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 September 2023:

Income tax rulings

- **Purchase of own shares by a company through Court approved scheme is liable for DDT**

  - Cognizant Technology -Solutions India Pvt. Ltd[1] vs. ACIT, LTU-1, Chennai

The taxpayer is a private limited company engaged in the business of software development and related services/solutions. The taxpayer had purchased its own shares from non-resident shareholders in a 'Scheme of Arrangement and Compromise' sanctioned by the Madras High Court in terms of provisions of Sec 391-393 of the Companies Act, 1956.

The taxpayer deducted tax on the consideration paid to non-resident shareholders of the USA since as per the India-USA DTAA, capital gains was chargeable to tax in India. However, no tax was deducted on the consideration paid to Cognizant (Mauritius) Ltd as capital gain was not chargeable to tax in the hands of Mauritius shareholders in India under the India-Mauritius DTAA.

The tax officer held that the purchase of own shares through the scheme of arrangement and compromise is not a buyback under section 77A and thus, section 46A of Income Tax Act, 1961 ('the Act') will not apply. Further, the consideration paid by the taxpayer fell within the ambit of dividend under section 2(22)(a)/(d) and accordingly, the taxpayer was liable to pay Dividend Distribution Tax ('DDT') under section 115-O of the Act.

The Chennai Tribunal held that the scheme is a colourable device intended to evade legitimate tax dues and that the transaction lacks genuine commercial purpose. The Tribunal observed that the taxpayer had bought back equity shares from its shareholders pursuant to the Scheme in a hurried manner considering the amendment to section 115QA[2] of the Act which was to be effective from 1st June 2016.

Further, the Tribunal held that the purchase of its own shares through a scheme of arrangement and compromise is not a buyback under Sec 77A of the Companies Act, 1956

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[1] ITA No.269/Chennai/2022

[2] The Finance Bill, 2016 proposed an amendment to Section 115QA with effect from 1st June 2016 to provide that the provisions of Sec 115QA shall apply to any buy-back of unlisted shares undertaken by the company in accordance with the provisions of the law relating to Companies and not necessarily restricted to Sec 77A of the Companies Act, 1956.

since it exceeds the limit of 25% of total paid up equity capital and therefore Sec 46A of the Act will not be applicable. Thus, the transaction of purchase of own shares by the company is the distribution of accumulated profits within the meaning of section 2(22)(a)/2(22)(d) and consequently liable to DDT under Sec 115-O of the Act.

JMP Insights - *On the basis of the above judgement, it is important to note that companies contemplating any restructuring through a scheme of buyback/capital reduction should have a commercial purpose backed with proper supporting evidence. While the ruling pertains to AY 17-18 which is prior to the applicability of the GAAR provisions, this is a case of the Tribunal approving the invocation of judicial GAAR by the tax authorities by adopting a 'look through' approach. The ruling will act as a guiding force in structuring M&A deals, especially under the GAAR regime, considering the 'look through' approach adopted by the tax authorities.*

- **TDS proceedings cannot be initiated where the recipient is not liable for tax**

  - Commissioner of Income Tax (IT) vs. Red Hat India Pvt Ltd[3]

The taxpayer had made foreign remittance to another group company for the purchase of subscription, and tax was not deducted treating the remittance as business income. The tax officer treated the remittance as taxable as Royalty and Fees for technical services and held the taxpayer as assessee-in-default under Section 201(1) of the Act.

The taxpayer relied on the Mumbai Special bench ruling in the case of Mahindra & Mahindra[4] wherein it was held that the following conditions need to be satisfied cumulatively for the taxpayer to be treated as assessee-in-default:

i. Failure on part of the payer to perform his obligation of making TDS and;
ii. Non-payment of tax by the payee/recipient

Further, the tax officer admitted that no assessment in this regard has been made in respect of the tax liability of the payee.

The Bombay High Court observed that in order to treat the payee as an assessee-in-default, it is important that the income so paid or credited to the account of the payee is capable of being brought to tax and such assessment can be lawfully made on the payee. The High Court concluded that an assessment should be lawfully made by the tax officer on the payee/recipient. Accordingly, in the absence of any such assessment, the High Court held that the taxpayer is not liable to deduct tax on the aforesaid transaction and hence, cannot be treated as assessee-in-default.

JMP Insights – *The underlying principle behind the deduction of tax at source is the presumption that there will be some liability of the payee towards tax on the sum paid to him. If there is no tax liability of the payee, then the payer cannot be treated as an assessee-in-default for non-deduction of tax.*

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[3] TS-532-HC-2023(BOM)

[4] [2009] 122 TTJ 577 (Mumbai) (SB).

- **Payment for obtaining a candidate profile report from the server located abroad cannot be treated as Royalty.**

  - CAE Simulation Training P. Limited vs. DCIT, Circle 4(2), New Delhi[5]

The taxpayer is engaged in the business of training pilots and providing services in relation to the assessment of pilot candidates for its customers. The taxpayer paid consideration to Symbiotics Ltd. UK for the provision of the candidate's reports. The tax officer disallowed the payment for non-deduction of tax by treating the payment as Royalty under the Act as well as under the India-UK Double Taxation Avoidance Agreement ('DTAA').

Based on the facts, the Tribunal observed that the taxpayer merely gets the report in the form of deliverables prepared from the analysis undertaken by the non-resident company using 'Adapt' software and the source code of the software is accessed only by such non-resident company, without allowing the taxpayer to access or modify or duplicate such source. The candidate's report is delivered to the taxpayer electronically which is in the nature of the copyrighted product and mere access to use the server/software to download the reports cannot be regarded as a transfer of any license/copyright in the software so as to fall within the definition of 'royalty' under Article 13 of the India-UK DTAA. The Tribunal further held the taxpayer does not get any right to use the copyright in the software as it merely has access to the information/data processed by the software/application which is owned and executed by Symbiotics Ltd. UK in its server located in the UK. Reliance was placed on SC ruling in Engineering Analysis[6] to observe that the taxpayer gets only a copyrighted article to use the product for its internal business purposes and not any right in any copyright to exploit the same for commercial reasons so as to constitute royalty. The Tribunal concluded that since the payment is not chargeable to tax in India, the taxpayer has no obligation to withhold tax under Section 195 of the Act.

JMP Insights *- The issue of taxability of payment for software as Royalty has been a contentious issue in India for many years. The distinction between 'copyright' and 'copyrighted article' has been made in many rulings and it has been held that if the payment is towards transfer of a 'copyrighted article' and not the 'copyright' itself, then the payment is not in the nature of royalty.*

The Finance Act, 2012 had expanded the definition of Royalty to include use or right to use a computer software, including granting of a license. However, there is no corresponding amendment in the various DTAAs entered by India. Hence, in such cases, the DTAAs being more beneficial are applicable to the taxpayer.

[5] ITA No. 2573/Del/2022

[6] [2021] 125 Taxmann.com 42 (SC)

- **Indian Associate Entity is not considered as Agency Permanent establishment ('PE') as contracts were concluded by independent distributors**

    - SanDisk International Ltd vs. ACIT (International Taxation), Circle 2(1), Bangalore[7]

The taxpayer entered a contract with SanDisk India to provide market research, marketing and promotion, data gathering and other support services. The tax officer on the basis of statements recorded from the employees during the survey concluded that Sandisk India creates an Agency permanent establishment and an appropriate portion of business profits are liable to be taxed in India.

The Bangalore Tribunal noted that the agreement between the taxpayer and SanDisk India prohibits Sandisk India from negotiating, concluding, signing, executing or in any other manner, accepting sales or other contracts in the name of or on behalf of the taxpayer. The Tribunal observed from the statements of employees and the agreement that the orders are secured by the independent distributors of the taxpayer and not by SanDisk India. The Tribunal took note of the fact that, in the final assessment order, the tax officer has recorded that SanDisk India does not procure goods, neither deliver them nor collect the payments. Accordingly, the Tribunal held that the scope of business connection in India is not applicable in the present case.

The Tribunal also held that the amendment made to Explanation 2 of Section 9(1)(i) of the Act by the Finance Act, 2018 provides for a business connection where Indian AE habitually plays the principal role leading to the conclusion of contracts. However, the Tribunal noted that the amendment in Act cannot be directly imported into treaty unless modified through protocol or MLI. The Tribunal further held that a similar amendment though proposed in the DTAA through MLI is not effective for the relevant year.

***JMP Insights** – This judgment highlights the importance of principal role in concluding contracts in order to get covered under the definition of business connection to determine taxability in India. It also emphasizes that an amendment to the term 'business connection' in the Act will be applicable only if a similar amendment is brought in the DTAA or through MLI.*

Income tax Notifications

- **Computation of the FMV of unquoted equity shares or compulsorily convertible preference shares ('CCPS')[8]**

Rule 11UA(2) of the Income-tax Rules,1962 ('the Rules') allowed a taxpayer to value unquoted equity shares of a company at the time of issue of such shares either by the Net Asset Value ('NAV') method or by the Discounted Cash Flow ('DCF') method. If the shares are issued by the unlisted Indian company at the FMV determined on DCF or NAV basis, then no tax incidence arises on account of section 56(2)(viib) of the Act.

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[7] ITA no 763 to 768/Bang/2022

[8] Notification No 81/2023 dated 25th September 2023.

The Central Board of Direct Taxes has notified new rules that will allow the taxpayer to value unquoted equity shares and CCPS.

1. The following are the options provided to the taxpayer to adopt method of determining value for unquoted equity shares to be issued, as per section 56(2)(viib) of the Act:-

   A. Adjusted NAV method

   B. DCF method, for which the valuation report needs to be obtained from a merchant banker

   C. A Venture Capital Undertaking can issue equity shares to any person at the same price at which it had issued equity shares to a Venture Capital Company ('VCC') or Venture Capital Fund ('VCF') or a Specified Fund provided –

      a. the aggregate consideration receivable for the issue of shares to such person should not exceed the aggregate consideration received from such VCC or VCF or Specified Fund; and

      b. equity shares should be issued within a period of 90 days from issue of shares to VCC or VCF or Specified Fund.

   D. Five new valuation methods have been prescribed for non-residents to be carried out by a merchant banker only. These 5 new methods are as follows:

      i. Comparable Company Multiple Method;

      ii. Probability Weighted Expected Return Method;

      iii. Option Pricing Method;

      iv. Milestone Analysis Method; and

      v. Replacement Cost Method.

   E. A company can issue equity shares to any person at the same price at which it had issued equity shares to a notified entity provided –

      a. the aggregate consideration receivable from such person should not exceed the aggregate consideration received from such notified entity; and

      b. shares are to be issued within a period of 90 days from the date of issue of equity shares to the notified entity.

2. The shares to be issued to a resident can be valued using NAV, DCF or actual transaction price method listed at Option 1(A),1(B),1(C) or 1(E) above. For the valuation of shares issued to non-resident entities, additional 5 methods listed at Option 1(D) above are available.

3. The above valuation methods may also be used for computing FMV of CCPS by the investors.

4. 10 percent deviation from the issue price is proposed to be accepted as a safe harbour (i.e. without any tax consequence).

5. The date of the valuation report from the merchant banker shall be deemed to be the valuation date, provided the gap between the date of issue of shares and the date of the valuation report is not more than 90 days.

JMP Insights *– The above amendment provides flexibility in determining FMV of unquoted equity shares as well as CCPS for taxation purposes.*

DID YOU KNOW?

The Income tax portal has enabled non-resident vendors not having a PAN to get registered to generate electronic Form 10F without obtaining a PAN. With effect from 1 October 2023, if the required information is not mentioned in the TRC, all non-resident vendors whether or not holding a PAN are now required to obtain electronic form 10F to be eligible for claiming beneficial provisions under the relevant DTAA.

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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