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 November 2020:

Atmanirbhar Bharat Package 3.0 - Income tax relief for Real-estate Developers and Home Buyers

With a view to revive the economy, the Hon'ble Finance Minister on 12 November 2020 announced an economic stimulus package 'Atmanirbhar Bharat Package 3.0' amounting to INR 2.65 trillion (~USD 35 billion).

As a part of the economic stimulus package, certain income tax relief measures were brought in for real-estate developers and home buyers. Section 43CA of the Income-tax Act ('the Act') provides for considering the stamp duty value ('circle rate') as the full value of consideration for the transfer of land or building (not being a capital asset) where the actual consideration is less than the circle rate.

Currently, there is a tolerance limit prescribed under Section 43CA of the Act, where the difference between the actual consideration and the circle rate upto 10% is acceptable. Similar tolerance limit has also been provided for buyers under Section 56(2)(x) of the Act.

With a view to boost demand in the real-estate sector and to enable the real-estate developers to liquidate their unsold inventory at a rate substantially lower than the circle rate and giving benefit to the home buyers, it has been proposed to increase the said tolerance limit from 10% to 20% under section 43CA of the Act during the period 12 November 2020 to 30 June 2021 in respect of only primary sale of residential units of value upto INR 20 million (~USD 0.26 million). A similar relief has also been extended to buyers under Section 56(2)(x) of the Act.

JMP Insights – *This is a welcome move as it would benefit real-estate developers in disposing off their unsold inventory of residential units. However, considering the fact that the relief is applicable only for value upto INR 20 million, how far the real estate developers will get benefit of this relaxation in metro cities is an open ended question. Moreover, on the part of the buyer, the proposed amendment is restrictive and arbitrary as the buyer is only benefitted when the purchase is made directly from a real estate developer and not from a resale transaction.*

However, the amendment is still in the proposed stage and further details/clarification on this are awaited from the Central Board of Direct Taxes ('CBDT').

Income tax rulings

- **Income arising from cashless stock option taxable as capital gains and not salary in the hands of a consultant**

    - Chittharanjan A. Dasannacharya v. CIT/ACIT, Bangalore (Karnataka HC) (ITA No.153 of 2014)

The Karnataka High Court ('HC') in this case has noted that as per the communication between the taxpayer and the US company, the taxpayer was an independent consultant and was not an employee of the US company at the time of grant of stock options. Thus, in the absence of employer-employee relationship, the difference between the exercise price and the fair market value of the shares on the date of exercise of the stock options cannot be taxed as income from salary in the hands of the taxpayer.

The HC has observed that stock options represent a right given to the taxpayer to purchase the shares underlying the options and hence, are in the nature of a capital asset in the hands of the taxpayer under section 2(14) of the Act. Under the cashless option, the taxpayer never received the shares but only the difference between the sale proceeds and the exercise price. By opting for such a cashless option, the taxpayer effectively made a transfer of a capital asset by way of relinquishment/extinguishment of the right in the capital asset and hence, it has been held that the taxpayer is liable to pay tax on the capital gains earned.

JMP Insights – *The HC has considered the holding period from the date of grant of options to the date of exercise of options and hence, the nature of capital gains has been held to be long term. The aforesaid view was also considered recently by the Bangalore Income Tax Appellate Tribunal ('ITAT') in the case of N.R Ravikrishnan vs. ACIT [2019] 102 taxmann.com 418 wherein it was held that ESOP options provided a valuable right to the taxpayer to exercise and have allotment of shares, and thus they were capital assets held by the taxpayer from the date of grant itself.*

- **Section 68 of the Act cannot be invoked on bogus/fictitious entries**

    - M/s. Rich Paints Ltd v. ITO (Ahmedabad ITAT) (ITA Nos.186/Ahd/2015, 187/Ahd/2015 & 188/Ahd/2015)

The issue under consideration before the Ahmedabad ITAT was whether a fictitious increase in share capital represents unexplained cash credit within the meaning of Section 68 of the Act.

The ITAT has noted that the enhancement in share capital represents merely a book entry, which was based on the manipulation of accounts with the collaboration of bank staff. Section 68 of the Act creates a legal fiction wherein an entry in the books of account is deemed to be the income of the taxpayer. However, the provisions of Section 68 of the

Act cannot be applied to transactions which are merely book entries and represent fake transactions.

Morever, the question of proving the identity, creditworthiness of the parties and genuineness of the transaction would arise where there is a real transaction and in such a case the taxpayer is obligated to discharge the onus imposed by Section 68 of the Act. In the given case, since the cash credit entries represent bogus entries, the question of discharging the onus as imposed by Section 68 of the Act upon the taxpayer does not arise.

The ITAT has directed to delete the addition made since the obligation gets discharged in the given case due to the law of impossibility of performance.

JMP Insights – *The ITAT in the given case has relied upon the maxim 'lex non cogit ad impossibilia' implying thereby that 'the law does not compel a man to do what he cannot possibly perform'. The amount received from the parties as a contribution towards share capital was siphoned off for an identical amount to the same parties in lieu of security deposit paid for taking office premise on lease from the said parties. The same was done to float the public issue and comply with SEBI regulations. Once it is ascertained that the transaction was bogus/fake, the taxpayer cannot prove its genuineness and hence Section 68 of the Act cannot be invoked.*

- **Transfer of shares of the company resulting into transfer of commercial shops not a colourable device**

  - Sunita S Bathija v. Addl. CIT (Bangalore ITAT) (ITA No.668/Bang/2017)

A company had floated a scheme wherein it obtained 67% leasehold rights in a land with a right to construct a building (comprising of offices and shops) and use the same for a period of 85 years. Every shareholder (member) including the taxpayer had been allotted commercial space/units in the building constructed on the above land to the extent of investment made in shares of the company and they placed security deposits amounting to 12 times of the face value of shares with the said company. As per the scheme, if a member transfers shares of that company, it has to mandatorily transfer the allotted commercial space/units also. Thus, the scheme only allowed members to enjoy the commercial space/units allotted over the lease period of 85 years.

The taxpayer transferred the shares and paid capital gains tax only on transfer of shares and not on transfer of commercial space/units allotted to her.

The Bangalore ITAT noted that there was an embargo on the taxpayer to sell commercial space/units as it emanated from the scheme. There is no allegation duly substantiated by the revenue that there was an intent to avoid tax in the guise of transfer of shares. The ITAT relied upon a decision rendered by the Karnataka HC in the case of Bhoruka Engineering Inds. Ltd v. DCIT [(2013) 36 Taxmann.com 82] wherein the HC held that "*If the shareholders choose to transfer the land and part with the land to purchase shares, it*

would be a valid legal transaction in law and merely because they were able to avoid payment of tax, it cannot be said to be a colourable device or a sham transaction or an unreal transaction".

Relying upon the aforesaid ruling and upon a close perusal of the scheme of the company, the ITAT has held that the transfer of commercial space/units was made to comply with the scheme as there could not be any transfer of shares otherwise and hence, though taxes are avoided but it is not a case of a colourable device with an intent to evade tax. The ITAT has held that only on transfer of shares, the taxpayer is liable to pay capital gains tax.

JMP Insights*: - The Bangalore ITAT has taken a view based on the form rather than substance of the transaction . However, in our view, with the advent of the General Anti-Avoidance Rules ('GAAR')/Principal purpose test ('PPT') clause of the Multilateral Instrument ('MLI') modifying the Tax Treaties, there is a paradigm shift in the outlook of the Tax Department and there will be increased litigation to establish legal sancitity of "legitimate tax planning" as against "use of colourable device for illegitimate tax evasion". Each transaction will have to be analysed precisely to ascertain the legal nature of the transaction and understand the substance of the transaction over its form.*

- **Unabsorbed depreciation of erstwhile partnership firm allowable to successor proprietorship**

  - Sh. Yerram Venkata Subba Reddy, Hyderabad v. ACIT (Hyderabad ITAT) (ITA No.1119/Hyd/2018)

The taxpayer took over the business of a partnership firm as a successor and converted the partnership firm into proprietorship concern as all the other partners retired from the firm. During the relevant year, the taxpayer set off the unabsorbed depreciation of the erstwhile partnership firm against the taxable income earned by him. However, the tax officer did not allow the taxpayer to do so and the same was confirmed by the Commissioner (Appeals).

Section 78 of the Act deals with carry forward and set off of losses in case of change in constitution of partnership firm or on succession. As per Section 78(2) of the Act, where any person succeeds business or profession carried on by his predecessor, otherwise by way of inheritance, the successor shall not be entitle to carry forward and set off **loss** against his income. However, Section 78 of the Act does not deal with unabsorbed depreciation.

Section 32 of the Act deals with depreciation. As per Section 32(2) of the Act, where depreciation allowance cannot be claimed in full, owing to inadequate profits or gains chargeable for that year, the unabsorbed depreciation allowance shall be added to the depreciation allowance of the next year and deemed to be part of that year's depreciation allowance and so on for the succeeding years.

On appeal, the Hyderabad ITAT has held that in view of Section 32(2) of the Act, the unabsorbed depreciation becomes the depreciation of the current year of the business and the same is eligible for set off against the income of the successor.

- **Being a distributor/intermediary does not change the nature of a transaction and therefore, withholding tax is applicable on software payments to foreign AE**

  - Kaseya Software India Private Limited v. DCIT (Bangalore ITAT) (ITA No.1304/Bang/2018)

The taxpayer acted as a distributor and purchased computer software from its foreign Associate Enterprise ('AE') at an agreed price to sell to its Indian customers. The taxpayer did not deduct any tax on the payments made to its foreign AE on the ground that it was acting as a mere distributor/intermediary.

The main issue raised before the Bangalore ITAT in this case was whether the sum debited to the profit and loss account by the taxpayer as software expenses was payment towards purchase of software or mere reimbursement of expenses to the AE.

The taxpayer submitted before the ITAT that there was no agreement entered with the AE, but there was a letter exchanged between them, as per which it was stated by the AE that:

i. The taxpayer was eligible for a margin of 15% on the cost and it should be retained by the taxpayer;

ii. The AE will reimburse all expenses incurred by the taxpayer on salary, including directors' remuneration, advertisement, travelling and travelling related expenses, business promotion expenses, communication expenses, marketing expenses, public relations cost, seminar and sponsorship, etc.

iii. The arrangement between the taxpayer and its AE was not that of a buyer and seller but the taxpayer was acting as an intermediary. Therefore, it was eligible to retain 15% margin on cost of AE and was also eligible to get reimbursement of various expenses as specified in this letter.

The ITAT has, on the basis of the said letter held that, the manner of fixing purchase price of the taxpayer would not alter the nature of the transaction. The ITAT has held that it was not established that the contents of the letter were being acted upon. Even if it was acted upon, the conditions of the letter about reimbursement of various expenses to the taxpayer by the AE such as salary, travelling and travelling related expenses etc. would not alter the nature of the transaction.

Further, the ITAT has relied upon the judgments of Karnataka High Court in the case of CIT v. Samsung Electronics Co. Ltd (345 ITR 494/245 CTR 481) and Synopsis International Ltd. v. CIT (28 Taxman.com 162) wherein it was held that withholding tax as

per Section 195 of the Act is applicable in case of making payments for computer software as the same is royalty under Section 9(1)(vi) of the Act.

The ITAT has held that the arrangement of the taxpayer with its AE is of purchase of computer software at agreed price and the fact that the taxpayer is a distributor does not change the nature of the transaction. Therefore, it is still a purchase as accounted for by the taxpayer, and hence subject to withholding tax under Section 195 of the Act .

JMP Insights – *Withholding tax on purchase of software as royalty has always been a matter of litigation. Various Courts and ITATs have given differing rulings on the issue of withholding tax on payment for purchase of software. In relation to the dispute whether purchase of software would be considered as purchase of copyright or copyrighted article to be considered as royalty has been put to rest by Explanation 4 to section 9(1)(vi) of the Act inserted by the Finance Act 2012 retrospectively. However, the above order has not discussed the treatment and implication of purchase of software under the Tax Treaty.*

- **Set off of prior year's unabsorbed losses/unabsorbed depreciation against the total income is mandatory and cannot to be denied solely for the reason that it was not claimed in the original return filed**

  - Mistral Solutions Private Limited v. DCIT (Bangalore ITAT) (ITA No.1911, 1912, 1913 and 1914/Bang/2018)

The Bangalore ITAT has directed the Income Tax Officer to consider the taxpayers claim of set off unabsorbed losses/depreciation of earlier years against the declared income of the current year and that the Tax Officer shall not reject the taxpayers claim of set off of unabsorbed losses/depreciation solely for the reason that the taxpayer had not made the claim of set off of unabsorbed losses/depreciation in the original return filed.

The taxpayer had filed the return of income and had inadvertenely omitted to set off earlier years' unabsorbed depreciation with the income from other sources earned in the current year. The losses and unabsorbed depreciation were correctly claimed in the return of income of the respective years and the return of income was filed within the due dates of the respective years.

During the course of assessment proceedings, the Tax Officer held that since the claim for set off of brought forward losses was not made while filing the original return of income for the current year, the fresh claim cannot be considered.

On appeal, the ITAT has observed that Section 72(1)(i) of the Act mandates set off of business loss with business income of a subsequent year. It is a statutory compulsion and it does not give any option to the taxpayer whether to set off the loss or not. Similarly, it has observed that it is a settled principle that unabsorbed depreciation forms part of current years' depreciation under Section 32(2) of the Act. Therefore, it has held that whether or not the taxpayer has set off the losses in the return of income, the income tax authorities are required to give effect to Section 72(1)(i) of the Act and set off such losses

and unabsorbed depreciation should also be set off against any income of a subsequent year under any head.

Further, going one step ahead, the ITAT, relying on the CBDT Circular No.14 dated 11 April 1955 has stated that the income tax authorities are required to bring to the notice of the taxpayer any claim of relief, exemption, deduction etc. to which the taxpayer is legally entitled and allow the same even though the taxpayer may not have claimed the said relief, exemption, deduction etc. for any reason.

JMP Insights – *The above case affirms the principle that setting off of eligible business losses and unabsorbed depreciation against the business income or total income, as the case may be, is not an option for the taxpayer but is mandatory. The Income Tax Officer cannot deny such set off even if the same was not claimed in the return filed. The ITAT has rightly observed that it is the duty of the the tax authorities to bring to the notice of the taxpayers about their entitilement to any relief, exemption or deduction under the law and not to take any undue advantage of the taxpayers ignorance of the law.*

- **Fees for technical services paid by Indian PE is an allowable expenditure under Section 37(1) of the Act and not to be categorised as HO expense under Section 44C**

  - Standard Chartered Grindlays Bank v. ADIT (IT) (Delhi ITAT) (ITA No.2920/Del/2008, 2995/Del/2008)

The taxpayer, a non-resident banking company carrying on banking business through its Permenant Establishment (‘PE’) in India, had entered into a service agreement with a group company through its Head Office in Australia to provide technical services. The service agreement relating to credit card support services did not stipulate that the services would be provided in India. The dispute before the ITAT in this case was whether payment towards credit card support services were incurred for the purpose of business of the taxpayer in India so as to claim the expenditure under Section 37(1) of the Act or to the extent allowable under Section 44C of the Act.

The ITAT has placed reliance on the report of the external auditor to the management, wherein it was explicitly mentioned that “charges which relate to production support, recovery from system failures, troubleshooting, problem investigation, user assistance, right to use the system software and services provided in respect of credit cards,….have been incurred on behalf of the Indian branch…”

ITAT has also perused the Memorandum of Agreement, tax report, notes to accounts and the details of the tax payment under Article 12 of the Tax Treaty and the related challans. The Delhi ITAT, based on the above documents, found that expenses such as fees for access and user technology related to services for credit card services have been incurred wholly and exclusively for the Indian banking business and held that since the expenses are meant for the business of the taxpayer in India, such expenses are allowable to be claimed by the taxpayer under Section 37(1) of the Act.

***JMP Insights –** The above case sheds light on the importance of documentation and effective drafting of service agreements when the service is to be consumed only by the PE in India. In the given case, the ITAT has established the rule for the classification of expenditure incurred by HO, which also has a PE in India. The ruling is crucial as it decides the allowability of expenditure under section 37(1) of the Act vis-à-vis section 44C of the Act.*

DID YOU KNOW?

Form 26AS displaying Tax Deducted at Source/Tax Collected at Source details on the Income tax website has been revamped to an "Annual Information Statement" to additionally disclose comprehensive information on specified financial transactions including turnover reported in GST return by the taxpayer. This is to ensure mapping of the income disclosed in the return of income with the turnover disclosed in the GST returns.

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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