsic to the existence of the license as well as trade itself, it should be characterized as capital in nature.

This decision by the Supreme Court may have wider ramifications and could be applied in other situations as well.

- **Angel tax provisions not applicable to issuance of rights shares in proportion to existing shareholding and renunciation of right shares by relatives**

  - PCIT vs Jigar Jashwantlal Shah[8], (Gujarat HC)

The taxpayer, a resident individual, was a director in a private limited company. The said company issued right shares and the taxpayer was allotted 200,000 right shares –

[8] R/Tax Appeal No.80/2023, R/Tax Appeal No.96/2023

- 1,03,000 shares in proportion to his existing shareholding in the company;
- 82,200 shares from renunciation of right shares by relatives; and
- 14,800 shares from renunciation of right shares by unrelated third party.

All the aforesaid shares were allotted at a face value of INR 10 per share.

The tax officer initiated reassessment proceedings and computed Fair Market Value ('FMV') of the shares which exceeds the amount of consideration paid by the taxpayer, for receipt of shares and accordingly, made an addition of the differential amount under section 56(2)(vii)(c) of the Act in the hands of the taxpayer under the head 'Income from other sources'.

The Ahmedabad Tribunal passed the judgement partly in favour of the taxpayer. The Gujarat HC affirmed the Tribunal ruling and concluded as under;

- Section 56(2)(vii)(c) of the Act cannot be invoked in case of allotment of 1,03,000 right shares allotted to the taxpayer in proportion to his existing shareholding in the company. It cannot be said that the taxpayer has "received shares from any person" as there was no transfer of shares which pre-existed prior to issuance of shares by the company. This is a transaction of creation of shares. There is a vital difference between 'creation' and 'transfer of shares'. The words 'allotment of shares' indicate creation of shares by appropriation out of the unappropriated share capital to a particular person who has the right to choose for such allotment.

- In case of renunciation of right shares by relatives, the shares were not 'received from any person', which is the fundamental requirement for invoking section 56(2)(vii)(c) of the Act. Further, as per the Explanatory notes to the Finance Bill, 2010[9], section 56(2)(vii)(c) of the Act ought to be applied only in case of transfer and not creation of shares.

- As regards 82,200 shares allotted to the taxpayer by renunciation of rights shares by the relatives, it would not be covered under the provisions of section 56(2)(vii)(c) of the Act on the basis that 'relatives' are specifically exempted under the section.

- About the 14,800 shares allotted to the taxpayer as a result of third party shareholder declining to apply for right shares, the HC concluded that this transaction was covered under section 56(2)(vii)(c) of the Act because this leads to disproportionate allocation of shares in favour of the taxpayer.

JMP Insights – *The above judgement emphasized the distinction between the 'issue/creation of shares' and 'received from any person'. The HC held that on the issue of right shares there is no pre-existing asset which is being transferred to apply the provisions of section* 56(2)(vii)(c) of the Act.

It is pertinent to note that the language of section 56(2)(vii)(c) of the Act and section 56(2)(x)(c) of the Act are quite similar and therefore this decision can be helpful while interpreting section 56(2)(x)(c) of the Act vis-a vis issue of right shares.

[9] F.No.142/1/2011-SO(TPL)

- **Mauritian entity allowed to carry-forward LTCL along with treaty exemption for STCG**

  - Indium IV (Mauritius) Holdings Limited[10] v DCIT (International transaction)

The taxpayer, a tax resident of Mauritius was engaged in investment activities in India. During the AY 2017-18, it had earned gains and incurred losses on account of the alienation of shares of various Indian companies.

The taxpayer claimed Short Term Capital Gains ('STCG') as exempt from tax in India in accordance with Article 13(4) of India Mauritius treaty and claimed carry forward of Long Term Capital Gains ('LTCL') accrued on alienation of certain shares under Section 74(1) of the Act.

The tax officer observed that the basic nature of both the transactions is same i.e., gains/loss on sale of equity shares. Further, relying on the judgement of SC in case of Harprasad & Co (P) Ltd[11], the tax officer ruled that the word 'gains' would also include 'losses'. Therefore, the taxpayer assessed that where the taxpayer had chosen to be governed by the treaty, all the incomes and losses arising out of sale of equity shares shall be governed by Article 13 of the India Mauritius treaty and domestic tax provisions will not apply.

The Tribunal made the following observations –

i. As per section 90(2) of the Act, the taxpayer is eligible to apply the provisions of the Act or the treaty whichever is more beneficial to it. As per Article 13(2) of the India Mauritius treaty, gains derived by a resident of Mauritius from the alienation of shares shall be taxable only in Mauritius.

ii. There are separate tax provisions prescribed in the Act for taxing gains on long term and short term capital assets. Accordingly, the scheme of Act itself recognizes STCG/STCL and LTCG/LTCL to be separate and distinct sources of income.

iii. Further, carry forward of losses incurred on short term and long term capital assets are also governed in a separate manner, allowing set off of LTCL against LTCG only. It can be seen that Legislature itself has recognized LTCL and STCL to be distinct sources.

iv. The Tribunal relied on the judgement of Bangalore Tribunal in case of IBM World Trade Corporation[12], wherein it was held that in case of multiple sources of income, taxpayer in entitled to adopt provisions of the Act for one source of income while applying provisions of Treaty for the other source.

Therefore, the taxpayer was allowed to claim beneficial provisions of the India Mauritius DTAA in respect of STCG and carry forward the LTCG as per section 74 of the Act.

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[10] ITA NO.2423/MUM/2022

[11] CIT v. Harprasad& Co. (P.) Ltd. [1975] 99 ITR 118 (SC)

[12] IBM World Trade Corpn. v. DDIT (IT) [2012] 20 taxmann.com 728 (Bangalore).

***JMP Insights** – The Tribunal ruling highlights the fact that where the Act clearly distinguishes between gains and losses on short term and long term capital assets, every transaction is required to be considered as a separate source of income.*

The Special bench of the Mumbai Tribunal in case of Montgomery Emerging Market Fund[13] has held that long term capital gains and short term capital gains are separate sources of income and merely clubbing of such income under the same head does not obliterate their identity as separate sources.

DID YOU KNOW?

The Ministry of Corporate Affairs vide Notification dated 9 November 2023 published Limited Liability Partnership (Significant Beneficial Owner) Rules, 2023 ('SBO Rules').

The SBO Rules are intended to tighten the framework around reporting of SBOs for LLPs.

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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[13] JCIT v. Montgomery Emerging Markets Fund [2006] 100 ITD 217 (Mumbai) (SB)