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————— Your Monthly Companion on Tax & Allied Subjects —————

Taxation of Financial Services – Key Issues



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Editorial

VIRUS SE VISHWAS

Never in the recent history, a tiny virus has caused so much illness, death, destruction and panic and gloom as this novel coronavirus [Covid – 19] has caused. Nowhere in the recent history large population, nay, towns and cities are under complete lockdown or quarantine and, that too, in such a brutal manner! May be it is a dire necessity for the benefit of the larger mass. Nowhere in the recent memory, an epidemic disease has caused so much vast effect at personal level, social level, commercial level and at global level, with the fear of world wide recession looming large if this epidemic is not contained soon. The epidemic has brought so much fear and scare in the mindset of people across the world that one gets reminded about the scary horror movies of past involving similar fictional scenario concerning such type of epidemic or similar disasters.

This also reminds us, yet again, that the mankind is yet to conquer the nature and the natural force and causes, in spite of sending human beings on the moon and sending exploratory missions to Mars and much beyond. It is said that the pace of advancement in science, including medical science, has decreased over the years. But such type of episode brings the man to his knees; with sheer fear, frustration, helplessness and, perhaps, surrender! One only hopes that the mankind ‘conquers’ such tiny virus soon with effective vaccine and, thereafter, learning a bitter lesson out it, gears up with preventive and controlling measures against such types of eventualities in future. But till then, it is as if the people have lost faith [vishwas] on the current medical advancement and its capacity to contain such epidemic.

As far as the ‘vishwas’ is concerned, the current hot topic – the flavor of the day – for the professionals is Direct Tax Vivad se Vishwas Bill, 2020, which was introduced as a part of the Budget 2020, with the object to reduce the huge pendency of income tax litigation, since the disputed tax arrears constitute nearly one year’s direct tax collection, and to generate timely revenue as required for this fiscal year.

However, as usual, the Scheme, as was so introduced, bore the typical government signature of being bereft of some essential and basic clarifications and explanations, subjecting the taxpayers and the tax consultants to go on guess work spree and thereby consuming considerable time and energy in such totally avoidable exercise. Fortunately, this time the Government seems to be in dire and desperate need for finance and, therefore, has been more amenable to the suggestions that poured from across the country and acted swiftly to such suggestions based on which certain amendments to the provisions of the Bill were made and the amendment Bill has been approved by the Lower House of the Parliament on 04.03.2020, which now awaits the President's assent after getting nod from the Upper House. On the same date, the Central Board of Direct Taxes issued Circular No. 7 / 2020, in which clarifications are given on various aspects in the form of Questions & Answers. In fact, clarifications go beyond the Scheme by broadening the scope in some cases as well as by restricting the scope in few cases. In any case, in spite of this Circular, there remain many issues for which there may not be definite or clear answer, either way. It is understood that the Government may come out with further clarifications. One only hopes that the CBDT comes out with clarifications on such aspects soon.

It should be remembered that Vishwas [trust] is always a two-way traffic. You get trust of a person only if you trust that person. It is as simple as that! Secondly, a Vishwas [trust] has to be earned; it can never be enforced or acquired forcibly. Unfortunately, on both the counts the Government has failed miserably. The way the amendments are bombarded in the Income tax Act – as well as in GST provisions - and the way they are implemented, it leaves impression that the Government does not trust the assesseees at all. It is true that there are quite a few unscrupulous elements in the tax payer community who hoodwink the Government and evade payment of huge amount of taxes by dubious means. There can be no dispute that such people and such practices should be curbed immediately with strong measures, and also the same should be deprecated and condemned by the tax payers - including tax practitioners – as a whole as well. However, as the famous doctrine ascribed by William Blackstone way back in 1769 goes: 'It is better that ten guilty persons escape than that one innocent suffer', which dictum has been followed in many avatars thereafter. The unadulterated tax laws had, and now have, enough provisions and the tax administration had, and now has, enough powers to deal strongly and quite effectively with such types of people and the practices, provided the law is administered firmly and fearlessly without any exception to anyone. The problem lies not in any inadequacy of the provisions or the powers to deal with such types of people and practices, but lies with the

inadequacy of the administrative will and measures to implement the law in its true spirit and uniformly. Unfortunately, instead of addressing such inadequacy on the part of the administration, the blame is always put on the doors of the taxpayers in general. Consequently, instead of tracking down such unscrupulous people / practices and dealing with them firmly by using the existing provisions and the powers effectively, what we see is an easy way out; that is, churning out more and more deeming and fictional provisions affecting all taxpayers across the board, in the name of plugging loopholes and revenue leakage. In such a scenario, where is the question of 'vishwas'?

Even otherwise, time has yet to come where an assessee has enough trust on the tax department; the trust that he will not be harassed unnecessarily, the trust that his all legitimate grievances (including appeals) will be addressed and sorted out promptly and effectively, the trust that he will not be saddled with unwarranted hi-pitched assessments, the trust that he will not be made to be on his knees and beg to the officers for a mercy from coercive recovery measures, etc. Unless the Department gives such trust to the assessee, Department will not get the assessee's trust in return. Here, periodic or weekly drives on random basis to 'earn' such trust serve no purpose, unless the same are backed by solid, visible and sustainable administrative reforms and actions that would earn such trust from the assessee. Till then, no amount of lollipop or carrot would win the real trust.

Wishing you all a fulfilling journey from Vivad to Vishwas!

Vipul B. Joshi
Editor



From the President

Dear Members,

The Coronavirus (Covid-19) outbreak which originated in China has infected tens of thousands of people across the globe. India also has found some cases in a few cities and is taking all the measures to minimise its spread and also aggressively campaigning to educate people as to how to protect themselves from Covid-19. There are no confirmed reports about the number of deaths due to Covid-19 but attempts are being made by all the countries to eliminate it at the earliest so that number of casualties are reduced. But more than the threat to people's lives, it is the impact on the global economy which is more worrisome. According to the OECD, the world's economy could grow at its slowest rate since 2009 due to the Coronavirus' outbreak. The last week of February saw the worst performance of the major Stock Markets, the world over since the 2008 financial crisis. China is one of the biggest exporters in the world but manufacturing is almost stopped in China for the past one month which has impacted the global market. The travel and hospitality industries are also severely affected. We can only pray and hope that this problem of Covid -19 is arrested at the earliest so that not only the precious lives are saved but also the economy gets revived.

The Union Cabinet has finally approved the amalgamation of 10 Public Sector Banks with effect from 1st April 2020. The announcement about the amalgamation was made some time in August but pending regulatory approvals and completion of other formalities, approval by the Union Cabinet was held up. The Government believes that this exercise will create seven large public sector entities with scale and national reach and each amalgamated entity will have business of ₹ 8 lakh crore. This is a step in the right direction and in the long run it would help the Indian Banking Industry and monitoring of these Banks by the Government would be easier. While this is positive news, the superseding the Board of the Yes Bank by the Reserve Bank of India is quite shocking for the reason that till about two years back, Yes Bank was considered to be amongst the top five Private Banks. Thankfully, the RBI has come out with a scheme to bail out the Bank as per which 49% of the shares will be held by the State Bank of India. But for this action, the Yes Bank would have collapsed and the worst sufferers would have been the depositors. As per the newspaper reports, the RBI was aware of the problems with the Bank and it acted slower than what is expected from a regulator. But the larger issue which makes

one think, is about the Governance , various audits which a bank is subjected to ,inspections by the regulator, the systems etc. When all these are in place, how can a Bank of the size of Yes Bank collapse? On top of it, one of the promoters of the Bank is taken into judicial custody for enquiry on charges of Money Laundering! Isn't this strange? The only conclusion which one can draw from the collapse of Yes Bank, and other Banks in the past, is that, in the absence of ethics and morality, no systems, audit or governance can work.

Recently, the Union Cabinet cleared a proposal to introduce 72 changes in the Companies Act, which cut down provisions pertaining to criminality and in turn reduce litigation. These are welcome amendments and should help in reducing the cost of running business. Another important legislation is the Vivad se Vishwas Scheme as per the proposal in the Finance Bill, 2020. There are about 4.5 lakh income tax cases pending with various appellate authorities and the disputed amount is to the tune of approximately ₹ 8 lakh crore. The Government expects sizeable amount of revenue from this scheme. It is understood that the Income-tax Department is approaching the taxpayers to settle the cases and avail the benefit of the scheme. Though the scheme is good for those litigants whose cases are weak on merit, the urge by the tax authorities to taxpayers to ask those taxpayers to take benefit of the scheme whose cases are strong on merit, may be questionable.

The Law and Representation Committee is always in the forefront in making representations on matters concerning the stakeholders in a timely manner. The Committee made representations on the Finance Bill, 2020 and Vivad se Vishwas Bill, 2020. The representations are available on Chamber's website. In February, the Ministry of Corporate Affairs issued a notice inviting suggestions and comments along with justifications on a consultation paper to examine the existing provisions of law and make suitable amendments therein to enhance audit independence and accountability. The Committee is in the advanced stage of making representation to the MCA and will be sent in due course.

The past month witnessed as many as twenty three events (including four webinars) conducted by various committees and Study Group at Pune and Bengaluru. The lecture meeting on Vivad Se Vishwas Bill, 2020 by Senior Advocate Firoze Andhyaryujina met with an overwhelming response and so did the workshop on Finance Bill, 2020 jointly with the WIRC of ICAI. The musical evening where the performers were the members and their family, was very well received and participants were enthralled by the excellent performance by the artistes. Inter Firm Cricket tournament where as many as 24 teams and 3 girls' teams enthusiastically participated, was like a carnival and was played in the true spirit of the game, and there was lot of camaraderie among players.

The highlight of the month was the 43rd RRC at the Hotel Le Meridien, Coimbatore, organized by the RRC Committee from 27th February to 1st March 2020. This RRC met with an overwhelming response with total registration of 240 delegates who were from as many as 28

different cities across the Country. That shows the increased popularity of this event over a period of time. The RRC was indeed memorable and the delegates were technically enriched in a five star relaxed ambience and got connected to their professional brethren. Success of the RRC was due to the mammoth efforts and great team work by the committee.

Under the powers conferred under sub-section (11) of section 143 of the Companies Act, 2013, the Central Government has notified the Companies (Auditor's Report) Order, 2020 (CARO, 2020). The new reporting requirement will be applicable for the reporting for the year ending 31st March 2020 and has cast huge responsibilities on auditors. **To equip the members with new reporting requirements, we have organized a lecture meeting on 17th March 2020 by a very eminent Chartered Accountant, Sudhir Soni.**

This issue of the Journal is on the Financial Services – Income-tax Issues. I compliment the Journal Committee for thinking of this subject as lot of complex tax issues are involved in financial services. The authors are also practicing in this field regularly and some of them are from the industry as well. This gives a wholistic perspective to the income-tax issues being faced. I thank all the authors for sparing their valuable time for a noble cause.

I would like to sign off with a meaningful and relevant quote by *Oprah Winfrey*

If you look at what you have in life, you'll always have more. If you look at what you don't have in life, you'll never have enough.

VIPUL K. CHOKSI

President



CA Sunil Kothare

Indian Banks – Tax Issues

Introduction

The present article is intended to give the readership a glimpse into the challenges that Indian banks face in discharge of their tax obligations. It is not intended to burden the reader with a plethora of case law which is now available on several search engines and databases. This article does not purport to be comprehensive nor does it portray the tax position of any particular bank operating in India.

For the purpose of this article, the issues are divided into (a) corporate tax issues relating to the bank; (b) issues relating to tax deduction under Chapter XVIIIB of the Income-tax Act, 1961 (ITA) or tax collection under Chapter XVIIIBB of the ITA; (c) issues faced in reporting of client transactions and (d) other issues.

Corporate tax issues

(a) Income Computation and Disclosure Standards (ICDS)

In the introduction of ICDS, the specific nuances relating to the banking sector were factored in.

Some of the special nuances and other areas of ICDS, to the extent they affect banks, are described below.

ICDS I – Disclosure of Significant Accounting Policies

As banks' financial statements have several such disclosures, this area was adequately covered by banks even prior to the introduction of ICDS.

ICDS II – Valuation of Inventories

Section 8 of the Banking Regulation bars banks from buying and selling of goods. By virtue of Para 1(c) of ICDS II, securities are excluded from the purview of ICDS II and are covered by ICDS VIII. Consequently, ICDS II has little impact on banks.

ICDS III – Construction Contracts

Banks are minimally affected by this ICDS.

ICDS IV – Revenue Recognition

Banks' revenue recognition policies are generally in line with the Reserve Bank of India (RBI)

All views expressed herein are personal and are not necessarily those of any organization that the author has been or is associated with in any employment or in professional capacity

directions on revenue recognition. As the RBI directions have statutory binding, banks' revenue recognition norms are generally in line with ICDS IV. Most banks' revenue recognition policies are disclosed in a very detailed manner in the disclosures under ICDS I itself.

ICDS V – Tangible fixed assets

This ICDS did not generally bring in any new challenges for banks except to the extent separately covered under ICDS VI in later paragraphs.

ICDS VI – Effects of Changes in Foreign Exchange Rates

Banks have foreign exchange items which are in the nature of monetary items, non-monetary items and foreign branches or foreign subsidiaries. As per Para 5.1 of ICDS VI, exchange gain or loss in respect of monetary items is required to be treated as income but not for any non-monetary items. As this requirement was broadly in line with banks' policies, it did not present much difficulty. Banks having branches outside India offer to tax, the foreign currency translation amounts as required in terms of the response to Frequently Asked Question (FAQ) No. 16 on ICDS contained in CBDT Circular No. 10/ 2017 dated 23rd March 2017. Para 3 of part B of ICDS VI to the extent that it deals with forward exchange contracts does not apply to banks, as they are required to follow the RBI guidelines.

ICDS VII – Government Grants

The normal grants generally received by banks could relate to (many of the grants are now discontinued) grants for setting up and running of Aadhaar Enrolment Centres, subsidy towards interchange given up on debit cards swipe up to ₹ 2,000/-, etc. Most banks have pragmatically adopted the correct accounting treatment in line with ICDS in respect of such grants rather than take aggressive positions. This ICDS, therefore, has limited relevance to banks.

ICDS VIII – Securities

As stated at Para 2(c) of this ICDS, Part A does not apply to banks. Para 1 of Part B of the ICDS states that Part B of the ICDS would apply to banks. As banks follow RBI directions on valuation of securities, this ICDS has minimal effect on banks.

ICDS IX – Borrowing Costs

It would be unusual for banks to have borrowings specific for creation of fixed assets, as it is commercially unviable. In the same manner, most banks have sufficient non-interestnon-interest bearing funds for funding of fixed assets acquisition. Accordingly, ICDS IX should generally be of no consequence for banks.

ICDS X – Provisions, Contingent Assets and Contingent Liabilities

Ind AS has not so far been made applicable to banks. As a result, banks follow AS 29 where the requirement of for recognition and measurement of these items is in line with that in ICDS X. Consequently, ICDS X generally has no impact on banks.

(b) Bad debts and provision for bad and doubtful debts

The peculiarity of banking business is recognized in the ITA in that banks are allowed to deduct bad debts and provision for doubtful debts without allowing for a double deduction.

Section 36(1)(vii) allows deduction in respect of deduction for debts written off. Section 36(2)(i) sets a general condition that the bad debt written off must have been treated as income in the year of write off or in a prior year. An exception to this general rule is provided in Section 36(2)(i) itself whereby if the debt written off represents money lent in the ordinary course of the business of banking is treated as being tax deductible. Section 36(1)(viiia) provides for deduction in respect of provision for bad and doubtful debts.

To safeguard against a double deduction once at the stage of provision and a second time at the stage of write off, the first proviso to Section 36(1)(vii) requires that the claim for deduction of bad debts written off in any year is to be reduced to the extent of the balance in the provision that was deductible. An additional nuance is provided in Section 36(2)(v) that unlike other taxpayers, banks are required to adjust ad debts against the provision deductible under Section 36(1)(viiia).

A few interesting questions in banks' assessments arising out of these seemingly simple deductions are discussed below.

Whether the opening balance or the closing balance of the provision must be set off before deduction of the bad debts written off in terms of Section 36(1)(vii) Proviso read with Sections 36(2)(v) and 36(1)(viiia)? The answer now in various appellate forums seems to be that it is the opening balance that is to be set off, as the closing balance comes up only after the writewrite offs were done.

Whether the write off of credit cardholders outstanding dues represents write off or money lent in the course of banking business and are such write offs deductible? The Revenue believes that credit card outstanding dues do not form part of money lent in the normal course of banking business and are also not deductible under Section 28 or under Section 37. Banks hold the position that the credit card outstanding dues are integral part of their activity of lending money in the normal course of banking business. The RBI treats such outstanding dues as unsecured loans, the RBI Master Directions on revenue recognition apply to sch card dues of customers, the dues are disclosed in banks' financial statements as 'unsecured loans'. Accordingly, this controversy may continue for some length of time.

In computing the taxable income of a scheduled bank incorporated in India or a non-scheduled bank or a co-operative bank, deduction is available under Section 36(1)(viiia) of the ITA in respect of any provision for bad and doubtful debts to the extent the amount does not exceed the sum of (i) 8.5% of the total income computed before deduction under that clause and any deduction under Chapter VI-A; and (ii) 10% of the aggregate average advances made by rural branches of the bank. Para (ia) of the Explanation to Section 36(1)(viiia) defines rural branch to mean a branch located at a place which has a population of not more than 10,000 according to the last preceding census for which data have been published before the first day of the 'previous year'. Despite this clear language, it is seen that some Revenue officials seek to rely on the census data available at the stage of assessment. This challenge generally comes up in the 2-4 years after a census has been done. The other complication in this area is that RBI classification of 'rural' advances may be at variance in certain cases. These are, to my mind, avoidable pitfalls.

As pointed out above, to the extent that a deduction is allowed under Section 36(1)(viiia) in any year, the claim for deduction of bad debts is reduced in the subsequent year. This mechanism ensures that a bank does not get a double deduction in respect of bad and doubtful debts. The interplay of the provisions of Section 36(1)(viiia) and of Section 36(1)(vii) is illustrated in the Table below. Assume that:

1. the total income before any deduction under Section 36(1)(viiia) or under Chapter VI-A is ₹ 1000 crore;
2. the aggregate average rural advances are ₹ 5,000 crores.

Table

<i>Provision for bad and doubtful debts (₹ crore)</i>	<i>10% of rural advances (₹ crore)</i>	<i>8.5% of total income as above (₹ crore)</i>	<i>Deduction under Section 36(1)(viiia) = amount to be adjusted in the subsequent year's claim for bad debts write off (₹ crore)</i>
1,000	500	850	1,000
250	500	850	250
2,000	500	850	1,350
1,700	500	850	1,350

It goes without saying that the provisions of Section 41(4) of taxing bad debts recovery also apply to banks.

(c) 'Broken period' interest

The issue of 'broken period' interest has been under litigation for several years. What is 'broken period' interest? The portion of interest relating to the period between two coupon dates is called 'broken period' interest.

When a bank buys debt securities between coupon dates, the bank has to pay to the seller not only the price of the securities but also interest accrued from the last coupon date to the date of purchase. On coupon date, the bank receives the full interest for the period from the previous coupon date. From the interest received, the bank will adjust the amount relating to the period for which the bank was not the owner of the securities (as that portion has been paid to the prior owner at the point of purchase) and will offer the balance amount of interest to tax.

Similarly, when a bank sells debt securities, it will receive from the buyer not only the price of the securities but also interest accrued from the last coupon date to the date of sale. The bank will offer to tax as income, the interest amount received from the buyer although the coupon date has not been reached and the right to receive the interest is not vested.

It is to be noted that banks generally hold most such debt securities as stock in trade. This characterization of the banks' investments is accepted in the Central Board of Direct Taxes (CBDT) Circular No. 665 dated 5th October 1993.

The Revenue has been accepting the banks' offer to tax on broken period interest on the sale side but not on the purchase side. The case of the Revenue is that the broken period interest on the purchase side constitutes cost of securities and will be deductible only on sale of such securities. This creates, in accounting parlance, 'timing difference' but also creates huge demands towards interest.

The Supreme Court in the case of *CIT vs. Citibank N.A. (Civil Appeal No. 1549/ 2006)* passed a detailed order dated August 12, 2008 dismissing the Revenue's Special Leave Petition (SLP) against the Bombay High Court decision in *CIT vs. Citibank N.A. (264 ITR 18)*. The Bombay High Court had held that the broken period interest on the purchase side was not to be treated as cost of purchase of securities but was fully tax deductible in the year of purchase. It was largely thought that this controversy had been laid to rest. The Revenue has raised this matter again in banks' cases arguing that the matter needed reconsideration by the Supreme Court on the basis that the Supreme Court had

admitted the Revenue's (SLP) in the case of State Bank of India.

(d) Expenditure incurred in earning tax free income – Section 14A

The general issue of determining the quantum of expenditure incurred by banks in earning tax free income is no different from how it affects other taxpayers. There are, however, a few differences that I shall touch upon. Unlike most non-bank taxpayers, banks have a huge pool of current account balances on which interest payment is not permitted. This pool is in addition to the net owned funds. As a result, in the case of banks, including interest in the computation under Section 14A becomes virtually unsustainable. Till the last decade, some banks had tax free Government securities as part of their investments. These instances are now rare.

I do not intend to get into the discussion of whether Rule 8D retrospectivity, as the matter is now settled in *CIT vs. Essar Teleholdings Ltd. (2018) 90 Taxmann.com 2 (SC)*. Similarly, the matter of whether Section 14A is applicable in respect of strategic investments has been settled in *Maxopp Investment Ltd. vs. CIT (2018) 91 Taxmann.com 154 (SC)*.

(e) Special Reserve

Section 36(1)(viii) provides for a deduction to a specified entity of an amount up to 20% of the profits from an eligible business on condition that the amount equal to the deduction claimed is transferred to a special reserve. Para (a) of the *Explanation* to Section 36(1)(viii) defines a 'specified entity, to mean (amongst others) a banking company and cooperative bank but does not extend to a primary agricultural society. For banks, the term 'eligible business' means the business of providing long term finance for industrial or agricultural development or for development of infrastructure facility in India or for development of housing in India. [Para

b)(i) of *Explanation* to Section 36(1)(viii)]. For this purpose long term finance means any loan or advance where the terms of loan/ advance provide that the repayment must be over a period of not less than five years. The deduction is available till such time as the aggregate special reserve created does not exceed twice the amount of the bank's paid up share capital and general reserves. [Proviso to Section 36(1)(viii)]. As many banks issue shares at a premium to face value, the exclusion of 'Securities Premium Account' is a gap in the computation base that continues. The statute dates back to the days when the issuance of shares at a premium was unheard of or, in any case, the premium to be computed under the guidelines of the (erstwhile) Controller of Capital Issues was negligible. Section 41(4A) provides that any amount is withdrawn from the special reserve shall be deemed to be income of that year.

(f) Transfer pricing

Indian banks are generally not affected by the provisions of Section 92BA relating to specified domestic transactions unless they have a unit (branch) in the Gujarat International Finance Tec-City (GIFT City) at Gandhinagar. In such a case, any services between the non-GIFT City branches (including the Head Office in India) and the GIFT City branch have to meet with the arm's length standard. Banks having overseas operations have challenges that may be looked at as mirror image of the challenges that foreign banks operating in India face. Where the presence in the overseas location is through a branch, the normal challenges of income attribution, arm's length dealings etc. arise. In the overseas location, if the presence is through a subsidiary, the transactions between the bank in India and its subsidiary overseas will have to meet with the arm's length standard in both countries. As bank subsidiaries are more often than not regulated in the foreign location, the provisions relating to 'Place of Effective Management' (POEM) in India

under Section 6(3) of the ITA should generally not apply.

Tax deduction or tax collection – Chapters XVIIB and XVIIBB

This portion deals with operational issues faced by banks, although the matter of erroneous tax deduction at source (TDS) in respect of a bank's income persists even today despite the clarifications issued by the CBDT. It is widely known that interest paid to a bank incorporated in India is not subject to TDS owing to the provision in Section 194A(3)(iii). This special dispensation applies also to cooperative banks including cooperative land mortgage banks. What is not generally known is that several other incomes of banks are also not subject to TDS e.g. merchant discount on card transactions, charges for letters of credit or for bank guarantees, demat charges, clearing charges, etc. [Notification Nos. SO 3069(E) dated 31-12-2012 and 2143(E) dated 17-6-2016].

Where banks enforce their security against a defaulting borrower, the asset is sold by or on behalf of the borrower. In case of sale of immovable property, some buyers deduct tax at source especially under Section 194-IA and erroneously report the TDS in the bank's name and not in the name of the owner of the asset. As the income arising on the sale is not the bank's income, the bank does not claim the amount of TDS and that TDS goes to increase the bank's loan loss to that extent. On the other hand, the defaulting borrower may get credit for the TDS if he pursues the procedure laid down under Rule 37BA(2).

As a deductor or as a collector of tax, banks face several challenges. Some of these are touched upon here.

Bank depositors are permitted to submit Form 15G or Form 15H but banks are required to submit them electronically. [Notification No. 6/

2017 (F.N. Pr. DGIT(S)/CPC(TDS)/2017-18) dated 30-5-2017. Every form received is to be allotted a Unique Identification Number (UIN). [Rule 29C(3) of the Income-tax Rules, 1962 (IT Rules)]. Several branches in semi urban and in rural areas face power shortage or network connectivity issues resulting in challenges for the persons in the branches. Several customers do not complete all the required fields in the forms and have to be handled patiently. Even when the processing of forms is done in 'hub and spoke' manner through semi decentralized processing centres, some forms tend to get rejected.

Where a person seeks to make remittances overseas, the bank, acting as an authorized dealer, may need to obtain Form 15CA and/ or Form 15CB depending on the nature of the remittance, the size of annual remittances by the remitter, etc. On a quarterly basis, banks submit Form 15CC which is a summary of remittances made during the quarter. There are several operational challenges in areas like remittances under non-resident Indians Portfolio Investment Schemes, remittances made by Foreign Institutional Investors (FIIs) now called Foreign Portfolio Investors, classification under RBI Codes, etc.

The Finance (No. 2) Act, 2019 introduced Section 194N requiring TDS at two per cent (plus surcharge and cess) to be done where the aggregate cash withdrawals by any person through one or more accounts maintained by the recipient (read 'account holder') with a bank. For this purpose, a cooperative society engaged in carrying on banking business is included amongst the deductors. This provision came into effect from 1st September 2019. An account holder does not withdraw cash at a bank branch but can do so either at the bank's own ATM or at the ATM of another bank. The deduction of tax at source on real time basis becomes a challenge especially where the cash withdrawal is at another bank's ATM. Withdrawals by Government, bank (including a cooperative bank), post office,

business correspondent of a bank and white label ATM operators are excluded from the TDS ambit under the Proviso to Section 194N. Under the power to notify additional exclusions, the following types of clients are notified to be outside the ambit of the TDS under Section 194N viz.

- (i) Cash Replenishment Agencies and franchise agents of White Label ATM Operators (Notification 68/ 2019 dated 18th September 2019);
- (ii) Commission Agents or Traders operating under Agricultural Produce Marketing Committee (Notification 70/ 2019 dated 20th September 2019).
- (iii) Authorised Dealer, Full Fledged Money Changers and their franchisees and sub agents (Notification 80/ 2019 dated 15th October 2019).

The Finance Bill, 2020 (by the time this is published, it may be converted into Finance Act 2020) as placed before Parliament on 1st February 2020 proposes through the proposed Section 206C(1G), tax collection at source at the rate of five per cent (plus surcharge and cess) on remittances under the RBI's Liberalised Remittance Scheme (LRS) where the aggregate remittances during the financial year are ₹ 700,000 or more. As LRS is available only to persons who hold a Permanent Account Number (PAN), the new proposal does not provide for a higher rate of TCS for non-PAN cases. It is to be noted that LRS is available to FEMA residents who may still be non-resident for tax purposes. The Finance Bill, 2020 also proposes through the proposed Section 206C(1H), tax collection at source on purchase of goods of the aggregate value exceeding ₹ 50 lakhs. This proposal has the potential to create an operational nightmare for banks. In both the proposed amendments, the Government has a power to notify any exclusions.

Reporting of client transactions including FATCA and CRS

Banks report a significant amount of financial information to the tax authorities at various points in time. These could be statutory structured requirements or event based. The structured reporting requirements and some of the nuances and issues are briefly touched upon.

(a) Client transactions done with Form 60 declaration i.e. without PAN

This reporting is done in Form 61 on half yearly basis in October and April every year for the preceding half year April-September and October-March respectively. The transactions could be opening of bank account, issuance of debit/credit card, cash deposits exceeding ₹ 50,000 in a day, cash payment exceeding ₹ 50,000 for purchase of bank drafts in a day or fixed deposit exceeding ₹ 50,000 or aggregating more than Rs. Five lakhs in a financial year.

(b) Statement of Financial Transactions

This reporting is done in Form 61A once a year by 31st May for the preceding financial year. Without going into the details of the requirements under Rule 114E, shall state that this is a significant wealth of information for the Government in assessment proceedings and in mapping of risk profiles in the e-assessment scheme.

(c) FATCA and CRS reporting

This is done annually in Form 61B to enable the Government to meet with its international commitment to combat cross border tax evasion. As this information goes to foreign Governments, there is significant quality control requirement. One of the key information requirements in this report is the foreign Tax Identification Number (TIN) of the bank's customer. Several customers are reluctant to provide the foreign TIN on the

basis of guidance (misguidance?) of their advisors that the TIN should not be provided. There is the added requirement of periodic renewal of client declarations of tax residence. In this area, the Government has proactively worked with banks and has provided detailed guidance resulting in ironing out of several of the technical uncertainties and interpretational issues.

(d) TDS/ TCS and other returns

Like all tax deductors and tax collectors, banks provide financial information through the mechanism of TDS returns (Forms 24Q, 26Q, 27Q, 27E). In addition, banks also furnish, on quarterly basis, Form 26QAA showing details of fixed deposit movement along with Form 26QA giving details of deposits and interest where TDS was not applied.

As stated earlier, banks also furnish a quarterly return in Form 15CC of foreign remittances made which is in addition to the Form 15CA and/ or Form 15CB provided by the remitters themselves.

These tasks have created their own challenges for banks viz. development and upgradation of systems, often at short notice, training of manpower, modification of forms/ net banking platforms, monitoring the quality of information etc. On the positive side, the Government generally has discussions with banks to get their feedback on the challenges, uncertainties and also provides clarifications where required.

There are some event-based reporting or actions demanded of banks. These vary from time-to-time and could be notices asking for bank statements or Know Your Customer (KYC) documents (often under summons), recovery notices under Section 226 in respect of client tax dues, notices under

Section 133 seeking information in respect of letter of credit or guarantee charges to support any ongoing transfer pricing assessments, notices to seal lockers and sometimes freeze demat accounts. Some of the challenges that banks face in respect of such notices are caused by the sheer volume of notices received and short timelines for compliance. In a bank, more often than not, the systems are segregated and old data is archived frequently. Retrieval of old data can only be done by following certain access security protocols. Many officials, being unaware of this limitation, may not give sufficient time for compliance. Sometimes the file format requirement becomes an issue. For example, many banks' older systems give reports including bank statements in text format whereas officials may require the statements in Excel format. A bank may be hesitant to convert text files to Excel for fear of loss of data sanctity. In some cases, the same account(s) may be attached by multiple agencies like Enforcement Directorate, Central Bureau of Investigation, income-tax and Goods and Services Tax (GST) authorities. Each of them requires statements or other documents/ reports to be deposited with them at short notice. This again creates the challenge as the system can generally run one set of information reports at a time.

Conclusion

I have been able to touch upon only the major corporate tax and tax operational issues faced by Indian banks. I have kept away from the area of GST. With advent of pre-filled returns, e-assessments and GST, the areas discussed above will be transformed and there could be different challenges to deal with in time to come.

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Select Issues for Non-Resident Banks



CA Sunil Badala

Introduction

Financial services as a sector in any country plays a major role in the economic development of the Country. Banks are the backbone of the Financial services sector. Considering the size and need of the economy, both the domestic private sector banks and the foreign banks play a key role. While both play an equally important role in the economy, the tax rules for both differ slightly basis the nature of the entity, as the foreign banks are not domiciled in India. The main difference being the difference in the rate of tax and this has caused quite a bit of heart burn for foreign banks recently, especially corporate tax rates were lowered for domestic companies, we shall discuss in more detail in this article hereafter. Also, as the Indian Branches of foreign banks are part of global organisations, transfer pricing plays a very important role. In fact today, most of the tax litigation of foreign banks is around transfer pricing issues.

Foreign banks, as also all other taxpayers, would like certainty in the regulatory and financial policies, especially as foreign banks operate in a global scenario and tend to compare the uncertainty in India with other foreign jurisdictions. Today the Courts are burdened with litigation. To reduce the number of appeals

pending and also, to give some certainty to the taxpayers, recently the Government has introduced the *Vivad se Vishwas* Scheme. This move of the Government has to be lauded, also it has to be acknowledged that this Government has been trying to give certainty to taxpayers. However, there are still many issues which are open and we will discuss some of them hereinafter in the context of foreign banks.

A. Expenses attributable to Indian operations paid by Head Office ('HO')

Indian branches of foreign bank (hereinafter referred as 'Bank branch') are part of a global Bank. MNCs need to adopt uniform practices across the globe and standardize policies, procedures etc. for smooth functioning. Therefore, certain costs will be incurred at a central level and then will be allocated to other regions in the ratio of time spent for that region and the benefit accrued to it. This allocation causes lots of issues in corporate tax as well as transfer pricing as the tax office tends to challenge the allocations on two folds- the value and the benefit accrued. To overcome the issue on verification of the costs, Section 44C was inserted in the Income-tax Act, 1961 ('the Act') from 1 April 1976 with the objective of overcoming the difficulty in

scrutinizing and verifying claims in respect of general administrative expenses incurred by the HO of a non-resident company in respect of their business in India. Section 44C lays down a ceiling limit of lower of 5 % of total income or the actual expenditure incurred. However, while the intent is to simplify the claim of HO expenses there are still many issues which pose a challenge for both, the taxpayers and the tax authorities, few of which are discussed below:

HO Expenditure not debited in the books of branch office/Permanent establishment in India

- Section 44C of the Act states that expenditure incurred in relation to HO expenditure, shall be allowed as per the provisions mentioned therein. The question arises whether the same would be allowed even if the expenditure is not debited in the books of branch office/permanent establishment?
- The Supreme Court in case of *Kedarnath Jute Mfg. Co. Ltd.*¹ laid down the principle that the allowance of an expenditure as a deduction does not depend upon its accounting in the books of the assessee. Thus, even if HO expenditure is not debited in the books of the Bank branch, the expenses maybe claimed as a deduction. Whilst there are case laws² in favour of the assessee this continues to be one of the disputes with the tax authorities.

Specific costs

- Section 44C of the Act restricts the expenditure on account of executive and

general administration expenses up to 5% of the adjusted total income. The most vexed issue in connection with this section is whether the specific cost incurred by the HO gets covered by the provisions of section 37(1) of the Act or whether the same are covered by section 44C of the Act?

- The term HO expenditure is defined to mean executive and general administration expenditure attributable to the business in India, including specified expenditure for premises outside India, compensation costs and travelling costs of any employees outside India.
- It can be considered that section 44C does not cover the expenses included by the HO wholly and exclusively for the Bank branch in India. Hence, such expenses may be claimed as deductible under section 37 without any restriction under section 44C. However, the AO generally does not accept the Bank branch's contention that the expenses are specific in nature and treats the same at par with 'general' and 'administrative' expenses. The next challenge is satisfying the tax office that the Bank branch has derived benefits from HO expenses and hence, deduction should be allowed under section 44C/37(1) of the Act.
- There are various judicial precedents supporting that if the expenses are incurred specifically for the Bank branch then it should be allowed in entirety without any restriction under section 44C. As regards the benefit test to be proved, as in most

1. [1971] 82 ITR 363 (SC)

2. *British Bank of Middle East vs. JCIT* [2005] 4 SOT 122 (Mumbai Tribunal), *ANZ Grindlays Bank vs. DCIT* [2016] 67 taxmann.com 191 (Delhi HC)

3. *CIT vs. Emirates Commercial Bank Ltd* [2003] 262 ITR 55 (Bom.), *Director of Income-tax, Circle-1 (1) vs. Antwerp Diamond Bank NV Engineering Centre* [2014] 44 taxmann.com 175 (Mumbai - Trib.)

things, the key here lies in data. It is very important to keep robust documents which prove the time spent by HO for India and the exact benefit obtained. Whilst this may sound simple, in complex multi layered and global organisations it is one of the biggest challenges. However, today with various technology tools it should be able to capture some of this data at source. Transfer pricing again plays a key role here in establishing the benefit test as discussed below in detail.

Transfer Pricing ('TP')

- It is imperative to note that TP of intra-group services (including HO expenses) is considered a high-risk area by Indian Revenue Authorities ('IRA'). It considers the payment for intra-group services to be base eroding in nature and accordingly, attaches great importance to the TP of such payments. Intra-group payments are often the soft targets for the IRA, subject to intense scrutiny, since they come with a pre-conceived notion that these payments are profit-extraction tool used by MNCs. As discussed above, the IRA insist for voluminous information to evidence the need, receipt and benefit test; challenge the commercial expediency of the payment. Accordingly, it needs to be ensured that underlying documents in form of supporting workings, write-up on various services availed, e-mail correspondences, etc. are reviewed thoroughly from tax and TP perspective.

At the time of the assessment proceedings, it would be good if the Bank branch is able to provide the following :

- o The commercial justification/business expediency of the services availed from Associated Enterprises (i.e. HO/overseas branches);

- o That the support services were indeed received from HO;
- o That the reasonability of the amount expensed in comparison to the benefits derived.

Even though the Indian transfer pricing regulations have prescribed detailed transfer pricing documentation requirements in general, no specific guidance has been given in the context of intra-group payments.

In this backdrop, safe harbour for payment towards low value-adding intra-group services availed was indeed a light at the end of the tunnel. Although a welcome step by introducing the safe harbour for payment made towards low value-adding intra-group services availed from HO, specific exclusion of business process outsourcing services from the definition of 'low value-adding intra-group services' has restricted its applicability and moreover has created a confusion in the mind of the Taxpayers as to what is low-value services. It is recommended that the definition for low value-adding intra-group services be revisited to bring in line with the OECD TP guidelines.

- B. Interest paid to offshore branches/HO**
 - Just as cost allocations are a normal phenomenon in global organisations so is borrowing and lending between the Bank branch and the HO to make best use of capital available with various branches. The issue with respect to payment of interest by branch to its HO, is twofold, i.e. firstly, whether the interest paid was tax deductible in the hands of Bank branch and whether the same is taxable in the hands of HO in India.

When it comes to deductibility of interest paid to HO, the Bank branches take shelter to Article 7(2) of the Tax Treaty to consider HO and branch as separate entities and therefore entitled to a deduction of interest paid to HO. Nevertheless, there being no specific provision either under the domestic law or the tax treaty to charge to tax the interest being paid by the Indian PE to the HO, no such tax can be levied on the HO as a separate taxable entity. Therefore, there is also no obligation on the Indian branch to withhold tax while paying to the HO.

- This controversy was decided by the Special Bench of the Mumbai Tribunal in case of Sumitomo Mitsui Banking Corporation⁴ wherein the Mumbai ITAT held Indian PE and the HO along with its other branches are the same legal entity and one cannot make profit out of self. Hence, interest paid by the Indian PE to the HO are neither taxable as income nor tax deductible as expenditure under the domestic tax law of India. However, where the concerned tax treaty treated the PE and HO as separate entities and there existed specific provisions that enabled Indian PE to claim tax deduction of interest paid by Indian PE to HO, a deduction under the tax treaty was to be allowed.
- The Calcutta High Court in the case of ABN AMRO Bank NV⁵ has also dealt with this issue and held that the payment of interest by a Bank Branch to its HO is an allowable deduction and withholding is not required on such payment. The department's SLP against the said decision has been dismissed by the SC.
- To overrule, decision in the case of Sumitomo supra, the provisions of section 9(1)(v) was amended w.e.f. 1.4.2015 to provide that in the case of a bank branch, any interest payable to the HO shall be deemed to accrue or arise in India and would be chargeable to tax in addition to any income attributable to the bank branch in India. The Branch shall be deemed to be a person separate and independent of HO. Accordingly, the Branch is obligated to deduct tax at source on any interest paid/payable to HO and the same will be taxable in the hands of HO in India. Whilst whether the amendment under the Act is enough to bring the interest to tax in the hands of the HO or there could be still some argument to argue the same is not taxable under the Tax treaty could be evaluated, the cost of litigation and the ultimate benefit will have to be carefully weighed.

C. Income of other branches reported in form 26AS

- With the Globalization kicking in and liberalized External Commercial Borrowings ('ECB') guidelines, the Companies in India tend to tap the offshore debt markets for the purpose of obtaining various kind of loans. Generally, such loans are recorded in the books of the HO and the Indian bank branch may or may not be involved in the process but generally the role could be to support the HO
- In case the Bank branch is involved in the ECB transaction, its role is to primarily acts as a communication channel between

4. *Sumitomo Mitsui Banking Corporation vs. DDIT [2012] 19 taxmann.com 364 (Mum. SB)*

5. [2012] 343 ITR 81

the HO and Indian borrowers . In any case, the contract, payment terms and negotiations are only done between HO and the borrowers. The role played by the Bank branch and the attribution of income is another challenging issue and will be separately discussed when we discuss the TP issues.

- HO and Bank branch are not separate entities and hence, they have single PAN. When the borrowers pay interest on ECB, they use the PAN of the Bank branch to deposit tax with the Government Treasury and the same is reflected under the Form 26AS. Form 26AS is a PAN based form which captures the tax credit against the PAN of the taxpayer.
- The Form 26AS would capture the income as reported by the payer but as the income is recorded in the overseas books by the Banks, following the accounting policies of that region, there would always be difference in the amounts as per Form 26AS and as recorded by the overseas branch. There could be multiple other issues in reconciling the income as per Form 26AS and as per the books of account. This could be on account of foreign currency conversion, differences in points of accrual by the payer and the Bank etc. However, as in all cases taxes are deducted at source there is no tax leakage. Therefore, the reporting of income as per Form 26AS should be considered as adequate disclosure of the income.
- **Transfer Pricing**
ECB loans can be provided only by non-resident (other than branch or permanent establishment in India) lenders to Indian

borrowers. Accordingly, Bank Branch cannot provide ECB to Indian borrowers. However, these Bank branches generally provide support services to HO.

Support services broadly include origination pre-disbursal support in form of pre-screening of new clients, undertaking client's financial and business due diligence, credit assessment, etc. and post-disbursal support in form of ongoing credit monitoring, monitoring covenants breach, etc.

HO deploys necessary funds to disburse loans to the borrowers and accordingly face substantial credit risk in respect of default in principal and interest payments. Income earned by HO from borrowers is generally in form of interest on ECBs and fees in form of arranger's fees, front end fee, etc.

For the above support services, Net Revenue split model is generally followed to remunerate Bank branch. While the computational aspects to remunerate Bank branch differs, there is a consensus that no interest income shall be attributable in the hands of Bank branch since no capital is contributed by the Bank branch. In other words, industry practice is generally to attribute only a portion of the arranger's/ administrative fees to India, considering the FAR (Functions, Assets and Risk) profile and interest income is the compensation to the entity deploying the funds. This principle is also acknowledged and upheld in various judicial decisions:

- **Credit Lyonnais⁶**. *These Tribunal orders have also been upheld by Hon'ble Bombay High Court*
- **Calyon Bank vs. DDIT⁷**;

6. ITA No. 1935 / MUM / 2007 and ITA No. 4433/Mum./2009

7. ITA. No.4474/M/2009

- ***RBS Financial Services (India) Pvt. Ltd. vs. DCIT***⁸;
- ***Barclays Bank PLC vs. ADIT(IT)***⁹.

It is seen that the IRA generally allege that the role of the Bank branch extends beyond origination support; the Bank branch plays a very active role in negotiation and structuring of the deal through their marketing and commercial expertise in facilitating ECB deals and also performs services relating to credit evaluation and monitoring; and that Key entrepreneurial risk-taking ('KERT') functions are undertaken by the Bank branch. Accordingly, the IRA are seen to allege that higher share of arranger's fees should be allocated to Bank branch. The IRA also allege that a portion interest earned by HO, besides the share of arranger's fees should be shared with the Bank branch as a part of arm's length remuneration.

Considering the aggressive nature of revenue authorities in India, it would be prudent to maintain robust documents (such as ECB agreements between HO and borrowers, deal-wise details of income earned by HO supporting workings, basis of how revenue split is derived, etc.) to substantiate the arm's length dealings.

D. ICDS

- The Government of India in exercise of powers conferred to it under section 145(2) of the Act had issued 10 ICDS with effect from AY 2016-17. The same was subsequently deferred for a year. ICDS have been issued with the aim of bringing uniformity in accounting policies governing computation of income in accordance with tax related provisions, and also reducing the irregularities amongst them.

- Later on, CBDT notified amended ICDS with effect from AY 2017-18. Some of the ICDS had major impact on the tax treatment of certain income/expenses in case of banks such as Marked to Market ('MTM') loss/Gain, opening balance in Foreign Currency Translation Reserve account, valuation of securities, etc. This was leading to a case of one-time additional tax burden for many large banks as there may be significant foreign exchange gains on account of depreciating rupee, based on MTM concept.

- In order to bring more clarity on the impact of ICDS and better compliance of these standards, the CBDT issued clarifications by way of 25 FAQ's for better compliance of these standards. Recognizing that Banks are a highly regulated entity and have to follow norms mandated by RBI, it was clarified that MTM loss or gain shall be recognized in line with the applicable RBI guidelines. Therefore, this does not disrupt the accounting principles. Likewise, with respect to securities held by banks as stock-in-trade, part-B of ICDS-VIII provides that securities shall be classified, recognised and measured in accordance with the extant guidelines issued by the RBI and any claim for deduction in excess of the said guidelines shall not be taken into account. This has taken care of lot of controversies that could have arisen.

E. TDS/TCS

TDS

The Bank's requirement to withhold tax at source on payments to resident or non-resident is similar

8. ITA No. 3260/Mum/2012 and ITA No. 5997/Mum/2013

9. ITA No. 178/Mum/2011 and ITA No. 4030/Mum/2014

to other persons subject to certain concession such as no withholding on interest on saving accounts and recurring deposit accounts. However, for ease of functioning, foreign banks can also obtain a Nil withholding certificate at the beginning of the AY which allows it to receive payments without any taxes being withheld.

TCS

Under the Liberalised Remittance Scheme ('LRS'), all resident individuals, including minors, are allowed to freely remit up to USD 250,000 per financial year (April-March) for any permissible current or capital account transaction or a combination of both in relation to specified transactions as mentioned in the scheme.

In order to widen and deepen the tax net, the Finance Act, 2020 has proposed to levy TCS obligation on an Authorised Dealer ('AD') who receives an amount of Rs.7 lakh or more in a financial year for remittance out of India from a buyer under the LRS. Rate of TCS is 5% (10% if there is no Aadhar/PAN). This will increase compliance burden on ADs and will also require certain changes to the data systems. We have discussed below key issues that ADs need to consider for TCS:

- Remittances under the LRS scheme can be consolidated in respect of family members however, care should be taken by the AD to give credit to respective person for the TCS of the amount contributed;
- The LRS scheme is applicable to resident individuals. The definition of resident under FEMA is different from Income tax (particularly in view of amendment to the definition of section 6 of the Act). Hence, the AD should observe the definitions under the FEMA;

The procedural requirement of TCS and giving credit to the parties concerned will increase the workload of the ADs.

F. FATCA/CRS

In 2015, India signed up treaties for automatic reporting of financial account information with the US and CRS countries. The Income-tax Rules prescribe the reporting requirements as well as the due diligence aspects for identification of reportable accounts. Penalties for non-compliance have also since been enhanced. While foreign banks in India are required to comply with these requirements in their capacity as Indian Financial Institutions, they may also be required to adopt stricter procedural norms as dictated by their Group.

G. Other issues

Branch Versus Subsidiary

Foreign banks traditionally operated in India through a branch model. Further, owing to various global financial crisis and in order to provide more effective control to the host country, there was a need for subsidiarization of the Indian branch subsidiaries of foreign banks. Accordingly, the RBI in November 2013 issued a framework (the RBI scheme) for foreign banks to establish wholly owned subsidiaries (WOS) in India. The RBI scheme advocated a WOS model for foreign banks with local incorporation, a local board and ring-fenced capital that would remain unaffected by global events impacting the foreign parent.

With a view to encourage foreign banks to convert existing Indian bank branches into WOS, the RBI scheme provided incentives in the form of "near national treatment" to WOS of foreign banks, creating a level playing field for foreign banks operating in India and Indian domestic banks.

To further incentivize foreign banks and to facilitate conversion of an Indian branch of a foreign bank into a subsidiary company, Finance Act, 2012 introduced section 115JG into the Act which prescribes special provisions governing such conversions with effect from 1 April 2013

and provides that the resultant capital gains will be exempt, subject to fulfilling certain prescribed conditions.

With the reduction in corporate rate to 22%, the WOS model of operating, purely from a tax perspective looked quite attractive. With DDT being abolished, it may be even more attractive for foreign branches to evaluate the WOS model of operations as it would further bring down tax costs for the branch. For the group also it may be beneficial as the WOS could withhold tax under

a reduced rate applicable to dividend income as per Treaty and the HO could claim credit for the same in the home country. However, one must keep in mind that ultimately tax is not the only consideration and the regulatory aspects of functioning as branch model will also have to be weighed. Perhaps one alternative could be for the Government to reduce the rate of tax for the foreign branches to bring it on par or as close to the rate for domestic companies as possible. We have highlighted below the key pros and cons of subsidiary vis-à-vis branch, from a tax perspective:

<i>Issues</i>	<i>WOS</i>	<i>Bank branch</i>
Taxation	Section 115BAA - 22% (plus applicable surcharge and cess) provided that no specified exemptions/incentives are availed	40% (plus applicable surcharge and cess)
MAT	Not applicable if availed reduced rate under section 115BAA	18.5% (plus applicable surcharge and cess)
Conversion	Conversion of branch to WOS would be tax neutral subject to the conditions as mentioned in the section 115 JG	Not Applicable
HO's ROI	The head office need not file its ROI if the only source of income is interest income from offshore loans	Need to offer HO related income in the ROI of bank branch in India
Provision for bad and doubtful debt	7.5% of adjusted total income + 10% of average aggregate advances made by rural branches	5% of adjusted total income
HO expenses – General and administrative expenses	No cap under section 44C	44C will be applicable
Receipt of interest from HO	Taxable	May not be taxable – receipt from self

Overall, whilst it may seem an attractive proposition from a tax perspective a proper analysis of the additional regulatory compliances should be understood to enable a balanced decision.

Concluding remarks

As we have seen above, there are various open litigation issues foreign banks are grappling with. Considering the aggressive nature of the IRA it is unlikely that litigation can be avoided.

Therefore, it is crucial that assessments at the first level are handled extremely carefully so that the submission of facts and data cannot be challenged by appellate authorities. The key to navigate the assessment proceedings before the IRA lies in the strength of the documentation that can be maintained in relation to the international transactions. The dealings between the Bank branch and the HO should clearly document the points at which the respective entities have contributed to the value chain in the international transactions and how the functions undertaken by each of them can be classified between KERT and routine functions. Such analysis will help the Bank branch to mitigate the risk of any potential adjustment to some extent.

Certainty is key to global corporates. Whilst under corporate tax there is no mechanism to pre-negotiate the position on litigious issues, from a transfer pricing perspective one of the options for the Foreign Banks is to evaluate an option of 'Advance Pricing Agreement'¹⁰ to obtain certainty in relation to its intra-group dealings. This is especially helpful as today the key litigation for foreign banks is in the context of transfer pricing.

Further, it is also relevant to touch upon the recent TP guidance released by the OECD on financial transactions as part of Base Erosion and Profit Shifting ('BEPS') Actions 4, 8-10. This guidance is significant because it is the first time the report aims to clarify the application of the principles included in the 2017 OECD Transfer Pricing Guidelines to financial transactions. The report covers specific issues relating to the intra-group loans, cash pooling, hedging, financial guarantees and captive insurance and also includes a number of examples to illustrate various principles discussed in the report. The Report further acknowledges that different views on various important topics may be possible.

Going forward, the multinational banking groups with intra-group financial transactions should assess and align with the new guidance and ensure appropriate supporting documentation is in place to support the arm's length nature of the transaction. As the world becomes more cohesive and global, evolving global policies will change the face and core of tax litigation in the years to come. Whilst there is no certainty in litigation, what is certain that interesting and challenging times lie ahead for the tax professionals and the tax authorities.

10. An Advance Pricing Agreement (APA) is an agreement between a taxpayer and revenue authority determining the transfer pricing methodology for pricing the taxpayer's international transactions for certain years. The methodology is to be applied for a certain period of time based on the fulfillment of certain terms and conditions.



It is only when the mind is very calm and collected that the whole of its energy is spent in doing good work. And if you read the lives of the great workers which the world has produced, you will find that they were wonderfully calm men.

– Swami Vivekananda

Direct tax issues for Non-Banking Finance Companies in India



CA Chaitrali Kamath & CA Apurva Rathi

Introduction

Non-banking financial Companies (NBFCs) are a group of diverse financial institutions which, in a bank-dominated financial system like India, serve as an alternative channel of credit flow to the commercial sector. NBFCs largely cater to the unbanked sector and take on 'riskier' bets (which banks are unable to accommodate due to regulatory constraints). Thus, NBFCs play a vital role in the Indian financial system by complementing and competing with banks, with over one-fourth of the credit flow still coming from them.

NBFCs are classified on the basis of their systemic importance (i.e. asset size). Further, given that NBFCs cater to niche areas, they are also categorised on the basis of activities they undertake such as Investment and Credit Company (ICC), NBFC-Infrastructure Finance Company, NBFC-Systemically Important Core Investment Company (CIC), Infrastructure Debt Fund-NBFC, NBFC-Micro Finance Institution, NBFC-Factor, NBFC-Non-Operative Financial Holding Company, Mortgage Guarantee Company, NBFC-Account Aggregator and NBFC-Peer to Peer Lending Platform.

After Infrastructure Leasing & Financial Services (IL&FS) crumbled in September 2018, banks, mutual funds and pension funds became extremely cautious in lending to NBFCs and thus, NBFCs had little or no support from banks or from other institutions. A year later banks are slowly opening doors to lending to NBFCs, prodded by Government of India incentives to rejuvenate the NBFCs. However, NBFCs with lower ratings and no big parent are still struggling to get funding.

The Reserve Bank of India (RBI), in its financial stability report 2019, said that stress tests showed that around 8.6 per cent of NBFCs will not be able to comply with the minimum regulatory capital requirement of 15 per cent. Also, around 14.2 per cent of the companies will not be able to comply with the minimum regulatory capital to risk (weighted) assets ratio norms.

While the NBFCs continue to grapple with aforesaid liquidity issues, on the direct tax front there is age old litigation on certain aspects that continue to haunt the NBFCs. Further, with advent of Ind-AS¹, NBFCs will have new issues to tackle. Some of the issues are associated with

1. Effective from 1st April 2018 for NBFCs.

the type of NBFCs, in this article, we have tried to cover typical tax issues faced by most types of NBFCs²:

A) Taxability of interest on non-performing assets

Background

1. The operations of NBFCs as far as providing loans to the customer is similar to banks. Further, banks and NBFCs amongst other financial institutions (FI), engaged in the lending activities, ordinarily account for and also offer to tax the interest income from lending activities on accrual basis. The Income Computation and Disclosure Standards (ICDS) prescribed under the Income-tax Act, 1961 (Act), also provide for interest income to accrue on time basis determined by the amount outstanding and the rate applicable.
2. At the same time, banks and NBFCs account for the interest on bad or doubtful debts/non-performing assets (NPAs) only at the time of actual receipt, basis the prudential norms prescribed by the RBI.
3. In this regard, it is relevant to note the provisions of section 43D of the Act, basis

which, the interest income in relation to the prescribed bad and doubtful debts/NPAs³ received by certain institutions⁴ is taxable in the previous year in which such interest is credited to the Profit and Loss account or is actually received, whichever is earlier.

4. While there is same treatment in books of account for banks and NBFCs, when it comes to taxation, NBFCs unlike banks did not enjoy the shelter of section 43D of the Act as far as taxability of interest on NPAs.
5. Since NBFCs were not included in section 43D of the Act, the industry adopted mixed views for the purpose of taxation of such income and even the tax authorities adopted inconsistent views and thereby resulting into subject matter of litigation with divergent rulings⁵.

Amendment by the Finance Act, 2019 and its impact

6. With the objective of incentivising NBFCs and also as a step towards bringing parity in NBFC's tax treatment with banks and certain other FIs, provisions of section 43D of the Act were extended to certain categories of NBFCs (i.e. Deposit taking NBFCs⁶ and Systemically important non-

2. We have not covered issue in relation to section 14A of the Income-tax Act, 1961 which is typical to ICC and CIC.

3. Rule 6EA and 6EB of the Income-tax Rules, 1962, provide for the determination of bad and doubtful debts for the purposes of section 43D of the Act.

4. Section 43D of the Act covers – Public Financial Institutions, Schedule Banks, certain Cooperative Banks, State Financial Corporation, State Industrial Investment Corporation, and Housing Finance Companies before the amendment made by Finance Act, 2019.

5. *Southern Technologies Ltd. [2010] (320 ITR 577)* – The Supreme Court upheld the constitutional validity of exclusion of NBFCs from section 43D of the Act; *Vasisth Chay Vyapar [2019] (410 ITR 244)* – The Supreme Court upheld the decision of the Delhi High Court (which was after considering the aforesaid Southern Technologies decision), that interest on NPAs accruing to the taxpayer NBFC, which is not received and not accounted for as per the extant RBI guidelines, cannot be said to be taxable in the hands of the NBFC.

6. NBFC accepting or holding public deposits and registered with the RBI under the provisions of the Reserve Bank of India Act, 1934 (RBI Act)

deposit taking NBFCs⁷) by the Finance Act, 2019. Correspondingly, the borrower shall get a deduction for the interest paid to such NBFCs on payment basis⁸.

These amendments are applicable with effect from Assessment Year 2020-21 onwards.

7. The amendment was meant for providing ease to the NBFCs but, surprisingly only deposit taking and systemically important NBFCs are covered but others, in particular non-deposit taking NBFCs have been left out from the amendment. No rationale has been provided in the budget documents for this exclusion.
8. Accordingly, NBFCs which are not covered by the said amendment, but which are also required to follow the RBI guidelines, the position existing prior to the proposed amendment would continue to prevail and reliance may be placed on judicial precedents to conclude on the taxability of interest on NPAs.
9. Further, since section 43D of the Act overrides ICDS IV, the NBFCs covered under section 43D of the Act shall not be required to make adjustment for interest on NPAs and simultaneously claim bad debt deduction if such interest is not accounted for in the books of account.

Given the Ind-AS on accounting of income, the interest on NPA (i.e. Stage 3 loans) could still not fall under section 43D of the Act.

Prescribed categories of bad and doubtful debts/ NPAs

10. For the purposes of section 43D of the Act, Rule 6EA and 6EB of the Income-tax Rules, 1962 (Rules) has been prescribed, to determine the categories of bad and doubtful debts/ NPAs on which interest can be recognized on actual realisation. Currently, it does not cover NBFCs and will require suitable amendment to cover NBFCs.
11. Section 43D of the Act, at the same time, uses the phrase “having regard to the guidelines issued by the RBI in relation to such debts”.
12. While the intent of prescribing Rules 6EA and 6EB of the Rules was to be in sync with guidelines issued by the RBI from time-to-time, the Rules have not kept pace with the evolving RBI guidelines on NPAs, and this has resulted in litigation on account of difference of opinion between tax payers and tax authorities.
13. Banks are facing litigation on notional interest addition based on strict interpretation of Rule 6EA of the Rules⁹.
14. Therefore, not only for banks and other FIs, but now also for NBFCs, who are proposed to be covered by section 43D of the Act, this procedural aspect needs utmost consideration to avoid the litigation and the said controversy may get addressed if the Central Board of Direct Taxes harmonises Rule 6EA and 6EB of the Rules with RBI guidelines while extending it to NBFCs.

7. NBFC which is not accepting or holding public deposits and having total assets of not less than INR 500 crore as per the last audited balance sheet and is registered with the RBI under the provisions of the RBI Act.

8. Section 43B of the Act was amended to give effect.

9. *Cosmos Co-op Bank vs. DCIT [2014] (64 SOT 90) (Pune)*, *GIC Housing Finance Ltd. vs. Addl. CIT [2011] (45 SOT 318) (Mum)*

Ind-AS implications

15. NBFCs, complying with Ind-AS, are required to categorize loan assets into three stages, based on the overdue period of receivables (Stage 3 loans are akin to NPAs as per the extant RBI guidelines), and make a provision for bad and doubtful debts following the Expected Credit Loss model.
16. In this regard, interest income in respect of Stage 3 loans is required to be recognised to the extent of the part of loan secured from the borrower. Interest on the unsecured part of loan (unrecoverable part) shall not be recognized in the books of account.
17. In such a case, unlike in Indian GAAP (wherein the classification made as per RBI guidelines (*viz.* standard and non-performing), recognition was dependent upon reasonable certainty of ultimate collection, given that the interest income on part (recoverable portion) of NPAs will have to be recognised, a question arises as to whether such recognised interest would become taxable in the year of such recognition, given the fact that even section 43D of the Act provides for taxation at the time of credit in Profit and Loss account or actual receipt, whichever is earlier.
18. In such cases, NBFCs would have to consider claiming deduction for such recognised interest under provision of bad and doubtful debts under section 36(1)(viii) and section 36(1)(vii) of the Act.

Even where NBFCs offer such income to tax in the year of accrual and subsequently claim a deduction under the Act when the same becomes a bad and doubtful debt, such a procedure results in outflow of cash at an early stage (i.e. could lead in the year of accrual) and cash trap for NBFCs.

B) Section 269ST of the Act

19. Section 269SS states that a person shall not take or accept a loan/deposit from another person otherwise than by the prescribed banking channels, i.e. a/c payee cheque or account payee bank draft or by use of an electronic clearing system, so that the aggregate from such a person is INR 20,000 or more.
20. Further, section 269T states that no repayment of any advance received in relation to a transfer of immovable property will be made except by the said prescribed banking channels if the aggregate is INR 20,000 or more.
21. In this regard, the CBDT has clarified that each instalment of loan repayment will be considered as “single transaction” and, accordingly, the threshold of INR 2,00,000 is to be considered w.r.t. each instalment of loan repayment and not aggregate receipt of all instalments.
22. Section 269ST of the Act does not apply to banking companies amongst other persons specified in the section. However, such exclusion has not been provided to NBFC’s, which having regard to its core activity of financing, may have receipts in the form of cash towards repayment of loans (especially from rural areas). Additionally, NBFCs will have following implications:
 - Due to this new threshold limit, NBFCs will not be able to make part disbursements or accept part repayments in cash and cheque.
 - In order to keep their businesses alive, NBFCs may want to guide farmers/ rural customers with opening a bank account to allow smooth disbursement of loans.

- NBFCs may need to set up procedures and strengthen them to speed up the process of disbursing loans to small marginal borrowers as these small borrowers are often in immediate need of cash to meet their liabilities.
- In a case, where interest receivable by NBFCs is converted in loan, it would be pertinent to analyse whether booking of interest and capitalising the same in the books of the NBFC could attract section 269ST of the Act. However, going by the intent of the Government, section 269T of the Act should not apply in this case.

C) Deduction for provision of bad and doubtful debts – section 36(1)(viia) of the Act

Quantum of deduction

23. Section 36(1)(viia) of the Act provides for deduction in respect of any provision for bad and doubtful debts. Indian banks (including certain categories of co-operative banks) are allowed a deduction in respect of provision for bad and doubtful debts of an amount not exceeding 8.5% of the total income (to be computed before certain specified deductions) and an amount not exceeding 10% of the aggregate average advances made by the rural branches of such banks computed in the prescribed manner. Further, foreign banks can claim a deduction of an amount not exceeding 5% of the total income towards provision of bad and doubtful debts.
24. Alternatively, a scheduled/non-scheduled bank may at its option, elect to claim a deduction for an amount not exceeding 5% of the amount of doubtful or loss assets (created in accordance with the relevant

guidelines) as appearing in the books of account as on the last day of the previous year.

However, the quantum of deduction is restricted to 5% of the total income (to be computed before certain specified deductions) of a NBFC compared to the deduction available to banks.

Computation of deduction

25. The language of the section 36(1)(viia) of the Act is specific which provides for deduction in respect of provision created for bad and doubtful debts. In this regard, the relevant extract of said provision is reproduced as under –

“36(1) The deductions provided for in the following clauses shall be allowed in respect of the matters dealt with therein, in computing the income referred to in section 28–

(viia) in respect of any provision for bad and doubtful debts made by–

.....

(d) a non-banking financial company, an amount not exceeding five per cent of the total income (computed before making any deduction under this clause and Chapter VI-A).”

26. From the language of section 36(1)(viia) of the Act, the deduction should only be available in respect of provision created for bad and doubtful debts.

27. As per the RBI guidelines, an asset is classified into the following and provision on the same is created as per the said guidelines:

- Standard assets;
- Sub-standard assets;

- Doubtful assets; and
 - Loss assets.
28. Based on various judicial precedents, it can be inferred that standard assets cannot be classified as bad and doubtful debts and accordingly, deduction for provision on standard assets under section 36(1)(viiia) of the Act is not in accordance with law.
29. However, since the term bad and doubtful debts has not been defined under the Act, an ambiguity exists as to provision made for which asset classification would fall under the meaning of bad and doubtful debts.
30. Further, under Ind-AS, loans will no longer be bucketed into standard/sub-standard/doubtful or loss categories (as currently prescribed under the RBI norms). Thus, the RBI guidelines would not be applicable, and the classification of loan shall be based on days past due and other qualitative criteria and shall be bucketed into Stage 1, Stage 2 and Stage 3.
31. In this regard, clarification is required as to provisioning on which stages of loan shall qualify for deduction under section 36(1)(viiia) of the Act for provisions for bad and doubtful debts.

D) Key tax issues arising under Ind-AS

Minimum Alternate Tax (MAT) impact on equity component on compound financial instruments

32. Section 115JB(2C) of the Act provides for the 'book profit' to be increased or decreased by one-fifth of the 'transition amount'. 'Transition amount', for this purpose, includes the amount or the aggregate of the amounts adjusted in other equity (excluding capital reserve and securities premium reserve) on the convergence date.

33. One of the adjustments on the convergence date pertains to reclassification of compound financial instruments (for instance convertible preference capital) where Ind-AS requires such instruments to be reclassified into equity component and debt component. The amount so classified as equity component is adjusted in 'Other Equity' and thus, technically one may have to be considered for transition amount.
34. As one may note that the equity component being referred above, in principle, represents a capital item as it is reclassification of share capital. The intent for taxing would not be to tax share capital in any form called. This intent is also supported by the fact that adjustment to security premium and capital reserve have been specifically excluded from transition adjustment under section 115JB(2C) of the Act.
35. Thus, an ambiguity exists whether such a capital item should be excluded from the MAT provisions.

Taxability of loan processing fees earned - Point of taxation

36. Loan processing fee is a one-time fee that is levied on the borrower at the time of processing of a loan.
37. Under the erstwhile Indian GAAP, while there was no guidance in terms of when such processing fee should be offered to tax, there were varied practices of recognizing this income where some recognized this in the profit and loss account in the year of receipt whereas some recognized this over the period of loan. Certain NBFCs follow a practice to recognise processing fee upfront on a conservative basis and to avoid litigation.

38. While, under Ind AS, the processing fee is required to be adjusted in the loan amount and amortized over the period of loan on the basis of effective interest rate model, under ICDS IV, the same is required to be taxed on time basis i.e. proportionately over the duration of the service/activity in relation to which such fee is accrued.

Taxability of Excess Interest Spread (EIS) earned on securitization of loans/Assignment of loan - Point of taxation

39. Under assignment of loan transactions, NBFC (as an assignor) earns EIS. Under the erstwhile Indian GAAP, accounting for such assignment of loan was undertaken as per the extant RBI guidelines whereby the EIS was accounted for on amortized basis.
40. Under Ind-AS, the EIS is recognized upfront, at the present value of future EIS cash flows.
41. In light of various provisions under the Act and well accepted principles of law, it may be concluded that the present value of cumulative EIS cannot be said to accrue or arise in the hands of the company in the year in which loans are assigned, and thus, should not be taxable upfront in such year. Accrual of EIS takes place as and when the company establishes a right to receive the same as per the terms of assignment (i.e. over the tenure of loan) and should, accordingly, be taxable over the tenure of loan.

A clarification in this regard is required such that EIS income should be allowed to be offered to tax on an amortization basis as the actual cash receipt is over the tenure of loan (i.e. only when the interest payment becomes due to be payable by the borrower on time basis).

Fair valuation of investments – Interplay with ICDS

42. Part B of ICDS VIII – ‘Valuation of securities’ permits a bank to value securities held as stock-in-trade (SIT) in accordance with the extant guidelines issued by the RBI for the purpose of the computation of taxable income. However, NBFCs are not covered in Part B. Accordingly, NBFCs are required to value SIT securities as per Part A of ICDS VIII which prescribes a bucket approach of valuation at cost or Net Realisable Value, whichever is less.
43. On the other hand, Ind-AS allows/requires to value such securities at fair value on a scrip-wise basis as against bucket approach in ICDS. It may be noted that the Ind-AS provisions may result in recognition of upward gain on securities as well, unlike ICDS provisions.
44. Given the two valuation approaches discussed above, the NBFC will have to maintain two sets of records for valuation of SIT securities, one under ICDS and other under Ind AS (where as the intent of introduction of ICDS was to align tax computation standards with accounting standards, especially Ind-AS).
45. It may be worth noting that the unrealised deduction under ICDS is merely a timing difference given that the actual loss or gain will in any case be taxed on a realised basis.

Penal/overdue interest levied by NBFCs upon default in interest payment

46. A NBFC recognizes penal/overdue interest (being contractually in the nature of interest income) on loans in its books of accounts on a receipt basis. As per ICDS-IV on ‘Revenue recognition’, interest income is

- taxable on time basis i.e. proportionately over the period of the loan.
47. ICDS-IV does not consider the concept of ‘reasonable certainty’ of ultimate collection as a criteria/factor for the purpose of recognition of interest income (as is considered in the case of revenue from sale of goods). Further, the provisions of section 43D of the Act providing for taxation of interest incomes on receipt basis is only applicable on bad and doubtful debts as are prescribed and not in respect of every loan portfolio.
 48. The second proviso to section 36(1)(vii) of the Act, provides that where the debt which has been included/ considered for the purpose of taxable income relating to the relevant year or past year(s) by reason of applicability of ICDS (without being recorded as income in the books of account), becomes irrecoverable, then a corresponding deduction for such bad debt shall be available in the year in which the debt becomes irrecoverable. Further, it provides that for the said purpose, it shall be deemed that the debt has been written off in the books of account.
 49. This aspect has also been clarified by the CBDT in its response to FAQ 13 in Circular 10/2017.
 50. Evidently, the treatment of interest income prescribed as per ICDS-IV creates disparity with the general principles of accrual as per section 4, read with section 5 of the Act. Therefore, it may be argued that ICDS, being a delegated provision under section 145(2) of the Act, cannot override the established principles of tax and cannot extend the scope of taxability beyond what is envisaged in sections 4, read with section 5, of the Act having regard to relevant judicial precedents. Thus, ICDS cannot bring to tax any income which is not taxable as per the charging provisions.
 51. The Institute of Chartered Accountants of India (ICAI), in its Technical Guide on ICDS, has also taken a view that ICDS cannot override binding judicial precedents on the scope and ambit of total income under the Act.
 52. On this aspect, the Hon’ble Delhi High Court (HC)¹⁰, while dealing with the question of Constitutional validity of various provisions of the ICDS, has *inter alia* held that ICDS cannot override binding judicial precedents on the scope of total income. The HC also struck down several contentious provisions of each individual ICDS (which were, however, subsequently reinstated within the Act by way of amendments introduced by Finance Act, 2018).
 53. However, while adjudicating on the issue of recognition of interest income in the absence of reasonable certainty of ultimate collection, the HC held that provisions of ICDS-IV in this respect cannot be held to be *ultra vires* since a corresponding bad debt deduction can be claimed by the taxpayer if the amount of interest is irrecoverable.
 54. Basis the above, a NBFC will have to contemplate the approach to be followed for offering such overdue interest income to tax.

10. The Chamber of Tax Consultants [W.P.(C) 5595/2017]

E) Other issues faced by NBFCs

Perpetual debt instruments (PDIs)

55. The RBI has permitted PDIs to qualify as tier-1 capital base under the capital adequacy norms and these PDIs are extensively used by NBFCs to supplement capital base. PDIs offer a fixed rate of interest and not fixed tenure. Further, the subscribers of PDIs do not have the right to enforce repayment of the principal.
56. There is debate whether return received from PDIs are to be classified as interest or dividend and hence its deductibility. A view can be taken that given the subscribers of PDI have no right to enforce repayment of the principal amount, it is akin to 'equity' and not 'borrowings' or 'debt'.
57. However, practically, subscribers get taxed on the return as interest and therefore, a deduction should be available to NBFC. However, in absence of any specific guidance, litigation for NBFCs cannot be ruled out on this aspect.

Applicability of exemption of tax deducted at source (TDS) under section 194A of the Act

58. As per section 194A of the Act, TDS at the rate of 10% is required to be deducted on the interest portion of the instalment paid to NBFCs. However, the Act provides a specific exemption on non-applicability of TDS on interest portion paid to banking companies and public financial institution.
59. Further, the provisions of section 195(3) of the Act enable Indian branches of foreign banks to obtain a certificate from the Indian Revenue authorities, authorizing the receipt of interest on securities and other sums without deduction of tax.
60. Similar option is also available for resident assesseees, including NBFCs, to make an

application for the grant of such nil/lower withholding certificate under section 197 of the Act, however, such certificate is issued by the tax authorities only subject to fulfilment of conditions as may be prescribed.

61. Owing to the above, persons who avail loans/ deposits from NBFCs are required to comply with the withholding tax obligations i.e. filing of quarterly statements of tax deducted at source, issue of certificates evidencing deduction of tax at source etc. Given that such administrative compliances involve extensive paper work, increased costs, unnecessary blockage of funds (as excess tax is paid) it results in significant inconvenience to the persons who are at an advantage while availing a loan from Indian or foreign bank branches.

Accordingly, the above compliance obligations impede the ability of NBFCs to lend money and create severe cash flow constraints since NBFCs operate on a thin spread/margin on interest which at times is even lesser than the TDS on the gross interest, putting NBFCs at a disadvantage over banks.

Credit for tax deducted by borrowers

62. Currently as per the Act, credit of tax deducted at source by borrowers shall be available in the year in which income is offered to tax. On adoption of Ind-AS, NBFCs shall be taxed in different years though the borrower would deduct tax at the time of payment.
63. Considering the above discrepancy, NBFCs would be required to keep adequate records and reconciliation for identifying tax credit not claimed as regard income offered to tax in past years, which is likely to pose operational challenges.

64. Where the exemption under section 194A of the Act is extended to NBFCs on the lines of interest paid to banks, the practical difficulties and maintaining TDS data for multiple years will be done away with.
65. Additionally, given the number of borrowers deducting TDS for NBFCs, at times, the TDS deposited by the borrower does not necessary get reflected on the income-tax portal, leading to rejection of claim for TDS for such amounts in the return filed by the NBFCs.

Withholding tax on cash withdrawals – Section 194N of the Act

66. Payments made by banks, co-operative societies engaged in the banking business and post offices in excess of INR 1 crore during a previous year are subject to tax withholding at the rate of 2%. Further, payments made to, *inter alia*, banks are outside the purview of the above provisions.
67. In several situations, NBFCs make cash withdrawals from banks for the purpose of disbursement of small ticket loans and thus, the withholding tax at the rate of 2% in respect of such withdrawals is likely to impact the business model and cash flows of the NBFC severely.

Monies received on mortgage of immovable property – Section 194-IA of the Act

68. In certain cases, loans are provided by NBFCs wherein an immovable property kept as collateral. In these cases, where there is a default and the NBFC sells the immovable property mortgaged against the said loans, the third-party purchaser of the immovable property deducts taxes at source at the rate of 1% (where the

consideration is INR 50,00,000 or more). Such tax withholding is done by the purchaser of immovable property in the name of the defaulting borrower.

69. The tax withholding has an impact on the margins of the NBFC and also, no tax credit is available in the hands of the NBFCs as well. Moreover, recovery of the tax withholding amount from the defaulting borrower also has several practical challenges.
70. In such a case, an amendment in Section 194-IA of the Act to exclude a purchase of immovable property under an auction process conducted by NBFCs/HFCs would ease the difficulty the NBFC would face. Alternatively, it may be specifically provided that tax withholding ought to be done by the purchase of the immovable property to the credit of the NBFCs.

Tax on receipt of pledged shares under section 56(2)(x) of the Act

71. In certain scrutiny audits, the income-tax authorities have brought to tax the difference between the book value of the shares (computed as per the prescribed methodology) and the amount of loan outstanding (including interest) in the hands of the NBFCs at the time of invocation of pledge of shares prevalent against the concerned loan.
72. While the intent of the provisions of section 56(2)(x) of the Act is to curb the mischief of artificial transfers, a literal interpretation may result in an additional income-tax burden in the hands of NBFCs. Further, such pledges are genuine and invoked only in case of bad loans. Thus, such a provision can lead to undue hardships to the NBFCs.

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Brokers



CA Vishal Khanna & CA Ankit Mehta

Introduction

Brokers perform the vital role of providing access to investors and traders to the markets and are one of the key intermediaries in a country's financial and capital market system. The stock broking industry in India traces its existence to the mid-19th century before the BSE (then the Bombay Stock Exchange) was established in 1875. Over the past decades, the industry has seen an increase in the investment potential of investors – both institutional and retail, and a steady growth in revenues and profits with trading volumes on stock exchanges scaling new heights almost every year.

Today, the stock broking industry relies heavily on information technology for almost all its business processes, i.e., research, selling, execution and settlement of trades. Internet and mobile-based trading platforms enhance user experience and prove to be an attractive feature for a certain set of customers, especially those seeking direct market access (DMA). Technology, coupled with a demographic shift in the price conscious Indian retail customer, has been the key disruptors for the industry and over the years, has substantially transformed the business. The change is evidenced by the advent and immediate (and astounding) success of discount and zero commission brokerage houses, which have in a few years clocked substantial market share.

While the change in the way business is conducted has been sweeping, the industry has faced certain tax issues over the years, which have led to interesting judicial rulings. This article seeks to analyse existing tax issues, tax reporting requirements in the context of CRS and tax incentives, for new business avenues available to the stockbroking industry.

1. Speculative transactions and speculation business

Stockbrokers undertake, on behalf of the clients, transactions of buying/ selling securities of listed securities such as shares, debts instruments and exchange-traded derivatives (transactions in futures and options or F&O segment of the stock exchange). In addition to providing broking services to clients, stockbrokers may also undertake such transactions on their own account. Such transactions are in common parlance referred to as “Proprietary” or “House” trades.

A stockbroker may undertake any of the following transactions on its own account:

- (i) Transaction of buying and selling of shares, which are settled by delivery, i.e., shares move into (or out of) the demat account of the broker and the corresponding cash is paid (or received) for settlement of the trade (delivery trades).

- (ii) Trading in the exchange-traded derivatives (F&O segment) of the stock exchange (F&O trades).
- (iii) Intraday trades – where the transactions are settled by squaring off the trade, i.e., do a buy and sell (or *vice versa*) of the same scrip in the same quantity on the same day such that the cash settlement is done on the difference between the buy and sell margins without delivery of the shares to/ from the demat accounts (intraday trades).

Income from brokerage business and from transactions done by a stockbroker on its own account is chargeable to tax under the head Income from Business or Profession (business income). However, certain specific provisions under the Income-tax Act, 1961 (the Act) dealing with taxation of income from speculation business may be triggered in some specific situations, and therefore, merit consideration.

A gist of these provisions is as follows:

- Section 43(5) of the Act, for the purposes of sections 28 to 41 of the Act, defines a speculative transaction to mean “*a transaction in which a contract for purchase or sale of any commodity, including stocks and shares, is periodically or ultimately settled otherwise than by the actual delivery or transfer of commodity or scrips.*”
- Proviso to section 43(5) exempts certain transactions, including *an eligible transaction in respect of trading in derivatives carried out in a recognised stock exchange* from being deemed to be a speculative transaction.
- Explanation 2 to section 28 of the Act provides that, “*where speculative transactions carried on by an assessee are of such a nature as to constitute a business, the business (hereinafter referred to as ‘speculation business’) shall be deemed to be distinct and separate from any other business.*”

- Section 73 of the Act specifies that losses in respect of a speculation business carried on by an assessee can be set off only against profits and gains if any, of another speculation business. This section also restricts the ability to carry forward such losses of a speculation business for a period of four years (instead of eight years carry forward available for business loss). Such carried forward losses can again only be set off against profits and gains of speculation business during the four-year period.

Explanation to section 73 of the Act provides that where the business of a company consists in purchase and sale of share of other companies, such company shall be deemed to be carrying on speculation business **to the extent to which the business consists of sale and purchase of shares of such other companies**. However, this deeming provision does not apply to a company:

- whose gross total income consist mainly of income chargeable under the head “income from securities” or “Income from house property” or “capital gains” and “Income from other sources”; or
- whose principal business is banking or granting loans and advances or trading in shares

Allocation of expenses of speculation business

As per provisions of section 43(5) highlighted above, profits earned on delivery trades and F&O trades mentioned above would not be considered as speculative in nature and would be regarded as normal business income. However, profits from intraday trading would be treated as speculation profit as per provisions of section 43(5).

Explanation 2 to section 28 states that speculation business carried on by an assessee shall be deemed to be distinct and separate from any other business carried on by such assessee. Thus, the stockbroker entity would be required to

segregate its business expenses and allocate the same on a reasonable basis to the speculation business. While expenses such as stamp duty, GST, etc., are easily identifiable to a transaction, the allocation of expenses such as fixed costs and overheads on a justifiable basis may pose certain practical challenges.

Loss from speculation business

- While the tax treatment of profits from stock market transactions undertaken on own account seems relatively straightforward, the losses from such transactions arising to a stockbroker company pose altogether different issues for consideration.
- It is now important to highlight that on a combined reading of provisions of section 43(5) and Explanation to section 73, losses from purchase and sale of shares, i.e. delivery trades [though not covered under definition of speculative transaction under section 43(5)] would by virtue of the deeming fiction contained in *Explanation* to section 73, be treated as a loss from speculation business and together with any losses from intraday transactions be constrained for set off only against profits from a speculation business in that year or in the next four years.
- Therefore, the *Explanation* to section 73 expands the meaning of the term speculative business, as envisaged in the definition contained in section 43(5) and purchase and sale of shares by actual delivery that is not a speculative transaction within the meaning of section 43(5) would be deemed to be speculative business once the provisions of *Explanation* to section 73 are given effect to.

This view is supported by the decision of the Calcutta High Court in the case of R.P.G. Industries Ltd,¹ wherein it was held that:

“In the case before us, undisputedly the loss suffered by the assessee resulted from a transaction of share where there was actual delivery of share scripts and therefore, the same could not be a speculative transaction as provided in the definition. However, by the added Explanation to section 73, a legal fiction has been created by which among the assesseees who is a company, as indicated in the said Explanation, deals with the transaction of share and suffers loss, such transaction should be treated to be speculative transaction within the meaning of section 73 of the Act notwithstanding the fact that according to the definition of speculative transaction mentioned in section 43(5) of the Act, the transaction is not within its purview as there has been actual delivery of the scripts of share. We should bear in mind that the benefits of sections 70 to 72 claimed by the assessee are available in accordance with the other provisions of the Chapter where those occur which includes the provision contained in section 73 of the Act including the Explanation added to it.

Therefore, by virtue of added Explanation given in section 73 of the Act, even the transactions, which are not speculative transactions within the meaning of section 43(5) of the Act, should be deemed to be speculative one if those come within the purview of the Explanation to section 73 of the Act.”

- The above deeming fiction gives rise to another issue, i.e., whether a business of purchase and sale of shares which is

1. [2011] 198 Taxman 349 (Calcutta)

deemed to be speculation business as per *Explanation* to section 73 in a year when losses were incurred would continue to be speculation business in a year when it earns profit. The Mumbai Tribunal in the case of Samba Trading & Investments² has held as under:

“There may be profit or loss in another speculation business and the loss has to be set off or carried forward and set off under section 73. In a different situation, there may also be profit or loss in the normal business which is deemed to be speculation business in terms of the Explanation and the loss from the business may also have to be set off or carried forward and set off in either of the situations, the business covered by the Explanation has to be deemed to be speculation business and the loss or profit from this business has to be regarded as speculation loss or profit and as such these results are to be treated within the parameters of section 73.”

- In context of loss from speculative business under *Explanation* to section 73 of the Act, following points may be noted:
 - The provisions are applicable only to assesseees that are Companies.
 - The Explanation applies to both shares in stock-in-trade and shares purchased during the year. Thus, once the business is identified as speculative in nature, the loss from such business will be treated as speculative loss, even if there is no other transaction of buying and selling of during the relevant year.
 - Allocation of expenses are required to be made to such speculative business also (in line with the above discussion on *Explanation 2* to section 28).

Does *Explanation* to section 73 apply to derivative transactions?

The *Explanation* to section 73 expands the term “speculation business” to the extent to which such business consists of the purchase and sale of shares of other companies. The related question that arises is whether proprietary or house trading in exchange-traded derivative (F&O) transactions, if any, undertaken by the stockbroking company on their account also be treated as speculative business or continue to be outside the purview of speculative business given the specific exemption in section 43(5).

Section 2 of the Securities Contract Act, 1956 (SCRA) define the term “Securities” to include derivatives. Section 2(ac) of the SCRA defines the expression “Derivative” as follows:

- “a security derived from a debt instrument, share, loan, whether secured or unsecured, risk instrument or contract for differences or any other form of security;
- contract which derives its value from the prices, or index of prices, of underlying securities;
- commodity derivatives; and
- such other instruments as may be declared by the Central Government to be derivatives.”

The above definitions under the SCRA recognise derivative as a type of security and a separate financial instrument. Market regulations issued by the Securities and Exchange Board of India (SEBI), trading directions/circulars by the stock exchanges and also in common trade and market practice and parlance, derivatives are understood as a separate financial instrument distinct from other types of securities, including shares. Accordingly, a reference to purchase and sale of shares in *Explanation* to section 73 does not

2. [1996] 58 ITD 360 (Mumbai)

automatically extend to derivatives trading, and the profits/ losses from such derivative trading should not be treated as arising from speculation business.

Whether a derivative transaction would be covered under the preview of *Explanation* to section 73 of the Act is a matter of debate, with courts holding divergent views.

The Delhi High Court in the case of DLF Commercial Developers Ltd.³ held as follows:

“The stated objective of Section 73 apparent from the tenor of its language is to deny speculative businesses the benefit of carry forward of losses. Explanation to Section 73 (4) has been enacted to clarify beyond any shadow of doubt that share business of certain types or classes of companies are deemed to be speculative. That in another part of the statute, which deals with computation of business income, derivatives are excluded from the definition of speculative transactions, only underlines that such exclusion is limited for the purpose of those provisions or sections. To borrow the Madras High Court's expression, "derivatives are assets, whose values are derived from values of underlying assets"; in the present case, by all accounts the derivatives are based on stocks and shares, which fall squarely within the explanation to Section 73 (4). Therefore, it is idle to contend that derivatives do not fall within that provision, when the underlying asset itself does not qualify for the benefit, as they (derivatives -once removed from it and entirely dependent on stocks and shares, for determination of their value).”

However, the Hon'ble Calcutta High Court, in the case of Asian Financial Services Ltd.⁴, after considering the decision of DLF Commercial Developers Ltd. (supra), held that the loss incurred on account of derivatives would be

deemed as business loss under proviso to section 43(5) and not a speculation loss, and accordingly, *Explanation* to section 73 could not be applied.

“The views expressed by the Hon'ble Delhi High Court are contained in a part of the sentence, which is as follows:

by all accounts the derivatives are based on stocks and shares, which fall squarely within the Explanation to Section 73(4).

We are inclined to think that the clause of the sentence 'which fall squarely....', qualifies the word 'shares' and not the word 'derivatives'. We have no difficulty in accepting the views of the Delhi High Court when they say that shares fall squarely within the Explanation to Section 73(4) but we are unable to agree when derivatives are treated at par with the shares because the legislature has treated them differently.”

In *Snowtex Investment Ltd.*⁵ the Hon'ble Supreme Court observed as follows:

“The consequence is that in A.Y. 2008-09, the loss which occurred to the assessee as a result of its activity of trading in shares (a loss arising from the business of speculation) was not capable of being set off against the profits which it had earned against the business of futures and options since the latter did not constitute profits and gains of a speculative business.”

Thus, it appears that presently the issue is covered by the Supreme Court's judgment to the effect that income/ loss from derivative transaction is covered. However, the Supreme Court has accepted an SLP against the aforesaid decision in *Asian Financial Services Ltd* (supra) and further litigation in the matter cannot be ruled out.

3. [2013] 218 Taxman 45 (Delhi)

4. [2016] 240 Taxman 192 (Calcutta)

5. [2019] 265 Taxman 3 (SC)

Also, the Apex Court in the case of Apollo Tyres Ltd.⁶ held that that units of UTI cannot be said to be shares and thus the business of buying and selling units of UTI does not amount to speculation business as per *Explanation* to section 73 of the Act. Similar view has been upheld by the Punjab and Haryana in the case of Porrits & Spencer (Asia) Ltd.⁷.

2. Loss from error trades

The stockbroking business is carried out on various electronic platforms, using advanced technology. The entire exchange system has been designed to execute transactions rapidly and efficiently at the click of a button. However, human intervention cannot be ruled out completely. Error Trades (or freak trades) may result from system faults or human errors in the execution of a trade by brokers on the exchange.

There may be instances in which a client does not fulfil its obligation to deliver cash or securities for a trade entered on behalf of such clients. In such situations, stockbrokers may have no alternative but to accept these transactions as their own, considering regulatory and commercial aspects. Stock exchanges may allow annulment/rectification of genuine error trades. Alternatively, the stockbroker may be forced to liquidate the error trades on the market and incur a loss in the process.

Such loss on error trades may be eligible to be treated as an allowable business loss to be deducted in computing the business income of the stockbroking entity. However, the allowability of such loss on error trades has been a subject of litigation. The Revenue contends that transactions of purchase and sale of securities undertaken by the brokers on their own account should be

regarded as speculative transaction, and therefore, the loss would be loss from speculation business, as per the provisions of *Explanation* to section 73 of the Act and not business loss.

The Hon'ble Ahmedabad Tribunal, in the case of Parkar Securities Ltd.⁸, held as under:

“Thus, the conduct of assessee showed that its intention had never been to deal in the sale and purchase of shares at its own and it was only an eventuality or forced circumstances under which the assessee had to adopt these purchases and these transactions entered into by assessee, under compulsion could not constitute business of the assessee, more so part thereof.”

Thus, there was lack of ingredient called ‘business’ in the sale and purchase done by the assessee of shares for which loss had occurred to assessee.

Therefore, the loss arising to the assessee did not fall within the ambit of the *Explanation* to section 73. The loss occurred to assessee was in the course of its business activity of brokerage. Thus, the loss was allowable as business loss in the normal course of business of the assessee and was available to be set off against the assessee’s brokerage income.”

The Hon'ble Ahmedabad Tribunal held a similar view in the case of Rajvi Securities (P.) Ltd.⁹

3. Penalties paid by stockbrokers

For efficient and stable functioning of the stock markets, stockbrokers are required to adhere to certain standards and prescribed procedures of professional and operational conduct, relating amongst others, to timelines, settlements, payments, etc. The SEBI and stock exchanges monitor stockbroker operations and are empowered to levy charges, fines and penalties

6. [2002] 255 ITR 273 (SC)

7. [2010] 329 ITR 222 (Punjab & Haryana)

8. [2006] 8 SOT 257 (AHD.)

9. [2012] 19 taxmann.com 274 (Ahd.)

where an entity violates any of the prescribed procedures and standards. These violations are often procedural/ operational in nature.

Consequently, stockbrokers may end up incurring charges, fines and penalties for such violations, which raises the question whether such charges, fines and penalties are allowed to be deducted for computing the income from business for the stockbroker.

Section 37(1) of the Act provides that any expenditure (not being expenditure of the nature described in sections 30 to 36 and not being in the nature of capital expenditure or personal expenses of the assessee), laid out or expended wholly and exclusively for the purposes of the business or profession shall be allowed in computing the income chargeable under the head “Profits and Gains of Business or Profession.”

The first *Explanation* to section 37(1) states that any expenditure incurred by an assessee for any purpose **which is an offence or which is prohibited by law** shall not be deemed to have been incurred for the purpose of business or profession and no deduction or allowance shall be made in respect of such expenditure.

The issue of allowability of sum paid as penalty has been a perennial issue of litigation with court rulings in favour and against.

In the case of Prakash Cotton Mills,¹⁰ the assessee was disallowed penalty levied under the BST Act and under the ESIC Act without an examination of the scheme of the provisions of the aforesaid Acts. The Hon’ble Supreme Court held as follows:

“whenever any statutory impost paid by an assessee by way of damages or penalty or interest is claimed as an allowable expenditure under section 37(1), the assessing authority is required to examine the scheme of the

provisions of the relevant statute providing for the payment of such impost notwithstanding the nomenclature of the impost as given by the statute, to find whether it is compensatory or penal in nature. The authority has to allow deduction under section 37(1) wherever such examination reveals the concerned impost to be purely compensatory in nature. Wherever such impost is found to be of a composite nature, that is partly of compensatory nature and partly of penal nature, the authorities are obligated to bifurcate the two components of the impost and give deduction to that component which is compensatory in nature and refuse to give deduction to that component which is penal in nature.”

In the context of stockbrokers, the charges levied by the SEBI or the stock exchange, for violations, are in regulatory and general nomenclature termed as a penalty, and would seem to be not allowable for computing business income. However, the operation of first Explanation to section 37(1) of Act disallows the amount of expenditure incurred for a purpose that is an offence, or that is prohibited by law. Accordingly, it is essential to understand what constitutes an offence or prohibition under the relevant statute levying such penalty, which will in turn attract disallowance under the Act. a penalty levied on the stockholder for certain technical defaults/ violations under a statute that is not per se an offence or prohibition under that statute, may not attract disallowance under the Act.

In the case of Stock & Bond Trading Co.,¹¹ the assessee paid penalty/ fine to BSE/ NSE for infringement of procedural rules, such as failure to maintain margins, trading beyond exposure limits, late submission of margin certificates, delay in making payment and deliveries, etc. The Hon’ble Bombay High Court held that penalty/ payments made by the assessee to the Stock Exchange for violation of their regulations, being

10. [1993] 201 ITR 684 (SC)

11. IT Appeal No. 4117 of 2010

risk management oriented, are not an account of an offence that is prohibited by law. Hence, the invocation of Explanation to section 37(1) is not justified and such penalty/ fines should be deductible.

In the case of Kaira Can Co. Ltd.,¹² the Hon'ble Mumbai Tribunal held that the payment made for failure to make disclosure are required under SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 1997, could not be treated as penalty. This is because it was a payment for regularising the default committed, and hence, such payment could not be allowed under section 37(1) of the Act. A similar view was also held in the case of Goldcrest Capital Markets Ltd.¹³

Another related issue is that of allowability amount paid as Consent Fee to the SEBI, which are paid for settlement of disputes with the SEBI. The Hon'ble Mumbai Tribunal examined this issue in the case of Reliance Share & Stock Brokers (P.) Ltd.¹⁴ The Mumbai Tribunal held that Consent fee paid to the SEBI for settlement of dispute, legal expenses and other administrative charges of SEBI without admitting or denying any guilt cannot be equated with penalty for infraction of law, and accordingly, the same should be allowed as deduction under section 37(1) of the Act. The Delhi Tribunal held a similar view in the case of VLS Finance Ltd.¹⁵

4. Deduction for bad debts

Existing regulations, stock exchange norms and market practices, require a stockbroker and their clients to follow well laid and strict payment timeline protocols for transaction-related payments, including margins, purchase price,

brokerage and related transaction charges – STT, exchange charges, stamp duty, etc. However, there may be instances in which a broking entity may incur bad debts.

The allowability of bad debts for computing income chargeable under the head “Business or Profession” is governed by the provision of section 36(1)(vii), which provides that subject to the provisions of section 36(2), the amount of any bad debt or any part thereof, which is written off as irrecoverable in the accounts of the assessee for the previous year, is to be allowed as a deduction in computing business income.

Section 36(2) *inter alia* provides that deduction for a bad debt or part thereof shall not be allowed, unless the debt has been taken into account in computing the income of the assessee of the previous year in which the amount of such debt or part thereof is written off or of an earlier year.

In view of the above condition in section 36(2), a question may arise with respect to allowability of bad debts on account of a client not making payment of margin money or purchase consideration, i.e., amounts that are not a part of brokerage income, and are therefore, not considered in computing the income of the assessee. The Hon'ble Bombay High Court considered this issue in the case of Shreyas S. Morakhia,¹⁶ where it held as follows:

“The value of the shares transacted by the assessee as a stock broker on behalf of its client is as much a part of the debt as is the brokerage which is charged by the assessee on the transaction. The brokerage having being credited to the profit & loss account of the assessee, it is evident that a part of the debt is taken into account in computing the income of the assessee. ... Both constitute

12. [2010] 127 TTJ 514(MUM.)

13. [2010] 2 ITR(T) 355 (Mumbai)

14. [2014] 51 taxmann.com 215 (Mumbai)

15. [2019] 74 ITR(T) 672 (Delhi - Trib.)

16. [2012] 342 ITR 285 (Bombay)

a part of the debt which arises from the very same transaction involving the sale or as the case maybe purchase of shares. Since both form a component of the debt, the requirements of section 36(2)(i) are fulfilled where a part thereof is taken into account in computing the income of the assessee.”

Thus, where the bad debt consists of brokerage (offered to tax in current or earlier year) and other amounts, the requirements of section 36(2) would stand fulfilled and the entire debt claim shall be allowed as deduction in computing the business income of the stock broking entity.

If the debt being written off does not include brokerage, i.e. no part of the debt was included in computing the income of the assessee, and consequently, the conditions under section 36(2) are not fulfilled, the same can be claimed as deductible under section 28(i) as trading loss incidental to the business. The Hon’ble Bombay High Court, in the case of Harshad J. Choksi,¹⁷ while relying on the decision of the Hon’ble Supreme Court in Badridas Daga¹⁸ held as follows:

*“... even if the deduction is not allowable as bad debts, the tribunal ought to have considered the assessee’s claim for deduction as business loss. This is particularly so, as there is no bar in claiming the loss as a business loss, if the same is incidental to carrying on of a business. **The fact that condition of bad debts was not satisfied by the assessee would not prevent him from claiming deduction as a business loss incurred in the course of carrying on business as share broker.**”*

The Bombay High Court held a similar view in the case of R. B. Rungta & Co.¹⁹

5. Tax incentives for brokers in IFSC

With an objective to bring the financial services transactions carried on outside India by overseas

financial institutions and overseas branches/subsidiaries of Indian financial institutions, the Government of India approved the setting up of “Gujarat International Finance Tec-City” Multi-Services SEZ (GIFT) as an International Financial Services Centre (IFSC).

An IFSC caters to customers outside India who are desirous of accessing the Indian capital and financial markets for investment and trading purposes. Such centres deal with the flow of finance, financial products and services across borders. The IFSC unit is treated as a non-resident under the RBI regulations.

The IFSC caters to several sectors – capital markets (Stock Exchanges Brokers, Segregated Nominee Account Providers, Clearing Corporations, Depositories, other intermediaries), offshore banking, offshore asset management (Alternative Investment Funds, Mutual Funds, Portfolio Management Services, Investment Advisers) amongst others.

India International Exchange (India INX) and NSE IFSC Ltd are the two stock exchanges currently operational in the GIFT.

To facilitate trading by eligible investors, brokers are permitted to provide financial services in IFSC as intermediaries. Brokers may undertake broking services and proprietary trading in IFSC. They are also permitted to provide services as Segregated Nominee Account Providers.

Several tax incentives have been provided to attract stockbrokers participating in IFSC:

- Income from business is 100% deductible for a period of 10 consecutive years out of 15 years in the IFSC.
- The Minimum Alternate Tax rate for units in the IFSC is 9% for income earned in

17. [2012] 349 ITR 250 (Bombay)

18. [1958] 34 ITR 10 (SC)

19. [1963] 50 ITR 233 (Bombay)

convertible foreign currency income as against 15% for units outside the IFSC.

- Transactions carried out on IFSC exchanges are exempt from stamp duty, STT and CTT.
- In addition, no GST is levied on services rendered in the IFSC or to an IFSC unit.

6. Tax reporting obligations on stockbrokers

The Government of India and the United States of America signed the Inter-Governmental Agreement (IGA) for Foreign Account Tax Compliance Act (FATCA) on 9th July 2015. India also signed up for Common Reporting Standard (CRS) on 3 June 2015.

Section 285BA of the Act was amended to provide for the obligation to furnish statement of financial transaction or reportable account with effect from 1st April 2015. In accordance with the same, Rule 114G of the Income Tax Rules, 1962 specifies that certain information must be maintained and reported by a reporting financial institution in respect of each reportable account. Brokers qualify as reporting financial institutions, with exceptions such as brokers with only Indian client base or low value accounts.

Reporting under section 285BA is a four-step process:

1. Identifying a reporting financial institution
2. Reviewing financial accounts maintained
3. Identifying the reportable accounts by applying due diligence process procedure specified in Rule 114H
4. Report the relevant information in respect of identified Reportable Accounts in Form 61B

For a stockbroking entity, reportable accounts include custodial accounts such as margin monies, collateral, etc., received by stockbrokers from their clients. The reporting would be required only for foreign (non-resident) client and not for clients resident in India. However, due diligence procedures, including self-certification, may be required to be obtained from all clients to determine the reportable accounts. The self-certification form may include details such as country of residence, entity constitution type, global identification number, etc.

The statement of reportable account must be furnished on or before 31st May, immediately following the calendar year in which the transaction is registered or recorded.



The less the thought of the body, the better. For it is the body that drags up down. It is attachment, identification, which makes us miserable.

The purer the mind, the easier it is to control it. The mind takes every thought that rises and works it out. The grosser the mind, the more difficult to control it.

– Swami Vivekananda

Taxation of Income from Life Insurance Companies



CA Ashwini Jayaram

1 INTRODUCTION

1.1 The taxation of a Life Insurance Company is governed by the provisions of Section 44 of the Income-tax Act, 1961 (the Act) read with the First Schedule thereto. Rule 2 of the said Schedule provides that the profits and gains of life insurance business shall be taxable based on “surplus disclosed as a result of actuarial valuation”.

1.2 An extract of Section 44 of the Act is below:

“Notwithstanding anything to the contrary contained in the provisions of this Act relating to the computation of income chargeable under the head “Interest on securities”, “Income from house property”, “Capital gains” or “Income from other sources”, or in Section 199 or in Sections 28 to 43B, the profits and gains of any business of insurance, including any such business carried on by a mutual insurance company or by a co-operative society, shall be computed in accordance with the rules contained in the First Schedule.”

1.3 Rule 2 of the First Schedule to the Act was introduced *vide* Finance Act, 1976 to compute taxable profits in accordance with the surplus disclosed as per the erstwhile Insurance Act, 1938. An extract of the same is given below:

“The profits and gains of life insurance business shall be taken to be the annual average of the surplus arrived at by adjusting the surplus or deficit disclosed by the actuarial valuation made in accordance with the Insurance Act, 1938 (4 of 1938), in respect of the last inter-valuation period ending before the commencement of the assessment year, so as to exclude from it any surplus or deficit included therein which was made in any earlier inter-valuation period.”

The Computation should therefore look like this; -

Particulars		Rs
A	Closing Surplus/ (Deficit) disclosed by the actuarial valuation made in respect of the last inter-valuation period.	+ / (-) xx
B	Less: Surplus/ (Deficit), included in ‘A’, which was made in any earlier inter-valuation period	+ / (-) xx
C = A - B	Taxable Surplus/ (Deficit)	+ / (-) xx

The surplus arrived at in 'C' above is to be taken as the taxable profits and gains from life insurance business.

- 1.4 Thus, in the case of life insurance business, the surplus disclosed by the actuarial valuation undertaken in accordance with the Insurance Act, 1938 is applied in computing the business income of life insurance company and the regular methodology of computation of business income as per sections 28 to 43B is not applicable. As a result, disallowance provisions such as section 40(a)/ section 43B, etc. have no relevance in case of life insurance business.

2 HISTORY OF TAXATION OF PROFITS FROM LIFE INSURANCE BUSINESS

Till AY 1976-77

- 2.1 Prior to the amendments made by Finance Act, 1976, the taxability of profits from life insurance business was governed by the provisions of Rules 2 and 3 to the First Schedule of the Act.

The erstwhile provisions of Rules 2 and 3 of the First Schedule to the Act provide that:

- (i) The profits and gains of life insurance business shall be taken to be the greater of gross external incomings less management expenses (with certain restrictions on the quantum of management expenses) OR the surplus disclosed by the actuarial valuation made in accordance with the Insurance Act, 1938 (with surplus of earlier period to be excluded) [erstwhile Rule 2];
- (ii) In computing the surplus, a deduction shall be allowed for 4/5th of the amounts paid or expended on behalf

of policyholders [erstwhile Rule 3(a)]; and

- (iii) Certain other adjustments were provided in respect of investment income/ expense and interest income [erstwhile Rule 3(b) and (c)].

- 2.2 Accordingly, up to AY 1976-77, while there were two methods for calculating the profits and gains of life insurance business, a specific deduction was allowed in respect of 80 per cent of the amounts paid to or reserved for or expended on behalf of policyholders (which would cover bonus allocated to the participating policyholders).

- 2.3 However, the Finance Act, 1976 deleted the 'external incomings less management expenses method' and retained only the method referring to surplus disclosed by actuarial valuation and also simultaneously deleted the deduction allowed in respect of 80 per cent of the amounts paid to or reserved for or expended on behalf of policyholders.

- 2.4 Thus, the interpretation of the tax authorities is that, the erstwhile Rule 3(a) of the First Schedule to the Act which permitted deduction in respect of 80 per cent of the amounts paid to or reserved for or expended on behalf of Policyholders, clearly indicated that surplus under erstwhile Rule 2 was earlier understood to be pre-allocation of bonus to policyholders and they believed that this interpretation should continue for the current Rule 2 even post amendments made by Finance Act, 1976.

- 2.5 Further, the profits from life insurance business were offered to tax at prescribed corporate tax rates – the rate for AY 1976-77 was 52.5 per cent. Till AY 1976-77, 80 per cent of the amounts paid to or reserved for or expended on behalf

of the Policyholders were also allowed as deduction from the taxable income as per Rule 3. Thus, estimating that 80 per cent deduction is available, balance surplus of 20 per cent was taxed at the rate of 52.5 per cent giving a tax rate of around 10.5 per cent on income from life insurance business.

Deletion of Rule 3 and Insertion of Section 115B in the Act

2.6 As per Finance Act, 1976, from AY 1977-78 onwards Rule 3 was deleted and Section 115B was simultaneously introduced providing a special rate of tax of 12.5 per cent on income from life insurance business.

Provisions post amendments introduced by the Finance Act, 1976

2.7 Under the provisions of the Act, a special code has been prescribed under section 44 read with First Schedule for the taxation of insurance business. Further, the provisions of Minimum Alternate Tax (MAT) prescribed under section 115JB of the Act do not apply to income accruing or arising from life insurance business.

2.8 As per the provisions of section 44 read with Rule 2 of the First Schedule of the Act, the profits and gains of life insurance business shall be taken to be the *annual average of the surplus arrived at by adjusting the surplus or deficit disclosed by the actuarial valuation¹ made in accordance with the Insurance Act, 1938, in respect of the last inter valuation period ending before the commencement of the assessment year, so as to exclude from it any surplus or deficit included*

therein which was made in any earlier inter-valuation period.

3 TYPICAL ISSUES PERTAINING TO TAXATION OF INCOME FROM LIFE INSURANCE BUSINESS

A. Actuarial Surplus and Taxation of Income from Shareholders' Account

3.1 While Rule 2 under First Schedule of the Act prescribes that the profits and gains of life insurance business shall be taken to be the annual average of surplus disclosed by the actuarial valuation made in accordance with the Insurance Act, 1938, there has been a lack of clarity on the 'actuarial surplus' to be considered for computing profits and gains from life insurance business leading to litigation and the issue is presently pending before the Supreme Court for adjudication². In the ensuing para, we have discussed in detail on the reasons for litigation.

3.2 The litigation has largely been on account of the fact that Rule 2 of First Schedule to the Act requires actuarial surplus to be computed as per the Insurance Act, 1938 whereas in practice, the preparation of financial statements and actuarial valuation of life insurance companies is being undertaken under the Insurance Regulatory and Development Authority of India Act, 1999 (IRDA Act, 1999) and guidelines issued thereunder.

3.3 The Insurance Regulatory and Development Authority of India (IRDA) has made specific rules for presentation of accounts of life insurance companies

1. The term 'actuarial valuation' as per the Insurance Act, 1938 has not been defined.

2. In the case of *CIT-6 vs. ICICI Prudential Insurance Co Ltd* [ITA No 711 of 2013]. A special leave petition (SLP) has been filed before the Supreme Court in this matter and the same is pending for hearing.

prescribed *vide* the IRDA (Preparation of Financial statements and Auditor's Report of Insurance Companies) Regulations, 2002 (IRDA FS Regulations). According to the said Regulations, Profit and Loss of a life insurance company is divided into:

- Technical account (Policyholders' account represented in Form A-RA) also referred to as Revenue account; and
- Non Technical account (Shareholders' account represented as Form A-PL) also referred to as Profit and Loss account (P&L a/c).

3.4 The insurance companies are mandated to prepare their financial statements as per the format prescribed under the IRDA Act, 1999 for presentation of insurance accounts and accordingly, actuaries of insurance companies now follow these guidelines rather than the erstwhile guidelines prescribed under the Insurance Act, 1938. Before the introduction of the IRDA, 1999 and regulations related thereto, the financial statements of the life insurance company were prepared as per section 11 of Insurance Act, 1938. Under the erstwhile reporting requirements applicable to life insurance companies, only one revenue account was prepared and there was no separation of Shareholders' and Policyholders' funds.

3.5 Further, under the old format for preparation of financial statements of life insurance companies, they were required to maintain the Revenue Account and Balance Sheet. The excess of income over expenses as per Revenue Account was transferred to the Life Fund. The surplus was determined in Form I – Valuation of Balance Sheet (old Form I). This surplus represented results from both a Shareholders' and Policyholders'

perspective. In effect prior to the notification of the IRDA FS Regulations, the change (increase or decrease) in the life insurance company's financial position was regarded as its taxable income/loss.

3.6 Subsequently for the purpose of effective reporting, the IRDA Act, 1999 has made a specific segregation of the Policyholders' Account and Shareholders' Account and revised the form for presentation of insurance accounts as prescribed in IRDA FS Regulations. This is because, unlike in the old era, the IRDA stipulated maintenance of a minimum capital of INR 100 crore by an insurance company and in order to achieve transparency on the method of dealing with the funds of the policyholders by the life insurance companies and in order to clearly avoid co-mingling of the results of the deployment of the minimum capital or any excess thereof, and the Policyholders' funds, the accounts which showed the results of the deployment of these funds were mandated to be separated but the Balance Sheet was one by which the financial situation of the company as a whole would be discernible.

3.7 Section 11 of Insurance Act, 1938 was therefore amended so as to include sub section (1A) which provides that every insurer on or after the commencement of IRDA Act, 1999 in respect of insurance business transacted by him and in respect of Shareholders' funds shall at the expiration of each financial year prepare a Balance Sheet, Profit and Loss account, a separate account of receipts and payments for Shareholders' and Revenue account with respect to the Policyholders' in accordance with the regulations made by the authority.

3.8 Thus, according to the IRDA Act, 1999, the Profit and Loss account of a life insurance

company has been divided into a Technical Account (Policyholders' Account) also called as Revenue Account and Non Technical Account (Shareholders' Account). The Technical Account deals with all the transactions relating to the income by way of premium and expenditure related thereto. All the transactions relating to Shareholders like funding the deficit, income earned on investment of share capital and reserves are dealt with by the non technical i.e. Shareholders' account.

- 3.9 The presentation of the financial statements does not lead to the conclusion that Shareholders' account is not part of life insurance business. In fact the Shareholders' funds are of utmost significance and a must for ensuing continuity in returns to the Policyholders. The bifurcation also gives a clearer picture as to how the insurance company has been able to deal with the Policyholders' funds.
- 3.10 Under the new reporting format, the income from Policyholders' account i.e. premium and income from their investment, etc and expenses on Policyholders' i.e. claims, commission, etc. are accounted for in the Policyholders' account. The surplus is reflected in the revised Form I. Revised Form I is a report prepared as a part of Actuarial report and Abstracts under the IRDA Regulations to ascertain segment wise (participating policies and non-participating policies) asset liability position of the policyholders. Revised Form I in its present format, does not provide the Profit and Loss account or indeed the actuarial surplus of the entire business but reflects the asset-liability position of only Policyholders' funds.
- 3.11 Therefore, it is pertinent to note that in order to determine the profit/ loss from life insurance business, the Act and regulations provide in principle, that the results in

both *viz.* Policyholders' account (Technical Account) and Shareholders' account (Non Technical Account) are required to be combined and accordingly surplus/deficit needs to be computed. Because the actuaries now undertake the actuarial valuation only as per the IRDA Act, 1999 and regulations issued thereunder, life insurance companies have been filing the return of income by combining the results from both the Shareholders' account and Policyholders' account and undertaking certain adjustments to this combined income.

An illustrative computation (adopted by most life insurance companies barring certain adjustments) is as under:

<i>Particular</i>	<i>Rs</i>
Surplus/(deficit) in Policyholders' Account	xxx
<i>Less:</i> Income from pension business exempt under Section 10(23AAB)	xxx
<i>Less:</i> Dividend income exempt under section 10(34)/10(35) (until FY 2019-20)	xxx
<i>Add:</i> Surplus/(deficit) in Shareholder's Account	xxx
Total surplus/(deficit) from insurance business	xxx

- 3.12 The income tax department on the other hand, has been rejecting the aforesaid computation method and instead, adopting surplus as per the Form I (prepared as per the IRDA Act, 1999 i.e. New Form I) and taxing the same at the rate of 12.5 per cent (plus applicable surcharge and education cess) and also denying on adjustment of surplus/deficit in Policyholders' account against the profit/loss in Shareholders' account. Under this approach adopted by the income-tax department, while the asset liability position and resultant surplus arising from

the Policyholders' segment is considered, the entire results from the Shareholders' segment is ignored. Also, the income-tax department contends that the income from Shareholders' segment is not an income from life insurance business and considering the same income from other than life insurance business and taxing at 30 per cent.

- 3.13 Given the long gestation period of the life insurance business, to the cover the losses in the Policyholders' account, the Shareholders' are required to bring in additional capital into the life insurance company. Because of this, the results in the Shareholders' account, at least for the initial 7 to 10 years from commencement is a loss. However, the income tax department has been considering only surplus as per Policyholders' segment (New Form I) and the losses arising under the Shareholders' account are entirely ignored leading to an inflated profit position and higher income tax liability.
- 3.14 Here, one may note that under section 2C of the Insurance Act, 1939, only an Indian Insurance Company can carry on the business of insurance in India. Further, the third proviso to section 2C(1) of the Insurance Act, 1938 provides that *"Provided also that no insurer other than an Indian Insurance Company shall begin to carry on any class of insurance business in India under this Act on or after the commencement of the IRDA, 1999"*.
- 3.15 From the above, it may be noted that the sole purpose of the insurance company is to carry on the business of life insurance or general insurance or re-insurance business. Thus, a company carrying on a

life insurance business is precluded from having any other purpose or carrying on any activity other than life insurance business. In fact, if it carries on any activity other than insurance, it would cease to be an Indian Insurance Company as defined and would not be allowed to carry on business in terms of third provision to section 2C(1). Therefore, any income earned by life insurance company whether from Shareholders' account (Non-technical account) or Policyholders' account (Technical account) should be regarded as income arising from life insurance business.

- 3.16 A circular issued by Central Board of Direct Taxes³ (CBDT), explaining the provisions of erstwhile Rule 3(b), which dealt with the question whether life insurance companies are liable to be assessed under section 12B of Income-tax, Act, 1922 in respect of profits from sale of their asset, read as below:

"...But this lacuna does not mean that in case of insurance companies, the income from sale of assets is to be computed separately from their business income. The general position is that in case of insurance companies, the investment of their funds forms part of the insurance business and as such is a floating asset and not a capital asset. In view of this, section 12B (of the Income-tax Act, 1922) would not apply to any profits arising from sale on realisation of the assets of life insurance business....where the profits of life insurance business are computed under Rule 2(b) on basis of actuarial valuation, the profits or losses on realisation of assets would be accounted for in arriving at the surplus".

- 3.17 Thus, CBDT has itself clarified that in case of life insurance companies, the investment of their funds forms part of the insurance

3. Circular No. 22 [R. Dis. N0.51 (14)II-47] dated 23 September 1947

business and the investment are a floating asset and not a capital asset and the profit/loss on realisation of investments is to be considered for the purposes of calculating surplus under Rule 2(b). It is submitted that the same principle would equally apply to a periodic return on investments (e.g. interest) not resulting in realisation of assets and it can be argued that all income from investments is a part of life insurance business. Income in Shareholders' account is essentially income from investments. Applying the above circular, one can say that income earned on such investment and accounted in Shareholders' account should be regarded as income from life insurance business.

3.18 While dealing with the provisions of section 80P of the Act, in [*CIT vs. Karnataka State Co-operative Apex Bank 251 ITR 194 (SC)*], the Supreme Court held as under:

“There is no doubt, and it is not disputed, that the assessee-co-operative bank is required to place a part of its funds with the State Bank or the Reserve Bank of India to enable it to carry on its banking business (in compliance with statutory provisions). This being so, any income derived from funds so placed arises from the business carried on by it and the assessee has not, by reason of Section 80P(2)(a)(i), to pay income-tax thereon. The placement of such funds being imperative for the purposes of carrying on the banking business, the income derived there from would be income from the assessee's business.”

3.19 Maintenance of Shareholders' account is imperative under the IRDA regulations for carrying the insurance business. Further, section 64VA(1) of the Insurance Act, 1938 mandates that every life insurer must maintain a prescribed solvency margin in respect of its life insurance business. The IRDA has formulated IRDA (Assets, Liability and Solvency Margin for Insurers),

Regulation 2000. The IRDA specifically requires consideration of the assets relating to both Policyholders' account and Shareholders' account. Failing to meet the solvency margin would mean that insurer has failed to meet the requirement and shall be deemed to be insolvent and may be required to wound up by the Court. While looking at the way one arrives at the solvency margin, which considers both Shareholders' account and Policyholders' account, emphasis the integrate and invisible nature of Shareholders' account in a life insurance business and thus one can say that it is an integral part of life insurance business.

3.20 To answer whether Shareholders' account and Policyholders' account constitute same line of business or different business, one would really need to look at whether there is “inter-connection, any inter-lacing, any interdependence, and any unity at all embracing the two businesses.” The test, propounded by Rowlatt, J, in *Scales vs. George Thompson & Co Ltd (1927) (12 TC 83)*, has been upheld by the Hon'ble Supreme Court in *CIT vs. Prithvi Insurance Co Ltd (1967) (65 IT 632)*, *Chabda & Sons (LM) vs. CIT (1967) (65 ITR 638)*, *Produce Exchange Corporation Ltd vs. CIT (1970) (77 ITR 739)*, *Hooghly Trust P Ltd vs. CIT (1969) (73 IT 685)*, and *Standard Refinery & Distillery Ltd vs. CIT (1971) (79 ITR 9)*. In *B R Ltd vs. Gupta (VP) (1978) (113 ITR 647)* it was held that the decisive test is unity of control and not the nature of the businesses. In case of a life insurance company entire activity including the reporting in the Shareholders' account and Policyholders' account is controlled and supervised by a common board of directors. The same team which invests funds in Policyholders' account also invests the funds in Shareholders' account and

both are subject to the same regulatory norms. Therefore, one can regard that Shareholders' and Policyholders' account both constitutes part of life insurance business.

- 3.21 The Mumbai Tribunal in the case of **ICICI Prudential Life Insurance Company Limited vs. ACIT**⁴ undertook the exercise of comparing the results of the Form I prepared as per the Insurance Act, 1938 (Old Form I) with that prepared under the IRDA Act 1999 (New Form I). Since the Form I prepared under the IRDA Act 1999 reflects only the results of the Policyholders' account, the Tribunal held that this does not give a complete picture of the income of the life insurance company and hence, under the financial statements prepared as per the IRDA Act, 1999 and regulations thereto, results of both Policyholders' account and Shareholders' account have to be combined (which are the same as the result under the Form I prepared as per the Insurance Act, 1938). It also held that that just because separate account for shareholders' profit and loss account is maintained, shareholders' account does not become separate from life insurance business. The relevant extracts of the case are reproduced below:

"In view of the above, looking at the issue in any way what we notice is that the computation made by assessee is in accordance with Rule 2 of the Insurance Act 1938 according to which only AO can base his computation. This also corresponds to the way incomes were assessed in earlier years i.e. the correct method as per Rule 2 and Section 44 of IT ACT." Refer Page 51 of the decision.

"We have heard the rival contentions. As briefly discussed while deciding the issue of taxing surplus, assessee is in life Insurance business and it is not permitted to do any other business. All activities carried out by assessee are for furtherance of Life Insurance business. Maintaining adequate capital is necessary to comply with IRDA (Assets, Liabilities and Solvency margin of insurers) Regulations, 2000. Income earned on capital infused in business is integral part of Life Insurance business. The Ld. CIT(A) gives a finding that assessee is exclusively in Life Insurance business. ...

...Just because separate accounts are maintained the incomes in Shareholder's account does not become separate from Life insurance business. As per Insurance Act 1938 all incomes are part of one business only and these incomes are considered as part of same business. Therefore, the incomes in Shareholder's account are to be considered as arising out of Life insurance business only. More over Sec 44 mandates that only First Schedule will apply for computing incomes and excludes other heads of income like, Interest on Securities, income from house property, Capital gains or Income from other sources. Being non-obstante clause, sec. 44 mandates that the profits and gains of insurance business shall be computed in accordance with the rules contained in First Schedule. Therefore, the incomes in Shareholder's account are to be taxed as part of life insurance business only, as they are part of same business and investments are made as part of solvency ratio of same business." Refer Pages 66 and 67 of the decision.

- 3.22 This decision has been followed by the Mumbai Tribunal in case of HDFC Standard Life Insurance Co Ltd⁵, Tata AIG Life Insurance Company Limited⁶ and by

4. [2013] 140 ITD 41 (Mum)

5. (OSD) (ITA No. 2203/Mum/2012 and others)

6. ITA No 1035/Mum/2011

Delhi Tribunal in case of Max New York Life Insurance Company⁷.

- 3.23 The income-tax department had filed an appeal against the order of the Mumbai Tribunal in the above case – ICICI Prudential before the Bombay High Court and the question of law regarding basis on which profits and gains of a life insurance company are to be computed, was admitted by the High Court for adjudication. The income-tax department had also appealed on the legal ground of Shareholders’ account not being part of life insurance business and this ground was not admitted by the Bombay High Court. The Income-tax department preferred a special leave petition (SLP) before the Hon’ble Supreme Court on this issue (whether the income from Shareholders’ account is also to be taxed as a part of life insurance business) and the SLP has been admitted and pending motion hearing.
- 3.24 Given the above, one could regard Shareholders’ account has an integral part of life insurance business and profits in the Shareholders’ account should be included as profits of life insurance business. Therefore, any surplus/deficit in Policyholder can be set off against the profit/loss of Shareholders’ account under section 70 of the Act. Given that Shareholders’ account is part of life insurance, the same should be taxed under the provisions of section 44 of the Act at the special rate of 12.5 per cent. As the matter is pending before the SC for adjudication, the uncertainty around this round loom over tax payer-life insurance company and litigation especially at the lower authorities level cannot be ruled out.

B TRANSFER OF FUNDS FROM SHAREHOLDERS’ ACCOUNT TO POLICYHOLDERS’ ACCOUNT

- 3.25 The IRDA regulations permit transfer of funds from the Shareholders’ account to the Policyholders’ account as and when there is a deficit in the Policyholders’ account. The deficit in the Policyholders’ account is met by the Shareholders by infusing capital. Maintaining adequate capital is necessary to comply with IRDA (Assets, Liabilities and Solvency Margin of Insurers) Regulations, 2000. Income earned on capital infused in business is an integral part of life insurance business. However, the income tax authorities (including the first appellate level) have been contending to add back the funds transferred from Shareholders’ account to Policyholders’ account on the basis that the said transfer resulted in an income chargeable to tax.

Internal transfer cannot be taxed

- 3.26 The amount transferred from the Shareholders’ account to Policyholders’ account may consist of the following:
- Net income in the Shareholders’ account (that is income contribution); and
 - Amount in excess of the net income in the Shareholders’ account resulting in a debit balance in the Shareholders’ account (that is capital contribution)

Amount transferred representing the income contribution

- 3.27 Both the income from Shareholders’ account and from the Policyholders’ account are part of profits and gains of

7. [TS-822-ITAT-2017(DEL)-TP]

life insurance business and any internal transfers gets cancelled. To the extent the amount transferred from Shareholders' account to the Policyholders' account is considered as taxable, it would result in double taxation since the same amount would be taxed as Shareholders' income and as Policyholders' income. This is clearly against the principles of taxation – the same income cannot be taxed twice and more so cannot be taxed twice in the hands of same tax payer.

Amount transferred representing the capital contribution

3.28 It is well settled principle that “a person cannot make a profit out of itself” as held by the Supreme Court in case of *Kikabhai Premchand*⁸. In the instant case, there is transfer of funds from the Shareholders' account to Policyholders' account, there is no vested right of the Policyholder to receive the same. The insurance company has not earned any income. Any loss/gain that arises because of transfer from Shareholders' account, is a notional gain arising due to the transfer of funds from one account to another account. Such gain or loss cannot be regarded as income under the Act. Applying the aforesaid principle, the notional gain cannot be taxed in the hands of Insurance company.

3.29 Further as held in decisions of Supreme Court⁹ accounting entries passed in the books of account are not conclusive in determining the tax liability. If the “income” is merely hypothetical income, it cannot be taxed under the provisions of the Act. The transfer of funds from Shareholders'

account to Policyholders' account in the books of the insurance company represents hypothetical income and not a real income and hence, the same should not be subjected to tax.

C BONUS TO PARTICIPATING POLICYHOLDERS – ALLOWABLE DEDUCTION

3.30 Bonus is return to participating policyholders in lieu of surplus generated out of accumulated funds arising in participating products offering. Participating Policyholders have a contractual right to receive various investment returns on their policy, which are in the form of Bonus. Bonus once declared forms part of the guaranteed benefits of the policy. Declared bonuses can be paid either at the prescribed intervals or on maturity of the policy and are an irrevocable credit to policyholders. These are generally approved by Board of Directors after consulting the Appointed Actuary. There are different types of bonus and can be classified into following types:

- Cash Bonus – Bonus distributed in cash and in case cash option is not opted, it can be utilized for buying additional sum assured
- Terminal Bonus – Onetime bonus payable at the time of claim during the tenure of policy.
- Reversionary Bonus – Declared Bonus which is payable at death, surrender or maturity. Here no cash option is available.

8. 24 ITR 506 (SC) (1953)

9. *CIT vs. Shoorji Vallabhdas & Co* – 46 ITR 144 (1962); *CIT vs. Birla Gwalior (P) Ltd* – 89 ITR 266 (1973); *G o d h r a Electricity Co Ltd vs. CIT* – 225 ITR 746 (1997)

- 3.31 Bonus by nature, is different from the concept of dividend. The life insurance policy contract by which a Policyholder is entitled to bonus, exposes the Policyholder to risks associated with the insurance contract. Dividend on the other hand, is a return to a shareholder for investment in the share capital of an entity. Thus, unlike a shareholder, a policyholder though participating in profits of a policy fund, does not carry the reward of ownership i.e. to a limited extent, entitlement of a share of the company's property (assets) on its liquidation. Any payment to a policyholder can therefore not be equated to a return on shareholder's equity. In fact, bonus to policyholders is paid only to ensure their continued participation in the policy and nothing more.
- 3.32 Further, while pricing participating products, the insurer makes allowance for bonuses to eventuate by assuming a prudent set of consistent future experience regarding investment returns, claims experience, expenses and persistency. In doing so, the insurer increases the likelihood of a surplus emerging compared to this prudent set of assumptions. This surplus is then used to distribute bonuses. Thus, one can view the distribution of bonuses as a return of a part of the policyholders' premium, since the premium reflects a 'bonus loading' arrived at by using a prudent set of assumptions rather than a realistic set of assumptions. With this premise, return of premium should not be subject to tax.
- 3.33 Separately it is pertinent to note that, even when there is a deficit in the Policyholders' account of life insurance companies (especially in the initial years), the Shareholders' have transferred funds (i.e. infused capital) in order to declare a bonus on the participating policies to be in consonance with the policyholders' expectations.
- 3.34 Bonus allocation to the policyholder, being in the nature of normal business expenditure incurred by the life insurance company, is necessitated out of its obligations to the policyholders forming part of the terms and conditions of the policy issued and is fully allowable under the normal provisions of the Act as policyholder bonuses are directly related to the illustrated benefits which are the basis of the purchase of the policy by the policyholder.
- 3.35 Given the above, bonus allocation to the policyholder, is in the nature of normal business expenditure and should accordingly, be allowed as a deduction in computing profits from life insurance business.
- 3.36 With the deletion of Rule 3 and simultaneous introduction of section 115B does the legislative intent seem to be to provide a tax rate of 12.5 percent on income from life insurance business without allowing any deduction for amounts paid to or reserved for or expended on behalf of policyholders? This issue of deductibility of provision of bonus has been a vexed issue, with different life insurance companies adopting different views. While, the revised Form I (prepared as per the IRDA Act 1999 read with regulations issued thereunder) specifically states that bonus allocated to policyholders does not form part of mathematical reserve liabilities while arriving at the surplus. The Old Form I on the other hand, does not contain an express mention of whether or not bonus is included in the mathematical reserve liabilities. Given this, some life insurance companies have adopted a view that actuarial surplus is required to be computed as per the Insurance Act,

1938 (i.e. as per the Old Form I) and accordingly, deduction for bonus allocated to policyholders should be available.

3.37 The Delhi Tribunal in case of Max York Life Insurance Company Limited¹⁰ has examined the allowability of par bonus deduction in the hands of the insurance company. The Bench after referring to various decisions of Supreme Court and High courts has held that provision for bonus allocation is an ascertained liability and should be allowed as deduction while computing the taxable income of a life insurance company. It also noted that once the bonus is declared, it cannot take character of surplus especially when the bonus paid is not taxable while working out the surplus. The amounts set aside for policyholder are in the nature of liability/charge and not dividend, which is a return on shareholders capital.

3.38 The income-tax department has filed appeal before the Delhi High Court on the above decision and the same has been admitted.

D FUNDS FOR FUTURE APPROPRIATION (FFA) – ALLOWABLE AS DEDUCTION

3.39 FFA is a provision for a future liability and it is uncertain if or when the said liability may occur. FFA represents all funds, the allocation of which, either to the policyholders or to the shareholders, has not been determined by the end of the financial year

3.40 The Insurance Regulatory and Development Authority of India (Assets, Liabilities, and Solvency Margin of Life

Insurance Business) Regulations, 2000 require that the mathematical reserves valuation should provide for all benefits payable to policyholders including the reasonable expectations of policyholders (regarding bonuses, including terminal bonuses, if any) and any established practices of an insurer for payment of benefits.

3.41 The Appointed actuary of a life insurance company makes an estimate of the potential future liabilities based on the contracts of life insurance already in force and after recording current and future incomings and outgoings. In doing so, the actuary also considers the potential future liability created based on a reasonable expectation that the policyholders would have of bonuses that would be declared and makes a technical provision for it. In arriving at the reasonable expectations of policyholders as regards future bonuses, that they would expect to get, the actuary takes into account various elements including marketing material, benefit illustrations, policy contract and past practice.

3.42 In case, there is a substantial deviation in realization of expected investment returns or the claims experience is materially adverse, the Appointed Actuary may draw from the FFA to smoothen out experience variances e.g. year in which investment returns are low, FFA would be used to pay for the shortfall of bonuses.

3.43 Additionally, as FFA is created out of the residuary funds remaining after allocation of bonus arising from participating policies there is a regulatory requirement that at

10. TS-3-ITAT-2018 (DEL)

least 90 per cent of the amount should be utilized for the benefit of policyholders. Accordingly, the ultimate utilization of the amount for the benefit of the policyholder (who is the customer) is not in doubt, only the timing of the utilization is a function of the circumstances (claims experience, returns earned on investment etc.) and the prudent business judgment of the life insurer.

- 3.44 The FFA, is thus, required to support the ability of the insurer to meet its contracted obligations to its policyholders as indicatively committed at the time of the inception of the policy contract. Statistical experience has shown that investment returns are not certain, and the performance of an insurer will necessarily vary from year-to-year but the insurer cannot shy away from the expectations which it has built when it issued the policy to the policyholders and therefore the need to create the FFA is paramount.
- 3.45 In the financial statements of a life insurance company, the amount of FFA is accounted for as an appropriation from surplus in the Revenue/Policyholders' account. Given this, the life insurance companies have not been claiming deduction of this expense (computed by the actuary which may not have necessarily resulted in an out go during the financial year) on a conservative basis.
- 3.46 The Delhi Tribunal in the case of Max New York Life (supra) has examined this issue and observed that FFA is different from a contingent liability. The Tribunal concluded FFA to be an allowable deduction on the

basis that FFA is an amount statutorily mandated to be kept aside for the benefit of policyholders for future distribution and cannot therefore, form part of actuarial surplus.

- 3.47 In the absence of any guidance under the Act on the deductibility of FFA while computing income from life insurance business, the tax officers may choose to deny deduction for FFA while assessing the surplus chargeable to tax under section 44 read with Rule 2 of the Act.

E APPLICABILITY OF TRANSFER PRICING PROVISIONS

- 3.48 On applicability of transfer pricing provisions to life insurance companies, section 92 of the Act provides that any income arising from an international transaction shall be computed having regard to the arm's length price (ALP). Similarly, allowance for any expenses arising from an international transaction shall also be determined having regard to the ALP. Sections 92 to 92F of the Act prescribe the Indian transfer pricing regulations. Business income is chargeable to tax under the provisions of Section 28 of the Act. However, Section 44 of the Act override the provisions of Section 28 to Section 43B of the Act, the provisions of section 92 of the Act should not be applicable.
- 3.49 Various Tribunals have upheld the above view in the following decisions:
- ***Habib Insurance Co. Ltd. vs. CIT***¹¹
 - ***Oriental Insurance Co. Ltd. vs. CIT***¹²

11. [1968] 69 ITR 174 (Bom)

12. [2003] 260 ITR 91 (Del)

- *Life Insurance Corporation of India vs. CIT*¹³
- *Himalaya Assurance Co. Ltd.*¹⁴
- *General Insurance Corpn of India vs. CIT*¹⁵
- *Life Insurance Corporation of India vs. CIT*¹⁶
- *Life Insurance Corporation of India vs. CIT*¹⁷

3.50 However, the Delhi Tribunal in the case of Max New York Life Insurance Company¹⁸ had *inter-alia* adjudicated on applicability of transfer pricing regulations in a case where income is computed on section 44 of the Act and the Delhi Tribunal in its ruling, held that the transfer pricing regulations apply additionally in cases where the special computational provisions of section 44 of the Act are applicable. The transfer pricing adjustment are warranted in addition to the computation as per section 44 of the Act.

3.51 Currently, on the above matter, the taxpayer has filed a further appeal before the Hon'ble Delhi High Court¹⁹ and the same is admitted (expected to be listed for hearing on 22 April 2020). The Hon'ble Delhi High Court will examine whether the transfer pricing provision embodied in Chapter X are applicable to an insurance company governed for the purpose of computation of its income by section 44 read with Schedule I to the Act.

3.52 While the taxpayer may rely on the favourable decisions, however one must continue to assess the potential risks of penalties on reporting and documentation and adopt a pragmatic approach of complying with the transfer pricing regulations.

F APPLICABILITY DISALLOWANCE UNDER SECTION 14A

3.53 Sections 27 to 27D of the Insurance Act compulsorily require life insurance companies in India to invest their entire assets in various specified securities in India. The investment activity as well as earning of investment income on such investments is a part of normal business activity. Further, Insurance Regulatory and Development Authority (Investment) Regulations, 2000 as amended from time to time also require that every insurance company carrying on the business of life insurance shall invest its assets in the manner prescribed in the said regulations. the investment activity as well as earning of investment income on such investments is a part of normal business activity.

3.54 From the investment made, the insurance company earns dividend income, [from shares or units from mutual fund which exempt under section 10(34)/10(35) till FY 2019-20]. Also, most of the insurance companies also earn income from the pension fund which is exempt under section 10(23AAB) of the Act. A question may arise whether on exempt income,

13. [1964] 51 ITR 773 (SC)

14. [1938] 6 ITR 227 (Cal)

15. [1999] 240 ITR 139 (SC)

16. [1996] 219 ITR 410 (SC)

17. [1979] 119 ITR 900 (Bom)

18. TS-822-ITAT-2017-DEL-TP

19. ITA 818/2019 – DEL HC

whether the provisions of section 14A which provides for disallowance of expenses in relation exempt income is attracted in the hands of insurance company?

3.55 As discussed above, the provision of section 44 of the Act is special provision made for computing income of insurance companies and have an overriding effect over the other provisions contained in the Act in view of the non-obstante clause contained therein. This view has also been affirmed by the Hon'ble Supreme Court in the case of **General Insurance Company of India vs. Commissioner of Income-tax**²⁰. The Hon'ble Supreme Court has further held that the provisions contain an alternate mode of computing the profits and gains of an insurance business and mandates the assessing authorities to compute the taxable income for business of insurance in accordance with the provisions of the First Schedule.

3.56 Section 14A which provides for disallowances of expenses incurred in relation to an exempt income, is applicable to all computational heads while computing the taxable income under any of those computational heads. Provisions of section 44 of the Act overrides all the provisions of computational heads and hence it would have an effect of overriding the provision of section 14A of the Act, which is not a standalone provision which is applicable while computing the taxable income under each head of income.

3.57 Thus, one can say that the provisions of section 14A is not attracted in case of life insurance companies. The Delhi Tribunal in the case of **Oriental Insurance Company Limited vs. ACIT**²¹ has held that:

“no disallowance under section 14A of the Act could be made for insurance companies as its income would be computed under the specific provisions of section 44 read with the First Schedule of the Act. The computation of profits and gains of insurance business would have to be computed in accordance with Rule 5 of the First Schedule. In view of section 44 having a non-obstante clause, the tax department is not permitted to travel beyond these provisions. Section 14A contemplates an exception for deductions as allowable under the Act (sections 28 to 43B of the Act). Section 44 creates a special application of these provisions in the cases of insurance companies.”.

3.58 Various Tribunals had an occasion to deal with identical issue in the following cases and the Tribunals have taken a view and upheld non-applicability of section 14A disallowance to insurance companies in the context of exemption claimed under section 10 of the Act:

- **ICICI Prudential Insurance Co. Ltd.**²²
- **Reliance General Insurance Co. Ltd. vs. ACIT dated 30 April 2010**²³
- **M/s Birla Sun Life Insurance Company Limited dated 9 September 2010**²⁴

20. (240 ITR 139)

21. ITA No. 5462 & 5463/D/03 dated 27 February 2009 (Delhi)

22. (ITA 6854/Mum/2010) and (ITA 1616/Mum/2013)

23. (ITA No.781/Mum/2007)

24. (ITA No.602/Mum/2009)

- *General Insurance Corporation of India dated 2 February 2012*²⁵
- *ACIT vs. SBI Life Insurance Company Ltd.*²⁶

3.59 Recently, in case of Aegon Religare Life Insurance²⁷, the Hon'ble Bombay High Court has admitted the income-tax department's appeal challenging Tribunal order rejecting the section 14A applicability to a life insurance company and the same has been admitted for hearing.

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4 CONCLUSION

4.1 The provisions of the Act pertaining to taxation of income from life insurance business have not kept pace with regulatory developments and have led to differing positions being adopted by life insurance companies. The income tax department

has also not accepted the position adopted by the life insurance companies leading to considerable litigation. The taxation framework for life insurance companies is presently before the High Court for adjudication in the absence of clear provisions under the Act.

4.2 A detailed circular on the line of circular 795 issued for MAT giving a detailed illustration of computation of profits from life insurance business would provide a clear and specific framework for taxing profits from life insurance business and reduce the litigation that presently exists owing to lack of specific tax provisions.

4.3 Further, it would be helpful if the tax administrators take a considered view on certain key issues, in consultation with the stakeholders, (e.g.: applicability section 14A, transfer pricing provisions) to a life insurance companies, which would mitigate uncertainty and avoid long drawn litigation.

25. (ITA No. 3554/Mum/2011)

26. (ITA 2576/Mum/2014)

27. Aegon Life Insurance-Bombay HC Order dtd. 15-01-2020



Whenever your promise to do any work, you must do it exactly at the appointed time, or people lose their faith in you.

– Swami Vivekananda

Taxation of General Insurance Companies



CA Manoj Purohit & CA Pranav Sakhdeo

1.0 Introduction

1.1 The world is moving at a fast pace and millennials have set their sights on high goals and priorities. Whether insurance features their priorities will depend on the time and further evolvement of insurance sector in accordance to the global trends. With the rapid pace of technological advancement, human life is exposed to uncertainties and the risks emerging out of those uncertainties. In such an era, people need to protect their life as well as their assets against uncertain events. The insurance sector has been helping in providing protection to the human life and minimizing the financial loss in case of any uncertain events.

The insurance sector in India is broadly divided into sub-sectors; the life insurance, non-life insurance (also known as general insurance including health insurance) and re-insurance sector. The non-life domain of insurance covers various risks viz: health, vehicle, home, fire, earthquake, marine insurance, travel, etc.

The insurance sector's journey in India goes back in the Eighteenth Century when the first insurance company was set-up under the British Rule.

1.2 Evolvement of General Insurance in India is summarized as under

<i>Year</i>	<i>Event</i>
1850	First general insurance company, Triton Insurance Co. Ltd. established under British rule
1938	Insurance Act, 1938
1961	<i>Income-tax Act, 1961 (Act)</i>
1971	The General Insurance Corporation of India incorporated
1972	The General Insurance Business (Nationalization) Act, 1972 nationalized the general insurance business in India
1988	<i>Finance Act, 1988 Clause (b) to Rule 5 of The First Schedule under the Act omitted</i>
1999	Insurance Regulatory and Development Authority (IRDA) formed as an autonomous body to regulate and develop the insurance industry
2000	IRDA opened the Indian insurance sector for foreign players to the extent of 26% in the form of Foreign Direct Investment (FDI)
2009	<i>Finance (No. 2) Act, 2009 reinserted Clause (b) of Rule 5 of the First Schedule under the Act</i>

Year	Event
2010	<i>Finance Act, 2010 amended the Clause (b) of Rule 5 of the First Schedule under the Act</i>
2016	Department of Industrial Policy and Promotion (DIPP) permitted 49% FDI in insurance sector
2020	34 general insurance companies registered with IRDA ¹
2020	<i>Finance Act, 2020 has proposed to insert a proviso to Rule 5 of the First Schedule under the Act</i>

2.0 Computation Mechanism of General Insurance Companies

2.1 The Act provides for a special tax regime for taxation of profits/loss of insurance business in India under the provisions of section 44 read with First Schedule of the Act. As per section 44 of the Act, profits and gains of any business of insurance, including any such business carried on by mutual insurance company or by a co-operative society, shall be computed in accordance with the rules contained in the First Schedule of the Act.

Section 44 of the Act states as under :

“Notwithstanding anything to the contrary contained in the provisions of this Act relating to the computation of income chargeable under the head "Interest on securities", "Income from house property", "Capital gains" or "Income from other sources", or in section 199 or in sections 28 to 43B, the profits and gains of any business of insurance, including any such business carried on by a mutual insurance company or by a co-operative society, shall be computed in accordance with the rules contained in the First Schedule.”

Further, First Schedule of the Act provides for the taxability of insurance companies

viz: life insurance, non-life insurance and reinsurance companies. Non-life insurance companies are taxed on the profits derived after specific adjustments to profits disclosed in the Profit & Loss Account prepared in accordance with the provisions of Insurance Act, 1938 or the rules made thereunder or the provisions of IRDA Act, 1999.

Rule 5 of the First Schedule of the Act is in relation to the general insurance companies and provides for following adjustments to the profit/ loss of general insurance companies as determined under Insurance Act, 1938/ IRDA Act, 1999.

Particulars	Amount
Profits before tax and appropriations as disclosed in the Profit and Loss account prepared in accordance with the provisions of Insurance Act, 1938 or the Rules made thereunder or the provisions of IRDA Act, 1999	XXX
Clause (a) <i>Add:</i> Any expenditure or allowance (including any provision of this rule, any expenditure or allowance either by way of provision for tax, dividend or any other provision) debited to Profit and Loss account and not admissible under the provisions of section 30 to 43B of the Act	XXX
Clause (b) <i>Add/ Less:</i> Gain/loss on realization of investments to be added/ deducted where such gains/losses are not credited/debited to the Profit and Loss account	XXX
<i>Add:</i> Provision for diminution in value of investments debited to profit and loss account	XXX

I. Source: https://www.irdai.gov.in/ADMINCMS/cms/NormalData_Layout.aspx?page=PageNo264&mid=3.2.10

<i>Particulars</i>	<i>Amount</i>
Clause (c)	
<i>Less: Amount carried over to a reserve for unexpired risk prescribed under Rule 6E of the Income-tax Rules 1962 (any amount of unexpired reserve already offered to tax in previous assessment year would not be again offered to tax in the subsequent assessment year)</i>	XXX

As stated hereinabove General Insurance companies are permitted to make only specific adjustments as per Rule 5 of the First Schedule of the Act for determining taxable profits under the Act.

Let us now dive deep and understand the implication of each clauses as stated hereinabove.

2.2 Clause (a) of Rule 5 of the First Schedule of the Act

The provisions of clause (a) states that, any amount which is not admissible under the provisions of sections 30 to 43B of the Act should be added back to profits and gains of business as determined under the provisions of Insurance Act, 1938/IRDA Act, 1999. It is to be noted that the clause provides for disallowance of inadmissible provisions, if any created under sections 30 to 43B of the Act. Thus, any disallowance ought to be made in accordance with sections 30 to 43B of the Act should be made for determining the profits/loss of insurance company.

Section 43B of the Act provides for certain disallowances and also provides for certain allowances/deductions, irrespective of the previous year in which the liability was incurred by the assessee according to method of accounting regularly employed by the assessee, such a liability ought to be allowed only in the previous year in which such sum is actually paid. However, there was no such specific provision in Clause (a) of Rule 5 of the First Schedule of the Act to allow the deductibility of expenses paid in subsequent years as per the provisions of section 43B of the Act resulting in higher disallowance for the general insurance companies, as such expenditure ought to be disallowed, if claimed on the payment basis under section 43B of the Act.

In order to align the provisions of section 43B of the Act and Clause (a) of Rule 5 of the First Schedule, the Finance Bill, 2020² has proposed to insert a proviso³ after Clause (c) of Rule 5 of the First Schedule to provide that, any sum payable by a non-life insurance company, which is added back under section 43B of the Act in accordance with Clause (a) of the said rule shall be allowed as deduction in computing the income in the previous year in which such sum is actually paid. Thus, clause 5(a) of the First Schedule of the computation mechanism will now be at par with other companies.

2.3 Clause (b) of Rule 5 of the First schedule of the Act

As per the amended⁴ Clause (b) of Rule 5 of the First Schedule of the Act, any

2. The Finance Bill, 2020 has not yet received Presidential assent and hence the amendment is subject to changes, if any as maybe amended before passing the Bill by the Lok Sabha.
3. The proposed Proviso reads as, *“Provided that any sum payable by the assessee under section 43B, which is added back in accordance with clause (a) of this rule, shall be allowed as deduction in computing the income under the said rule in the previous year in which such sum is actually paid”.*
4. Substituted by Finance Act, 2010 with effect from 1st April 2011.

gain/ loss on realization of investments is required to be added/deducted as the case maybe, if such gain/ loss is not credited or debited to the Profit and Loss account. The second limb of the clause states that any provision for diminution in the value of investment debited to the Profit and Loss account is required to be added back to compute the taxable gain/loss.

The first limb of clause (b), has a restricted implication and will be triggered only in a case wherein the gain/loss is not credited to the Profit and Loss account. To elaborate further as an example in a scenario wherein, the gain/loss on realization of investments are directly debited/credited to the reserve account, the adjustments ought to be made as per first limb of clause (b). Since the accounts of the insurance companies are governed by IRDA regulation such adjustments have limited applications.

Further clause (b) states that, any diminution or any increase in the value of investments cannot be claimed as expenditure/ income as the case maybe, by the general insurance company. Thus, in a scenario wherein an investment is marked-to-market, any gain/loss on such an event will be ignored and adjustments as stated hereinabove will be carried on if such, gain/loss is debited/credited to the profit and loss account of general insurance company.

Clause (b) has undergone some change since inception. Under the erstwhile provisions⁵ of Clause (b) of the said rule, a

general insurance company was permitted to claim the deduction in respect of diminution⁶ in value of investments as well as the loss realised on such investments and was liable to offer to tax the increase in value of assets and gains realised on such investments. However, the aforesaid clause was omitted by Finance Act, 1988 to enable General Insurance Corporation (GIC) and its subsidiaries to play more active role in capital markets. The Finance Act 1988 amended Clause (b) of Rule 5 of the First Schedule to provide for exemption of profits earned by GIC and its subsidiaries on sale of investments. Since this clause was omitted during 1st April 1989 to 1st April 2011, the general insurance companies did not claim the loss incurred on sale of investments, neither the companies offered the gains to tax on sale of investments. The tax authorities, especially at the lower level tried to levy tax on the aforesaid gains earned by other general insurance companies on the ground that the amendment was applicable only to GIC and its subsidiaries. However, the Income Tax Appellate Tribunals ('tribunal') ruled their judgments in favour of the general insurance companies by granting them exemption for the profits earned on sale of investments. The Pune tribunal case of Bajaj Allianz General Insurance Company⁷ held that the profits on sale of investments is exempt in hands of a general insurance company in the absence of Clause (b) of Rule 5 of the First Schedule of the Act. The Mumbai Tribunal followed the ruling of Pune Tribunal in case of

5. Clause (b) reinserted by Finance (No. 2) Act, 2009 with effect from 1st April 2011 which was omitted by Finance Act, 1988

6. Diminution/increase and gain/loss computed in accordance with the regulation made by IRDA.

7. ITA No. 1447/ PN/2007

8. ITA No. 338/ Mum/2009

HDFC Ergo General Insurance Co. Ltd.⁸, Reliance General Insurance Co. Ltd.,⁹ Tata AIG General Insurance Co. Ltd.¹⁰ on gains earned on sale of investments. Since clause (b) of the Rule 5 was amended by Finance Act, 2011 the above case laws and discussion are academic in nature.

2.4 Clause (c) of Rule 5 of First Schedule of the Act

Income of insurance companies is in form of premium for the risk undertaken during the year. As per the regulation insurance premium covers the risk of the policy holder for the year and therefore, if the risk is undertaken during the year the same spills over to the next year and therefore it is imperative for the insurance companies to create a reserve for unexpired risks.

Clause (c) of Rule 5 of the First Schedule permits a non-life insurance company to claim expenditure of reserve created for unexpired risk, provided the reserve amount does not exceed the limits prescribed in Rule 6E of the Income-tax Rules, 1962 (Rules). In other words, the amount of reserve created for unexpired risk as per IRDA guidelines in excess of the limits prescribed under Rule 6E of the Rules, will be disallowed under Clause (c) of Rule 5 of the First Schedule of the Act.

The limits prescribed under Rule 6E of the Rules are as under

<i>Category</i>	<i>Maximum amount allowed in respect of reserve for unexpired risk</i>
Fire insurance business which provides insurance for terrorism risk	100% of net premium income ¹¹
Fire insurance business other than the business above	50% of net premium income
Engineering insurance business which provides insurance for terrorism risks	100% of net premium income
Miscellaneous insurance business other than the business above	50% of net premium income
Marine insurance ¹² business	100% of net premium income

Based on the categorization of the insurance business one can claim the deduction for reserve for unexpired risks within the stipulated limits. As per the categorization, clause (aa) of Rule 6E of the Rules covers all 50% category which includes the reserve for miscellaneous insurance business. It is interesting to note that Rule 6E of the Rules is silent about the determination of amount as per the limits for each line of business and no guidance has been provided by Central Board of Direct Taxes (CBDT). As per the industry practice, in this regard one can adopt either of the following two approaches:

- Business category-wise approach i.e. individual line of business; or

9. ITA No. 781/ Mum/ 2007

10. ITA No. 2597/Mum/ 2009

11. Net premium income means the amount of premium received as reduced by the amount of reinsurance premium paid during the relevant previous year

12. Marine insurance includes the Export Credit Insurance

- Line-by-line approach i.e. on aggregate basis for line of business falling under same percentage/limit prescribed in Rule 6E of the Rules.

Moreover, the proviso to Rule 6E of the Rules states that any amount so disallowed as per the prescribed limits in a particular year, will not be considered in the total income in the revenue account relating to which the aforesaid amount is credited in subsequent year.

3.0 Tax treatment for Indian Motor Third Party Insurance Pool (IMTPIP)

3.1 On 1 April 2007 IMTPIP was setup by all general insurers in India. The main objective to form IMTPIP was to make available Third-Party Insurance (TPI) to all commercial vehicle owners at reasonable prices and terms and to distribute the losses on this account to all market participants. Third party motor insurance is required because a person driving a vehicle on public road is bound under the Motor Vehicles Act, 1988 to have a third-party motor insurance policy.

The general insurance companies in India were incurring huge liabilities based on the judgments of courts. Based on the representations received from General Insurance (GI) Council, IRDA directed to dismantle the IMTPIP model from 31st March 2012. Further, IRDA *vide* its order dated 22nd March 2012¹³ prescribed the accounting treatment to be followed by the general insurance companies to claim the expenditure liabilities (expenditure) in relation to the IMTPIP. IRDA *vide* its aforesaid order prescribed the following two methodologies to recognize IMTPIP liabilities estimated by the actuary.

- To recognize the entire liability as expenditure in the financial year ended 31st March 2012; or
- To claim the expenditure on a straight-line basis over a period of 3 years beginning with the financial year ended 31st March 2012, subject to fulfilment of prescribed conditions.

The general insurance company had to follow either of the two methods prescribed by IRDA for recognising the IMTPIP expenditure. Those general insurance companies in India which were making profits and had sufficient reserves, followed the first option of recognizing the expenditure in the first year i.e. in the financial year ended 31st March 2012. Since majority of the general insurance companies were running into losses due to high gestation period of insurance sector, these companies preferred to follow the second operation i.e., to amortise the expenditure over a span of three years starting from the year ended 31st March 2012. Also, claiming of huge expenditure in one year affected the solvency ratio required to be maintained by such general insurance companies. With the solvency ratio getting affected, the general insurance companies had to infuse additional capital to maintain the solvency ratio. However, there were restrictions on infusing of the capital as only 26% foreign direct investment was permitted during the year 2012 (now allowed up to 49%). Hence, majority of the companies preferred to amortize the expenditure over a period of 3 years as they were incurring losses and had to maintain their solvency margin.

It is important to note that the Act does not provide for amortization/allowability

13. Order No. IRDA/F&A/ORD/MTTP/070/03-2012

of such expenditure. As stated in the preceding paragraphs, the insurance companies are governed by a special regime under the provisions of the Act which also do not permit amortization of expenses over a span of years for general insurance companies. However, since the IRDA regulation which governs the operations/ accounting of insurance companies permits amortization of expenditure and that the expenditure was estimated by actuaries, such expenditure is generally amortized by general insurance and are claimed over a span of three years. The issue therefore arises is whether in the absence of any provisions in the applicable Rule 5 (supra) for allowability of such expenditure whether such expenditure can be claimed by the general insurance companies.

In the recent past General Insurance Companies have amortized the pre-operative expenses incurred between the period of incorporation of the company and obtaining the certificate for commencement of insurance business. Various jurisprudence are available on allowability of such expenditure including the decision of Mumbai Tribunal in case of Tata AIG General Insurance Co. Ltd. (supra) which had upheld that a general insurance company can amortize and claim the pre-operative expenses incurred. One can rely on the aforesaid decision and other decision, wherein the amortization of expenses was allowed in the hands of general insurance companies.

4.0 Tax deduction at source under section 194A of the Act

4.1 Finance Act, 2003¹⁴ inserted clause (ix) to section 194A of the Act for deducting tax

at source on the income credited or paid by way of interest on the compensation amount awarded by Motor Accident Claims Tribunal (MACT), provided the aggregate amount of interest paid during a particular financial year exceeds ₹ 50,000. In other words, a general insurance company had to deduct tax at source on the interest component at the time of payment or credit, whichever is earlier.

Subsequently, the Finance (No. 2) Act, 2009 amended the provisions of section 56 of the Act to, *inter-alia*, provide that the interest income received on compensation or enhanced compensation shall be deemed to be the income of the year in which the same is received. In order to bring parity between the provisions of section 56 of the Act and section 194A of the Act which provides for tax deduction at source on interest income on the compensation awarded by MACT, the Finance Act, 2015 substituted clause (ix) and (ix a) of section 194A of the Act whereby no tax is required to be deducted on income credited by way of interest on compensation award by MACT. However, tax is required to be deducted on actual payment of interest income on such compensation, provided the interest amount exceeds ₹ 50,000 during the financial year.

5.0 Applicability of section 10 of the Act in case of General Insurance Companies

5.1 Section 10 of the Act specifies the income which does not form part of the total income and therefore out of the tax net. Taxation of general insurance companies is governed by a special tax regime under the provisions of the Act and therefore the revenue authorities at lower level have taken a negative view during the course of assessment proceedings and have

14. Inserted by Finance Act, 2003 with effect from 1 June 2003

opined that since insurance companies are governed by a special regime under the provisions of the Act, the insurance companies will not be eligible to claim the exemptions, if any provided under section 10 of the Act.

As per the Rules of interpretation before going to charging section full effect needs to be given to section 10. i.e. income which does not form part of total income. General insurance companies typically claim exemption under section 10(34) and 10(35) of the Act for dividend income earned on their investments in equity shares and mutual funds respectively. Various decisions including the ruling in case of General Insurance Corporation of India¹⁵ has held that a general insurance company can claim exemption under section 10(34) of the Act for the dividend income earned on its investments. Consequently, the issue arises, if any income is exempt under section 10 then whether provisions of section 14A in relation to expenditure incurred to exempt income should be invoked. In one of the recent decision the Hon'ble Bombay High Court in Life Insurance company have admitted an appeal and therefore one needs to have a close watch on the outcome of the said decision as the same will be having a far reaching impact of the insurance companies

In Finance Bill 2020, the government has proposed to abolish the Dividend Distribution Tax (DDT), there will be corresponding change in the provisions of section 10(34) and 10(35) of the Act, whereby the payer will not pay DDT and the receiver will be liable to pay taxes (at applicable rates) on the dividend income. However, the payer of dividend shall deduct tax at source under section 194

of the Act on the dividend income so declared and distributed.

The second proviso to section 194 of the Act provides exemption to the payer from deducting tax at source on the dividend income paid to Life Insurance Corporation of India, General Insurance Corporation of India and to any other insurer in respect of any shares owned by it or in which it has full beneficial interest.

In view of the proposed amendment of abolishing the Dividend Distribution Tax, the general insurance companies will have to pay tax on the dividend income earned on its investment in equity shares after giving effect to section 80M of the Act.

6.0 Applicability of Minimum Alternate Tax (MAT) in case of General Insurance Companies

6.1 Every assessee being a company and maintaining its financial statements as per Companies Act, 1956 (now Companies Act, 2013) is required to compute book profit as per the provisions of section 115JB of the Act and pay a MAT of 18.50% on the book profit so computed considering the adjustments under section 115JB of the Act.

Since the financial statements of insurance companies are to be prepared in accordance to the IRDA guidelines and that the insurance companies are governed by a special tax regime under the provisions of the Act, there were divergent views on whether insurance companies are liable to pay MAT under the provisions of the Act.

The Finance Act, 2012 retrospectively¹⁶ amended the provisions of section 115JB of the Act to state that the provisions of MAT shall not apply to income accrued or

15. ITA No. 3554/Mum./2011

16. With effect from 1 April 2001

arising to a company from life insurance business referred to in section 115B¹⁷ of the Act. It is important to note that exemption was given only to life insurance companies, and therefore general insurance companies will be governed by the MAT provisions under the Act. However, the Mumbai tribunal in case of ICICI Lombard General Insurance Co. Ltd.¹⁸ has held that prior to 1st April 2013 section 115JB was inapplicable to insurance company as they were not required to prepare accounts as per parts II and III of schedule VI of Companies Act.

Thus, now MAT is applicable to General Insurance companies and therefore one interesting issue arises with respect to the reserve created by the insurance companies. As stated in the earlier part of the article insurance companies need to create reserve and therefore the question will arise is whether such reserve is ascertained or unascertained liability and if any, adjustment ought need to be made for computing the profit under MAT. There has been controversy about the provisions and reserves created by general insurance companies i.e., whether these reserves are ascertained liabilities or *ad-hoc* provisions thereby affecting the MAT computation. As per IRDA guidelines, insurance companies have to create/maintain certain reserves in order cover the claims liabilities that may arise out of the insurance contracts. Such reserves and provisions are typically created as per the guidelines issued by IRDA and are verified/certified by actuary appointed by the insurance company. Since the provisions/reserves are created to fulfil the claims under insurance contracts, such provisions are to be considered as ascertained liabilities and hence not

to be considered for computing book profits under section 115JB of the Act. It has been observed that tax authorities at lower level have not appreciated this fact that the nature of business of insurance sector is such that it is mandatory to create provisions/ reserves to honour the liabilities which may arise in the form of claims and hence they are in the form of ascertained liabilities and not *ad-hoc* or unascertained liabilities.

Presently, there is an on-going litigation on whether the reserve for unexpired risk should be disallowed for computing the book profits under section 115JB of the Act. The Kolkata Tribunal in case of National Insurance Co.¹⁹ has categorically held that reserve created for unexpired risk in case of general insurance companies need not be added back for the purpose of computation of book profits under section 115JB of the Act. However, since the judgment is pronounced by Kolkata tribunal, tax authorities in other jurisdictions may not consider the same and may try to add back the reserve for unexpired risk for computing the book profit.

7.0 Let me conclude this article with one interesting issue on allowability of reinsurance premium paid by the Indian insurance company to reinsurance company outside India.

General insurance companies as well as the life insurance companies transfer a part of the risk under an insurance contract to a reinsurance company as per the IRDA regulations. The primary insurance companies (i.e., life and general insurance) transfer the proportionate premium under

17. Provisions of section 115B of the Act provide for tax on profits and gains of life insurance business

18. 54 SOT 538 (Mumbai)

19. 72 taxmann.com 116 (Kolkata ITAT)

an insurance contract to the reinsurance companies.

In early 2017, the reinsurance business was liberalized and number of foreign reinsurers have set-up their branch office in India to undertake/ generate business pertaining to India and neighbouring countries. Prior to set-up of branches in India, the foreign reinsurance companies operated directly from outside India, where the reinsurance premium was paid outside India. Since the reinsurance contract was with an overseas entity the risk, assets, functions, etc., associated to the reinsurance contract was outside India. Broadly speaking the said income earned by the foreign reinsurance companies was not taxed in India as the income earned was in the nature of business income and in the absence of Permanent Establishment (PE) in India no income was considered as taxable as per the relevant treaty read with provisions of the Act. Accordingly, no tax was deducted at source on the reinsurance premium paid outside India.

As stated hereinabove with the opening up reinsurance space for foreign companies, major global reinsurance players established their branch office in India. However, certain reinsurance companies continued to underwrite reinsurance contracts from outside India. Under such contracts, the Indian insurance companies continued not to deduct tax at source on the reinsurance premium paid outside India. The Chennai Tribunal in case of Cholamandalam MS General Insurance Co. Ltd.²⁰ held that such payment to a reinsurance company outside India is illegal as the foreign reinsurance company

had not set-up a branch office in India and hence the amount so paid should be considered as violation of provisions of Insurance Act, 1938 and therefore the same needs to be disallowed under section 37(1) of the Act.

The aforesaid judgement of Chennai tribunal was overruled by Madras High Court. The Hon'ble High Court in its order held that the tribunal exceeded its jurisdiction in stating that the company was engaged in a transaction which is prohibited under a law as the regulations do not wholly prohibit any reinsurance contract with foreign reinsurance companies, subject to specified conditions. Accordingly, the amount of reinsurance premium paid outside India is not prohibited and therefore the reinsurance premium paid will be allowed as business expenditure under section 37(1) of the Act. Further, the High Court remanded the matter back to Chennai tribunal to re-examine the allowability of the expenditure under section 40(a)(i) of the Act.

However, the income tax department filed a Special Leave Petition (SLP) before the Hon'ble Supreme Court of India against the order passed by Madras High Court. Based on the SLP filed by the income tax department the Hon'ble Supreme Court of India has presently put a stay on the issue. One therefore needs to have a close watch on the outcome of this judgment as it may have an adverse repercussion if decided against the company and therefore the tax authorities reopening assessments for earlier years cannot be ruled out.

With all the above discussions it's time for me to lay down my pen.....

20. 96 taxmann.com 625

21. 102 taxmann.com 292



Foreign Re-insurance Branches – Key Issues



CA Rajesh Bhagat & CA Ankit Jain

Background

India has been the prominent market for the re-insurance companies operating globally. In recent years, the landscape for doing re-insurance business in India has changed for these players. The Insurance Law (Amendment) Act, 2015 liberalised the regime for foreign re-insurers by allowing them to set up a branch office in India for carrying out re-insurance business from India. Till then, foreign re-insurers operated from outside India by accepting re-insurance business with Indian insurance companies from outside India. Over the years, General Insurance Corporation of India (“GIC”) has continued its journey as the single monopoly player operating in India in this business. At present, ten such globally renowned re-insurance players have established a branch office in India under the permission from the insurance regulator i.e. Insurance Regulatory and Development Authority of India (“IRDAI”), while some of the foreign re-insurers continue to operate from outside India as the ‘cross border re-insurers’ as approved by IRDAI.

Of the ten branches operating in India, five have reported profit for the Financial Year (“FY”) 2018-19 while others have incurred book losses. Having witnessed profits/loss scenario, foreign re-insurers are worried about their actual tax liability in India

with questions like - what is likely to be their profit liable to tax? What would be actual income-tax outgo? What would be effective tax rate on the income earned in India? How certain is their tax liability in India? All these questions arise for a valid reason that there is a lack of clarity on taxation of profits of re-insurance business of foreign reinsurance branches. This necessitates examining the provisions of the Income-tax Act, 1961 (the “Act”) i.e. the scheme of taxation that would apply for taxation of such profits.

1. Scheme of taxation

The provisions dealing with computation of business income are contained in Part D of Chapter IV of the Income-tax Act, 1961 (the “Act”). Part D contains a special provision for taxation of insurance business by way of section 44. Section 44 (along with its heading) reads as under:

“Insurance business

44. *Notwithstanding anything to the contrary contained in the provisions of this Act relating to the computation of income chargeable under the head “Interest on securities”, “Income from house property”, “Capital gains” or “Income from other sources”, or in section 199 or in sections*

28 to 43B, the profits and gains of any business of insurance, including any such business carried on by a mutual insurance company or by a co-operative society, shall be computed in accordance with the rules contained in the First Schedule.”

1.1. **Applicability of section 44 to re-insurance business**

It is worth noting that the heading of section 44 refers to the phrase ‘insurance business’ and the substantive part of the section refers to the phrase ‘any business of insurance’. Thus, at both places, the word ‘insurance’ has been used and not specifically, the word ‘re-insurance’. Also, since section 44 refers to the phrase ‘any business of insurance’ and requires computation of profits and gains of such business as per the rules contained in the First Schedule to the Act, it is worthwhile to also examine the said rules to ascertain if there is any scope for interpretation that section 44 read with rules in the First schedule intends to cover re-insurance business as well.

1.2. **Applicability of rules to re-insurance business**

The First Schedule to the Act is divided into three parts - Part A contains Rules 1 to 4 dealing with ‘life insurance business’, Part B contains rule 5 dealing with ‘other insurance business’ and Part C contains Rules 6 and 7 dealing with other provisions applicable to insurance business. In particular, Rule 2 provides the manner of computation of taxable profits of a life insurance business, and Rule 5 provides the manner of computation of taxable profits of any business of insurance other than life insurance. Rule 6 provides the

deeming basis of computation of taxable profits of any business of insurance carried on by India branch(es) of a non-resident. The deeming basis of computation applies in case of absence of reliable data. All three rules (i.e. Rules 2, 5 and 6) refer to insurance business. While Rules 5 and 6 are wide in scope to cover any business of insurance, they do not specifically refer to re-insurance business.

Therefore, a moot question arises as to whether section 44 read with rules in the First Schedule covers within its scope the computation of profits and gains of re-insurance business.

1.3. **Re-insurance business a kind of insurance business**

It may be noted that, neither the Act nor the Insurance Act, 1938 (the “Insurance Act”) defines the terms ‘insurance’ or ‘insurance business’. For that matter, even the Insurance Regulatory and Development Authority Act, 1999 (the “IRDA Act”) which has been enacted primarily for establishing IRDAI to protect the interest of policyholders, does not provide any meaning of these terms.

Further, while the Insurance Act has defined the terms ‘life insurance business’, ‘general insurance business’ and ‘health insurance business’, it has not specifically defined the term ‘re-insurance business’.

1.4. **Analogy from insurance laws/regulations**

In this context, it may, however, be noted that the term ‘Indian insurance company’ has been defined¹ under the Insurance Act to mean, *inter alia*, any insurer whose

1. Section 2(7)

sole purpose is to carry on life insurance business or general insurance business or re-insurance business or health insurance business. Hence, any Indian company carrying on re-insurance business would be called as ‘Indian insurance company’ and not “Indian re-insurance company’. Another inference which can be drawn from the definition is that the re-insurance business is one amongst different types of insurance businesses, that an India insurance company can carry out as its insurance business.

Further, the Insurance Act provides the definition² of the term ‘re-insurance’ to mean the *insurance of part of one insurer’s risk by another insurer who accepts the risk of a mutually acceptable premium*. As per the said definition, re-insurance involves insurance. Further, in layman’s term, ‘re-insurance’ would mean an insurance that is purchased by an insurance company. Hence, it can be said that re-insurance business is nothing but a kind of insurance business only.

It can also be said that the contract of re-insurance has all the elements of an insurance contract as laid down by the Supreme Court in the case of **General Assurance Society Ltd vs. Chandumull Jain and Anr.**, and hence, the re-insurance business is nothing but one kind of insurance business. In General Assurance decision³, the Supreme Court held that the four essentials elements in a contract of insurance are:

- a) the definition of the risk;
- b) the duration of the risk;

- c) the premium; and
- d) the amount of insurance.

In view of the above, an analogy can be drawn from the insurance laws/regulations that insurance business referred to in section 44 and the rules in the First Schedule, includes re-insurance business.

1.5. Intention of the legislature

As per section 44, the profits and gains of any business of insurance have to be strictly computed as per the rules contained in the First Schedule to the Act and in computing such profits, the provisions relating to the computation of income under various other heads of income as well sections 28 to 43B would not be applicable. Thus, section 44 contains special provisions for taxation of profits of insurance business due to which normal provisions of the Act which ordinarily apply in case of companies do not apply to companies engaged in insurance business unless specifically provided for. Even under the Income-tax Act, 1922, similar such special provisions (section 10(7)) were made applicable to computation of profits of insurance business.

This suggests the intention of the legislature to treat insurance business differently for taxation purposes given its peculiar nature of business. Based on this, it can be said that since re-insurance business is also one such peculiar type of insurance business, the computation of profits and gains of re-insurance business should be governed by section 44 of the Act.

2. Under section 2(16B)

3. AIR 1966 SC 1644

1.6. Position on applicability of section 44 and rules in the First Schedule

The above discussion from a tax and regulatory point of view support a position that the computation of profits of re-insurance business should be governed by section 44 read with rules in the First Schedule to the Act. In general, the re-insurance branches have adopted this position for computing their income from re-insurance business.

1.7. Applicability of specific Rule(s)

Having adopted such position, next question that arises for consideration is as to which specific rule(s) in the First Schedule ought to apply for computation of taxable profits where a re-insurance branch carries on re-insurance business in the field of life insurance as well as in the field of general insurance or in any one of these fields. This is particularly relevant as the manner of computation of taxable profits is different under Rules 2, 5 and 6, and the applicable tax rate (as discussed in subsequent paragraphs) would also differ accordingly.

1.7.1. Applicability of Rule 6

Rule 6 (along with its heading) reads as under:

“Profits and gains of non-resident person.

6. (1) The profits and gains of the branches in India of a person not resident in India and carrying on any business of insurance, may, in the absence of more reliable data, be deemed to be that proportion of the world income of such person which corresponds to the proportion which his

premium income derived from India bears to his total premium income.

(2) *For the purposes of this rule, the world income in relation to life insurance business of a person not resident in India shall be computed in the manner laid down in this Act for the computation of the profits and gains of life insurance business carried on in India.”*

Rule 6 provides the deeming basis of computation of taxable profits of India branch(es) of a non-resident where there is absence of reliable data. In the case of re-insurance branches, Rule 6 ought not to apply as the reliable data for computing their taxable profits is available, as explained below.

The re-insurance branches are governed by the insurance laws which includes the Insurance Act, the IRDA Act and the rules and regulations issued under these acts. One of the objectives of the IRDAI (Registration and operations of branch offices of foreign re-insurers other than Lloyd’s) Regulations, 2015 (the “Branch Regulations”) is to regulate the business operations of re-insurance branches. The said regulations require, *inter alia*, that the re-insurance branches submit financial returns including the statements of account prepared in the manner specified in the IRDA (Preparation of Financial Statements and Auditor’s Report of Insurance Companies) Regulations, 2002 (the “Financial Statements Regulations”), with the IRDAI. In addition, the Branch Regulations lay down various reporting requirements⁴ and return submission requirements⁵ to be complied with by

4. Such as financial reporting, actuarial reporting, business reporting, downgrading reporting and erosion of net owned fund related reporting

5. As specified by the IRDAI

the re-insurance branches. Further, the Financial Statements Regulations require them to prepare financial statements and management report following the same accounting principles, disclosure norms and format as applicable in the case of insurers carrying on general insurance business. Also, the auditor's report is required to be prepared in the format prescribed in the said Regulations.

Thus, the reliable data for computing the taxable profits is available in the form of audited financial statements and other returns and records maintained by re-insurance branches in accordance with the applicable IRDAI regulations, which makes applicability of rule 6 irrelevant in their case.

As a result, the computation of taxable profit of re-insurance branches can only be considered under Rule 2 or Rule 5 or under both, depending on the nature of re-insurance business and the tax position adopted in this regard. These aspects are discussed in subsequent paragraphs.

1.7.2. *Applicability of Rules 2 and 5*

As mentioned earlier, Rule 2 provides the manner of computation of taxable profits of a life insurance business, and Rule 5 provides the manner of computation of taxable profits of any business of insurance other than life insurance.

For the meaning of the term 'life insurance business', Rule 7(1)(iv) in the First Schedule refers to the definition of the said term provided in clause (11) of section 2 of the Insurance Act, which reads as under.

“(11) 'life insurance business' means the business of effecting contracts of insurance upon human life, including any contract whereby the payment of money is assured on death (except death by accident only)

or the happening of any contingency dependent on human life, and any contract which is subject to payment of premiums for a term dependent on human life and shall be deemed to include—

- (a) the granting of disability and double or triple indemnity accident benefits, if so provided in the contract of insurance;*
- (b) the granting of annuities upon human life; and*
- (c) the granting of superannuation allowances and benefits payable out of any fund applicable solely to the relief and maintenance of persons engaged or who have been engaged in any particular profession, trade or employment or of the dependents of such persons;*

Explanation.— For the removal of doubts, it is hereby declared that “life insurance business” shall include any unit linked insurance policy or scrips or any such instrument or unit, by whatever name called, which provides a component of investment and a component of insurance issued by an insurer referred to in clause (9) of this section.”

Thus, life insurance business includes business of effecting any contract whereby payment of money is assured on any contingency dependent on human life. Re-insurance in the field of life insurance would also involve effecting a contract whereby payment of money is assured by a re-insurer on any contingency dependent on human life as the re-insurer underwrites the risk which is linked to the underlying risk dependent on human life. Therefore, in so far as the re-insurance contract involves element of life insurance, it should fall within the meaning of the term 'life

insurance business' defined in Rule 7(1)(iv) in the First Schedule to the Act.

In view of the above and, even otherwise, once the position is adopted that the re-insurance business is covered by section 44 and rules in the First Schedule to the Act, logically speaking, rules that are relevant for a particular field of insurance should also apply in case of re-insurance in the same field.

Accordingly, where a re-insurance branch carries on re-insurance business in the field of life insurance only, Rule 2 alone should apply for computation of taxable profits from such business whereas in case of re-insurance business in the field of general insurance only, Rule 5 alone should apply for computation of taxable profits from such business. As a corollary, where the re-insurance business consists of both the fields of insurance, respective rules should apply for respective field of re-insurance. The said view is also considering Rule 1 in the First Schedule which envisages that where there are two types of insurance businesses, computation of profits in the field of life insurance should be made separately (i.e. as per Rule 2 under Part A of the First Schedule). Likewise, Rule 5 is worded accordingly to cover computation of profits of any business of insurance other than life insurance. It is also worth noting that, Rule 6(2) in the First Schedule, while not applicable in this case, also requires that, the computation of profits of the business in the field of life insurance in the case of Indian branch of a non-resident should be made as per

Rule 2. From a regulatory perspective also, the solvency margin regulations⁶ issued by IRDAI separately for life insurance business and general insurance business are made applicable by the IRDAI to the corresponding fields of re-insurance business, although the format of financial statements to be adopted by foreign re-insurers is specified by the IRDAI to be the same as that applicable in the case of general insurance business.

1.8. **Applicable tax rate**

It is relevant to note that, as per section 115B of the Act, the profits of life insurance business (computed in accordance with Rule 2) are taxable at a concessional rate⁷ of 12.5% (plus applicable surcharges and cesses) whereas the profits of other insurance businesses (computed under Rule 5) are taxable at the normal rates⁸ (plus applicable surcharges and cesses) as applicable depending on the residential status of the assessee.

So, the profits of re-insurance branches in the field of life insurance should be taxable at the effective tax rate of 13.65%, whereas the profits re-insurance business in the field of other insurance business (i.e. general insurance business) should be taxable at the highest effective tax rate of 43.68%.

1.9. **Need for a clear scheme of taxation**

The above discussion brings out the point that there is a lack of clarity on the scheme of taxation applicable to re-insurance branches. A lack of clarity in this regard can lead to pointless

6. IRDAI (Assets, Liabilities and Solvency Margin of Life Insurance Business) Regulations, 2016 and IRDAI (Assets, Liabilities and Solvency Margin of General Insurance Business) Regulations, 2016

7. As provided in section 115B(1)(i) of the Act

8. As per section 115B(1)(ii) of the Act

litigation, as already witnessed in case of life insurance companies. It may be noted that in case of life insurance companies, the changes in regulatory laws have resulted in different interpretation of Rule 2 being adopted by tax payers and tax authorities for the purpose of computation of profits of life insurance business. Therefore, it is desired that a required clarity is brought under the Act for computing taxable profits of re-insurance branches. In the past, recommendations were made to Central Board of Direct Taxes (“CBDT”) to make necessary amendment in the Act. Where the said recommendations are accepted and necessary amendments are brought under the statute, it would help in avoiding unnecessary litigation.

Apart from the above issues on the applicable scheme of taxation, there are certain other key tax issues concerning re-insurance branches, which are discussed in the ensuing paragraphs.

2. Computation of taxable profits under Rule 5

As discussed earlier, Rule 5 can be said to be applicable for computation of taxable profit from re-insurance business in the field of general insurance. However, interpretation of Rule 5 in a particular manner can in certain cases result in an unintended and/or illogical consequence of either permanent difference or double taxation. These cases are discussed below in light of provisions of section 44 read with Rule 5.

2.1. Section 44 read with Rule 5

As discussed earlier, as per section 44, the profits and gains of any business of insurance have to be computed as per the rules contained in the First Schedule to the Act and in computing such profits,

the provisions relating to the computation of income under various other heads of income as well as sections 28 to 43B would not be applicable. Thus, section 44 contains special provisions for taxation of profits of insurance business due to which normal provisions of the Act which ordinarily apply in case of companies do not apply to companies engaged in insurance business unless specifically provided for.

Rule 5 in the First Schedule to the Act provides the manner of computation of taxable profits of any business of insurance other than life insurance. Rule 5 (along with its heading) reads as under.

“Computation of profits and gains of other insurance business.

5. *The profits and gains of any business of insurance other than life insurance shall be taken to be the profit before tax and appropriations as disclosed in the profit and loss account prepared in accordance with the provisions of the Insurance Act, 1938 (4 of 1938) or the rules made thereunder or the provisions of the Insurance Regulatory and Development Authority Act, 1999 (4 of 1999) or the regulations made thereunder, subject to the following adjustments:-*
 - (a) *subject to the other provisions of this rule, any expenditure or allowance including any amount debited to the profit and loss account either by way of a provision for any tax, dividend, reserve or any other provision as may be prescribed which is not admissible under the provisions of sections 30 to 43B in computing the profits and gains of a business shall be added back;*
 - (b) (i) *any gain or loss on realisation of investments shall be added or deducted, as the case may be, if such*

gain or loss is not credited or debited to the profit and loss account;

(ii) any provision for diminution in the value of investment debited to the profit and loss account, shall be added back;

(c) such amount carried over to a reserve for unexpired risks as may be prescribed in this behalf shall be allowed as a deduction.”

As per Rule 5, the profit (before tax and appropriations) as disclosed in the profit and loss account⁹ (“P&L account”) is the starting point for computing taxable profits of business other than life insurance. This profit is subject to adjustments provided in clauses (a) to (c) of Rule 5. It has been consistently held by Courts¹⁰ that the profit as per P&L account cannot be altered/modified by making adjustments other than those specified in clauses (a) to (c) of Rule 5. Thus, the scope of adjustment to P&L profit is limited to those provided in clauses (a) to (c) of Rule 5.

Further, rule 5(a) provides that any expenditure or allowance or certain specified provisions (debited to the P&L account) which are not admissible under the provisions of sections 30 to 43B shall be added back while computing the taxable profits.

It may be noted that section 44 renders sections 28 to 43B inapplicable and requires computation of profits of insurance business strictly in accordance with the

rules in the First Schedule. However, at the same time, Rule 5(a) makes sections 30 to 43B applicable but for the limited purpose of adding back/disallowing any expense or allowance or specified provision which is not admissible under the said sections. This raises a specific issue as to the adjustment to be made as per Rule 5(a) with respect to depreciation allowance.

2.2. Restricted claim for depreciation allowance

In case of businesses other than insurance business, the claim for depreciation allowance is ordinarily made under section 32 of the Act. In which case, for the purpose of computing taxable profits, book depreciation is added back and the tax depreciation¹¹ as per section 32 is reduced from book profits.

In case of a computation under Rule 5, the starting point i.e. P&L profit is after considering the depreciation allowance debited to the P&L account. Rule 5(a) would require that the said profit be adjusted by adding back the excess claim of depreciation than what is admissible under section 32 of the Act.

Therefore, in a situation where book depreciation is higher than tax depreciation, as per Rule 5(a), the excess of book depreciation over tax depreciation is to be added back to P&L profit as the claim for depreciation allowance cannot exceed the amount of depreciation calculated as per section 32 of the Act. However, in a situation where book

9. Prepared in accordance with the applicable insurance laws and rules/regulations thereto

10. In the case of *General Insurance Corporation of India vs. CIT* [1999] 240 ITR 139 (SC); *CIT vs. United India Fire & General Insurance Co. Ltd* [1982] 11 Taxman 217 (Mad.); *Union Co-operative Insurance Society vs. CIT* [1967] 66 ITR 360 (SC); *CIT vs. Calcutta Hospital and Nursing Home Benefits Associations Ltd* [1965] 57 ITR 313 (SC); *South India Insurance Co Ltd vs. CIT* [1977] 106 ITR 969 (Bom); *Oriental Fire and General Insurance Co. Ltd vs. CIT* [1983] 143 ITR 378 (Bom)

11. Calculated applying the rates of depreciation provided in Appendix IA of the Income-tax Rules, 1962

depreciation is lower than tax depreciation, the claim for depreciation allowance is to be restricted to the amount of book depreciation. Such tax treatment as per Rule 5(a) results in an unintended and/or illogical consequence of not being able to claim full cost of the asset by way of depreciation allowance over the years, which otherwise is not the case for assessees claiming depreciation allowance under section 32 of the Act. In effect, there is a situation of permanent difference (to the extent of book depreciation added back to P&L profit) in case of re-insurance branches as compared to a situation of temporary difference in case of other than insurance players.

2.3. Claim for deduction of expenses based on deposit of TDS

As per Rule 5(a), any expenditure which is not admissible under the provisions of sections 30 to 43B shall be added back while computing the taxable profits. Therefore, any expenditure that is not admissible as per section 40(a)(i) or section 40(a)(ia) on account of non-deduction of tax would be added back to P&L profit by virtue of Rule 5(a).

However, a question arises as to whether any such amount added back would be allowed as a deduction from the P&L profit of the subsequent year in which taxes that ought to have been deducted have been deposited. It may be noted that none of the clauses in Rule 5 provide for such adjustment. Further, as held by courts, the P&L profit cannot be altered/modified for any adjustments other than those specified

in clauses (a) to (c) of Rule 5. The absence of enabling provision under Rule 5 leads to unintended and/or illogical consequence of a *bona fide*/genuine expenditure not being allowed as deduction. In effect, this results in a permanent difference issue for re-insurance branches, which is a temporary difference issue in case of other than insurance players.

It is worth noting here that the Mumbai bench of the Income-tax Appellate Tribunal (“ITAT”) in the case¹² of *New India Assurance Co. Ltd vs. ACIT* held that the gratuity liability and leave encashment liability disallowed considering sections 40A(7) and 43B respectively cannot be claimed as deduction in the subsequent year of payment due to absence of specific provision under Rule 5 allowing any such deduction from the P&L profit. The key observations of the ITAT in this regard are as under.

“9. *“If the Assessing Officer holds the opinion that a particular deduction claimed is of the nature which is not permissible as per the regular provisions of the Act, his hands are tied so long as the Profit and loss account has been drawn as per the Insurance Act. He cannot make such addition. As the Profit and Loss account so drawn is binding on the Assessing Officer, so is the case with the assessee as well. If certain amount has been credited to the Profit and loss account so prepared and the assessee holds the opinion that it cannot be subjected to tax either because of exemption under the normal provisions of the Act or for any other reason whatever, he cannot claim deduction in respect of such amount*”

12. *New India Assurance Co. Ltd vs. ACIT* [2011] 12 taxmann.com 465 (Mumbai)

in the computation of total income. Section 44 read with Rule 5 of the First Schedule makes the figure of profit disclosed by the Profit and loss account drawn as per the Insurance Act as absolute and binding both on the assessee as well as the Revenue. Only the adjustments specified in clauses (a) and (c) can be given effect to while computing the total income.”

Here it may be noted that the Union Budget for FY 2020-21 has proposed an amendment¹³ in Rule 5 to allow deduction of the expenses in the year of payment if the same was disallowed in earlier years considering the provisions of section 43B. The said amendment has been proposed stating that it was not the intention of the legislature to not allow deduction for expenses specified in section 43B in the year of its payment.

However, a similar amendment has not been proposed for the items covered by section 40(a)(i)/(ia) of the Act. It is, therefore, expected by the industry players that the amendment similar to what is proposed for items covered by section 43B, be introduced for such items.

2.4. Double taxation in case of reversal of provisions disallowed earlier

As per Rule 5(a), any expenditure which is not admissible under the provisions of sections 30 to 43B shall be added back while computing the taxable profits. Therefore, the expenditure debited to P&L by way of ‘provision for gratuity’ that is not admissible under section 40A(7) would be added back to P&L profit. Similarly, any other provisions that are not admissible

under provisions of sections 30 to 43B would be added back by virtue of rule 5(a).

However, a question arises as to whether any such amount which is added back in the year of making provision would be allowed to be reduced from the P&L profit of the subsequent year in which reversal of such provision is credited to the P&L account. It may be noted that none of the clauses in Rule 5 allow such adjustment. Further, as held by courts, the P&L profit cannot be altered/modified for any adjustments other than those specified in clauses (a) to (c) of Rule 5. The absence of enabling provision under Rule 5 leads to untended and/or illogical consequence that the provision amount disallowed earlier would be taxed again as the income in the year of its reversal. In effect, this results in a double taxation issue, which otherwise does not happen in case of other than insurance players as the reversal of provision disallowed earlier is not taxed again as income in their hands.

The above consequence of double taxation of the same amount does not seem to be the intention of the legislature especially when the conditions laid down for claiming deduction for the same have been satisfied. Therefore, similar to amendment made in Rule 5 with regard to items covered by section 43B, amendment be made in Rule 5 such that reversal of provisions disallowed in earlier years is not treated as income in the year of such reversal.

It is, therefore, expected by the industry players that the amendment similar to what is proposed for items covered by section

¹³. By inserting a proviso after clause (c) in rule 5 w.e.f. 01 April 2020.

43B, be introduced for the items covered by section 40(a)(i)/(ia) and for provisions that are disallowed under provisions like section 40A(7) of the Act.

3. **Disparity in tax rates**

The profits of re-insurance branches from re-insurance in the field of general insurance is subject to effective tax rate of 43.68%. However, when such profits are earned by a domestic re-insurer, it is subject to tax rate¹⁴ of 25.63%. With the proposal in the Union Budget for FY 2020-21 to abolish levy of dividend distribution tax (“DDT”), the said rate of 25.63% would also represent the effective tax rate for a domestic re-insurer. Thus, there is a huge disparity in the effective tax rates for domestic re-insurers and foreign re-insurers.

While this disparity would exist also amongst the foreign and Indian companies in any other industry, it has considerable impact in case of (re)insurance industry. The higher tax outgo on account of high tax rates impacts re-insurance branches in several ways such as reduced cash flow, higher cost of products making it less competitive, and more importantly, lower solvency ratio¹⁵. Under the insurance regulations, all re-insurers are required to maintain solvency ratio at or above the minimum ratio prescribed by the IRDAI. However, the higher tax outgo results in lower solvency ratio for the foreign re-insurers which, in turn, impacts the ability of re-insurer to gain enough confidence of its customers and take on more business, unless it is adequately funded by its head office. Further, although the re-insurance branches and

the domestic re-insurers operate in the same or similar market conditions and are subject to similar regulations, due to higher tax outgo, foreign re-insurers are less favourably placed than the domestic re-insurers. Hence, there is a need for level playing field which can be achieved only by streamlining the tax rates applicable to domestic re-insurers and re-insurance branches.

The higher tax rate reduces the attractiveness of Indian market for the foreign re-insurers who may be willing to establish a presence in India. It also acts as a deterrent to the government’s aim of making India a ‘re-insurance’ hub as currently, other jurisdictions like Singapore, etc. provide a favourable and lower tax regime for such payers.

4. **Need for NIL withholding tax regime**

Another significant issue bothering re-insurance branches is about the withholding of tax on their gross receipts (i.e. re-insurance premium and interest income) at the maximum tax rate (i.e. 43.68 percent) unless they apply and obtain a specific nil/lower withholding tax certificate from the income-tax authorities. Since the tax is deducted by the payers under section 195 on the gross amount of re-insurance premium (and not on the profit element) and that also at the maximum tax rate of 43.68%, it results into significantly higher amount withheld towards tax as compared to the actual tax liability arising based on the profit margins of re-insurance business. The higher amount of tax withholding severely impacts the cash flow of re-insurance branches.

14. Assuming the conditions specified in section 115BAA are satisfied

15. A norm that reflects the company’s ability to pay its debts as they become due

Under the Act, there is no requirement to withhold tax from the (re)insurance premium¹⁶ and interest income¹⁷ paid to a domestic (re)insurer. Therefore, to provide a level playing field, it is desired by the industry players that the provisions of the Act be amended to provide for nil tax withholding regime in case of re-insurance premium and interest income paid to re-insurance branches.

Alternatively, it is desired by the re-insurance branches that they be provided with the facility to obtain a blanket NIL withholding tax certificate on the similar lines as provided¹⁸ in the case of Indian branches of foreign banks. This is keeping in mind that like foreign banks, the foreign re-insurers are globally renowned highly regulated entities and are adequately capitalised to meet solvency norms.

Further, the object of section 195 as laid down in the CBDT Circular No. 152 dated 27th November, 1974 was to ensure that the tax due from non-resident persons is secured at the earliest point of time so that there is no difficulty in collection of tax subsequently at the time of regular assessment. The circular also provides that the failure to deduct tax at source from payment to a non-resident may result in loss of revenue as the non-resident may sometimes have no assets in India from which tax could be collected at a later stage. However, in the case of re-insurance branches set-up by such non-residents, there would be adequate assets maintained in India in accordance with the regulatory norms.

Therefore, based on the intention of the circular and specific provisions in case of foreign bank branches operating in India, it is desired by re-insurance branches that the NIL withholding certificate regime be provided in their case.

5. **Challenges in obtaining nil/ lower tax withholding certificates**

Section 197 provides an option to the taxpayers whose income is subject to tax withholding, to apply to the tax authorities for issuance of a nil or lower tax withholding certificate. Due to the above issue of higher tax withholding, most of the re-insurance players approach the tax authorities for obtaining either a nil or lower tax withholding certificate depending on the facts of their case.

In past, the procedure for seeking nil/ lower tax withholding certificate involved manual filing of application and usually, such application was filed by the taxpayers well in advance before the start of the next financial year with a request to issue such certificate covering re-insurance premium income that would fall due or be received during the next financial year. However, the manual filing procedure was replaced by mandatory electronic filing of an application (i.e. online) by the CBDT *vide* notification dated 31-12-2018 and subsequent amendment in rule 29B of the Income-tax Rules, 1962. The online filing procedure, however, presented its own set of challenges from operational/procedural standpoint.

16. Act does not contain specific provision requiring tax withholding in case of payment of (re)insurance premium to domestic (re)insurer

17. As per clauses (vi), (vii) and (viii) in Proviso to section 193 of the Act

18. Under rule 29B of the Income-tax Rules, 1962

Under the online system, the application was required to be submitted through TRACES portal. However, due to technical reasons, the portal did not allow submitting of application before the start of the financial year. In view of, the required nil/lower certificate were issued by the tax authorities sometime during the mid of the relevant financial year. This resulted in higher tax withholding by the payers of income during the year and thereby, created a serious cash flow issue for the re-insurance branches. Thus, the option of seeking nil/lower tax withholding certificate did not serve its desired purpose. Based on representations made by the non-resident tax payer, the CBDT issued instructions¹⁹ on 24th January 2020 allowing advance filing of the online application from 28th February 2020 for seeking a nil/lower tax withholding certificate for the next financial year 2020-21. Thankfully, the portal opened even before 28th February 2020 allowing taxpayers to file application well in advance of the beginning of the next financial year.

Another issue faced under the online procedure was that due to technical reasons, the IT system of the income-tax department did not allow issue of nil/lower tax withholding certificate effective from the beginning of that financial year i.e.

1st April, 2019 although the request was made by taxpayers for issuance of certificate effective from that date. The certificates were however issued with a validity period starting from the date of issue of certificate (instead of 1st April, 2019). In the aforesaid instructions, the CBDT has stated that the advance filing of application is enabled keeping in view of the time being taken to process the online request for lower/nil deduction certificate and to facilitate the applicants to get the certificates issued with effect from 1st April of the next financial year. Therefore, one can expect that the IT system of the income-tax department would now be geared up to issue a nil/lower tax withholding certificate which is effective from 1st April of the next financial year irrespective of the date of issue of such certificate. Till such time, one will have to keep fingers crossed and hope that the issue does not persist going forward!

Conclusion

To sum up, there is a need for a well-defined taxation framework for foreign re-insurance branches operating in India. This would not only help in avoiding unnecessary litigation on various tax issues but also help in meeting the stated objective of the government to make India a 're-insurance' hub.

19. Instruction no. F. No. CPC(TDS)/197 Certificate /Cut Off Date/2019-20, dated 24th January 2020

Taxation of Foreign Portfolio Investors – An overview



CA Sneha Bhagat & CA Ketki Shah

1. Background

Foreign Portfolio Investors (FPIs) have played a pivotal role in the development of Indian capital markets. Since liberalisation of the Indian economy in early 1990's, India has remained on the forefront as an attractive investment destination for foreign investors. Currently, over 9,500 FPIs are registered under the Securities and Exchange Board of India (FPI) Regulations, 2019 (FPI Regulations 2019) with INR 3,500,234 crore¹ worth of assets under custody as on January 2020.

From a regulatory standpoint, FPIs need to adhere to FPI Regulations 2019 and Exchange Control Regulations prior to making investments in Indian capital markets and repatriating the sale proceeds out of India.

As per the FPI Regulations 2019, FPIs are classified into the below mentioned categories:

- Category I FPIs that include government and government related

entities, pension funds, university funds, appropriately regulated investment managers/advisors and entities from Financial Action Task Force (FATF) member countries.

- Category II FPIs that include appropriately regulated funds from non FATF member countries, endowments, foundations, charitable organisation, corporate bodies, family offices, individuals and unregulated funds.

Exchange Control Regulations governing foreign investment in India have recently undergone a change. The Central Government issued the Foreign Exchange Management (Non-Debt Instruments) Rules, 2019, which governs foreign investment in all non-debt instruments and the Reserve Bank of India issued Foreign Exchange Management (Debt Instruments) Regulations, 2019, which governs foreign investment in all debt instruments. These regulations provide for

1. Source: NSDL website

permissible instrument for FPIs, investment limits, repatriation related rules, etc.

FPIs can invest in listed equity shares, listed and unlisted debt securities, derivatives, mutual fund units, listed units issued by Real Estate Investment Trust (REITs) and Infrastructure Investment Trusts (InvITs), etc.

This article acquaints the reader with the key provisions of the Income-tax Act, 1961 (the “Act”) governing the taxation of FPIs and other topical issues.

2. Overview of taxation of FPIs in India

2.1 Charge of tax

Income tax is levied on the total taxable income earned by a person during a financial year. Total income is required to be computed in accordance with the provisions of the Act read with the Income-tax Rules, 1962. The basis of charge of income tax in India depends upon, amongst others, on the following:

- the residential status of the assessee during the financial year; and
- accrual, deemed accrual or receipt of income earned.

A person who is regarded as a non-resident under the Act is subject to tax in India on income that (a) accrues or arises or (b) is deemed to accrue or arise or (c) is received or deemed to be received in India. FPIs are non-residents for India tax purposes. They make investments in Indian securities from a special non-resident rupee account maintained with the local custodian bank in India. Also, the sale proceeds and other income earned from investments are credited to this bank account. For an FPI,

income arising on its Indian investments is received in India and thus, subject to tax in India as per the provisions of the Act.

2.2 Characterisation of income

In the past, the income of Foreign Institutional Investors (FIIs) was largely characterised as capital gains. Additionally, section 115AD of the Act (specific section that provides for the taxation of the income of FPIs) mainly provides for the tax treatment of capital gains. However, as is well known, business income and capital gains are subject to different tax treatments under the Act. In view of the differential tax rates, a dispute often arose between the tax authorities and assesseees on whether income from sale of securities should be treated as capital gains or business income.

Further, in terms of the provisions of the Double Taxation Avoidance Agreement (DTAA) signed by India with various countries, the business income earned by a tax resident of such country could be subjected to tax in India only if the tax resident has a permanent establishment (PE) in India. Accordingly, certain FIIs characterised their income as business income. Specific rulings were obtained from the Authority for Advance Rulings (AAR) on this issue. The AAR in the case of Fidelity Advisor Series VIII [2004] 271 ITR 1 (AAR), based on the facts in that case, held that the income earned by the applicant FII was in the nature of business income and accordingly, in the absence of a PE in India, such profits could not be taxed in India. However, the AAR, in the case of Fidelity Northstar Fund [2007] 288 ITR 641 (AAR), had taken a different view and held that income earned by the FII is in the nature of capital gains and could not be treated as business income.

This controversy was put to rest by changes to section 2(14) of the Act, wherein investments held by FIIs/ FPIs were deemed to be capital assets. As per section 2(14) of the Act, the term “capital asset” includes any security held by an FII, which has invested in such security in accordance with the regulations made under the Securities and Exchange Board of India Act, 1992.

Clause (a) of *Explanation 2* to section 2(14) of the Act, provided that the FII shall have the meaning assigned to it in clause (a) of *Explanation* to section 115AD of the Act. Since the SEBI (FPI) Regulations, 2014, replaced the SEBI (FII) Regulations, 1995, the Central Board of Direct Taxes (CBDT), *vide* notification dated 22nd January 2014, clarified that FPIs registered under the SEBI (FPI) Regulations, 2014, shall be considered as FII for the purposes of the said section. A similar notification is yet awaited for FPIs registered under the FPI Regulations 2019.

2.3 Special tax regime for FPIs

Section 115AD of the Act provides a separate scheme of taxation in case of FPIs on income received in respect of securities or income by way of capital gains arising from the transfer of securities.

FPIs will typically earn the below mentioned streams of income from investments in Indian securities:

- Capital gains on transfer of Indian securities;
- Dividend income; and
- Interest income.

FPIs are permitted to invest in security receipts issued by trust floated by Asset Reconstruction Companies, mutual fund units, listed units of REITS, InvITs, etc. However, tax nuances pertaining to these specific instruments are not covered in this article.

The taxability of each stream of income under the provisions of the Act is set out below.

Capital gains on transfer of Indian securities

A. Period of holding

A capital asset is categorised as short-term or long-term on the basis of period of holding of such asset. The following table indicates the categorisation of capital assets into short-term or long-term on the basis of period of holding of the capital asset prior to its transfer:

<i>Nature of asset</i>	<i>Short term capital asset</i>	<i>Long term capital asset</i>
For a security (other than a unit) listed in a recognised stock exchange in India or a unit of the Unit Trust of India or a unit of an equity-oriented fund or zero-coupon bond (as specified under the provisions of the Act)	Held for not more than 12 months	Held for more than 12 months
Unlisted share*	Held for not more than 24 months	Held for more than 24 months
For assets other than those specified above	Held for not more than 36 months	Held for more than 36 months

* FPIs may hold unlisted shares that are received under involuntary corporate actions and can sell them off-market subject to exchange control regulations.

B. Computation of capital gains

As per the provisions of the Act, in case of transfer of a capital asset, capital gains shall be calculated as net sale consideration less the cost of acquisition.

- Net sale consideration is the full value of consideration received for the transfer of a capital asset, as reduced by the expenditure incurred wholly and exclusively in connection with the transfer of the asset (e.g. brokerage paid, transaction fees charged by the local custodian, etc.);
- The cost of acquisition is the consideration paid for acquiring the relevant capital asset.

The cost of acquisition and period of holding is determined on the basis of first-in-first out method for securities held in dematerialised form.

As per the provisions of section 115AD(3) of the Act, the benefit of first proviso (forex fluctuation benefit) and second proviso (indexation benefit) to section 48 of the Act shall not be applicable for computing capital gains for an FPI.

As per the seventh proviso to section 48 of the Act, no deduction is allowed in computing the income chargeable under the head “capital gains” in respect of any sum paid on account of Securities Transaction Tax (STT).

C. Rates of tax

The tax rates on capital gains under the provisions of the Act are as follows:

<i>Nature of capital gains</i>	<i>Tax rate</i>	<i>Tax rate section under the Act</i>
Long term capital gains (LTCG) on transfer of equity share in a company, unit of an equity-oriented fund and unit of a business trust (i.e. REITs/ InvITs) where STT is paid on acquisition ² and transfer	10% (Refer Note)	Section 112A read with section 115AD of the Act
LTCG on transfer of debt security (i.e. corporate bond and government security)	10%	Section 115AD of the Act
Short term capital gains (STCG) on transfer of equity share in a company, unit of an equity-oriented fund and unit of a business trust where STT is paid on transfer	15%	Section 111A read with section 115AD of the Act
STCG on transfer of debt security/ derivative instrument/ unit of a mutual fund other than an equity-oriented fund	30%	Section 115AD of the Act

The tax rates mentioned in the above table are exclusive of applicable surcharge and health and education cess. The same is discussed later in the article.

Note:

As per section 112A of the Act, with effect from 1 April 2018, tax on LTCG arising on transfer

2. The CBDT has issued a Notification No. 60/2018/F. No. 370142/9/2017-TPL dated 1st October 2018 clarifying that condition of paying STT at time of acquisition shall not apply for all transactions of acquisition of equity shares other than the specified negative list.

of listed equity shares, units of equity oriented mutual fund and units of business trust are applicable at the rate of 10% (plus applicable surcharge and health and education cess) where such gains exceed INR 1 lakh. The benefit of cost step up to 31st January 2018 shall be available to the assessee as provided under section 55(2)(ac) of the Act.

As per section 55(2)(ac) of the Act, the cost of acquisition of long-term capital asset specified under section 112A of the Act which are acquired before 1 February 2018 shall be higher of:

- (a) The cost of acquisition of such asset; and*
- (b) Lower of*
 - The fair market value of such assets; and*
 - The full value of consideration received or accruing as a result of the transfer of the capital asset.*

The fair market value in case of capital asset listed on any recognised stock exchange as on 31st January 2018, is the highest price of such capital asset quoted on such exchange on the said date.

As per the third proviso to section 48 of the Act, the benefit of the computation of gains in foreign currency and cost inflation index shall not be available on such gains.

However, the benefit of cost step up shall not be available in case of certain corporate actions such as bonus, demerger, etc. wherein new shares are acquired by the assessee after 31st January 2018, although the original shares were acquired prior to that date.

D. Netting-off of capital gains and losses

Capital gains can be offset by capital losses. Short term capital loss (STCL) can be offset against LTCG and STCG. Long term capital losses can be offset only against LTCG. Further, netting-off of gains and losses arising on transfer of different securities should also be possible so long as the amounts are arrived at under a similar computation. This is irrespective of the fact that STCG on equity shares and derivatives are taxable at different tax rates.

For example, STCG earned on transfer of futures contract can be set-off against STCL incurred on sale of equity shares and only balance STCG on the futures contract should be offered to tax.

Capital losses can be carried forward for up to eight assessment years immediately succeeding the assessment year in which the loss was first computed. This is subject to furnishing a loss return within the prescribed tax return filing due date.

E. Deduction of tax on capital gains

As per section 196D(2) of the Act, no deduction of tax shall be made from any income by way of capital gains arising to an FPI from transfer of securities referred to in section 115AD of the Act.

Dividend income on equity shares

Dividends distributed by an Indian company, which are subject to the levy of Dividend Distribution Tax (DDT) payable by the Indian company under section 115-O of the Act, are exempt in the hands of the shareholders under section 10(34) of the Act. The dividend income is accordingly claimed as exempt in the hands of the FPIs.

The Finance Bill, 2020, has proposed that with effect from 1 April 2020, dividend income will be subject to tax in the hands of all investors including FPIs. In the case of FPIs, the same shall be taxable at 20% (plus applicable surcharge and health and education cess) under section 115AD(1)(a) of the Act. The FPI will offer this income to tax under the head “Income from Other Sources”. Further, the Finance Bill, 2020, proposes that the assessee can claim a deduction of interest expenditure under the provisions of the Act against such dividend income up to 20% of the dividend income.

Considering the proposed change in taxation of dividend income, dividend stripping provisions as contained in section 94(7) of the Act should not be of any consequence from 1st April 2020.

From a withholding tax perspective, section 196D(1) of the Act provides that any income in respect of securities referred to in section 115AD(1)(a) of the Act (not being income by way of interest referred to in section 194LD of the Act) payable to FPI will be subject to withholding tax at the 20% (plus applicable surcharge and health and education cess). Earlier, there was an exclusion provided for non-deduction of tax on dividend income as the same was exempt. However, the Finance Bill, 2020, proposes to delete the exclusion made under section 196D of the Act for non-deduction of tax in respect of any dividends referred to in section 115-O of the Act, which is aligned.

There is a possibility of FPIs investing from countries with which India has signed a DTAA, wherein the dividend income could be taxable at a rate lower than 20% (plus applicable surcharge and health

and education cess). Considering this, flexibility should be provided under section 196D(1) of the Act whereby the Indian company paying the dividend should be permitted to withhold taxes at the rate of 20% or “*rates in force*”. Further, section 197 of the Act should be amended to provide an option to the assessee to seek a certificate of tax deduction at a lower rate for dividend income. In case the same is not appropriately addressed, it could lead to refund claims by FPIs for excess tax deduction on dividend income, thereby resulting in cash flow issues. This may negatively impact the return of investors in the short term.

Interest income

The FPIs will typically receive interest income from investment in corporate debt and government securities. This will be taxable in the hands of the FPI under the head “Income from Other Sources” at applicable rates.

As per the proviso to section 115AD(1)(i) of the Act, the interest income referred to in section 194LD of the Act shall be taxable at the rate of 5% (plus applicable surcharge and health and education cess). In all other cases, interest income shall be taxable at the rate of 20% (plus applicable surcharge and health and education cess).

Section 194LD of the Act, which is the tax withholding section for certain cases of interest income for FPIs, provides that the interest income earned by the FPIs is subject to a concessional withholding tax rate of 5% (plus applicable surcharge and health and education cess), if such interest is:

- (a) payable on or after 1st June 2013 but before 1st July 2020; and

- (b) is in respect of investment made in rupee-denominated bond of an Indian company whose coupon rate does not exceed the prescribed rate and in government security.

The Finance Bill, 2020 proposes to extend the period of the concessional withholding tax rate of 5% (plus applicable surcharge and health and education cess) to 1st July 2023. It also proposes that the provision of the said section shall apply to interest payable, on or after 1st April 2020 but before 1st July 2023, to FPIs in respect of the investment made in municipal debt security.

Surcharge rate and health and education cess

FPI registered as a “corporate” assessee for India tax purposes will be liable to pay surcharge at 2% on its tax liability arising out of income earned in India in case the total income of the FPI exceeds INR 1 crore but does not exceed INR 10 crores or a surcharge at 5% on its tax liability arising out of income earned in India in case the total income exceeds INR 10 crore.

FPI registered as a “non-corporate” (such as Association of Persons, Trust, etc.) assessee for India tax purposes, the surcharge rate varies from 10% to 37% depending on the slab of total income.

However, the surcharge rate in case of income referred to in section 115AD(1)(b) of the Act (i.e. capital gains), shall not exceed 15%.

Additionally, health and education cess is leviable at 4% on total tax liability (including surcharge).

2.4 Minimum Alternate Tax (MAT)

As per the provisions of section 115JB of the Act, MAT is levied at the rate of 15% (plus applicable surcharge and health and education cess) on the adjusted book profits of the company in cases where the tax payable under the Act is less than 15% (plus applicable surcharge and health and education cess) of their adjusted book profits. The liability to pay a minimum tax of 15% (plus applicable surcharge and health and education cess) on book profits is applicable to both domestic and foreign companies.

MAT is not applicable to a foreign company, if:

- such foreign company is a resident of a country with which India has entered into a DTAA and does not have a PE in India; or
- the foreign company is a resident of a country with which India has not entered into a DTAA and no registration is required in India under any law for the time being in force relating to companies.

Subject to the above, MAT provisions should not apply to income earned by FPIs in India.

2.5 Taxability under relevant DTAA

As per the provisions of section 90(2) of the Act, provisions of the Act or the applicable DTAA, whichever is more beneficial, shall apply to the non-resident assessee.

FPIs who are eligible to avail the benefits of the relevant DTAA may opt to be taxed as per such DTAA on its income earned in India to the extent that they are more beneficial than the provisions of the Act.

The FPIs, however, will be required to obtain a Tax Residency Certificate and a duly completed Form No. 10F along with supporting documents, to the extent applicable.

While availing benefits under the DTAA, the assessee ought to satisfy the General Anti-Avoidance Rule (GAAR) provisions, beneficial ownership related conditions and such other conditions, to the extent prescribed under the DTAA and applicable to the facts of the case.

2.6 Key tax compliances for FPIs

Some of the key tax compliances that FPIs need to undertake in India are listed below.

Obtaining a Permanent Account Number (PAN)

Every entity registered as a FPI in India is mandated by the SEBI to obtain a PAN. PAN is a mandatory requirement for opening bank and securities accounts.

With the Ministry of Finance (Department of Economic Affairs) notifying the Common Application Form for registration, opening of bank and securities accounts and application for PAN by FPIs, there will be no requirement for the FPIs to apply for a PAN separately. This will simplify the account opening process for FPIs in India.

For certain fund structures investing through the FPI route, divergent practices have been used for obtaining PAN. These include umbrella-sub-fund structures from countries such as Luxembourg and Ireland. With the introduction of the Singapore Variable Capital Companies structure, which has an umbrella entity with various sub-funds, wherein each sub-fund has its

own investors, assets and liabilities ring-fenced from other sub-funds, the question that arises is whether the umbrella entity should take a PAN or whether it should be obtained at each sub-fund level as each sub-fund is likely to take a separate FPI registration. Further, in these countries, the umbrella entity is considered as a corporate taxpayer. However, if FPI registration and PAN are obtained at a sub-fund level, there is a lack of clarity on the legal status of these assesseees for India tax purposes.

These issues are prevalent within the investor community with no clear guidance being available.

Payment of advance tax

FPIs are required to pay appropriate taxes before the repatriation of sale proceeds outside India or before the stipulated quarterly advance tax due dates, whichever is earlier.

Typically, the bank account of the FPI with the local custodian will be credited with proceeds on sale of shares, dividend income, interest income, etc. When the FPI wishes to repatriate the said proceeds/income outside India, the local custodian based on the advice provided by the tax consultant of the FPI arranges to discharge appropriate taxes, if any, and then repatriates the funds outside India. In case the funds are not repatriated outside India, the FPI will need to ensure that the taxes are discharged prior to advance tax due dates, in order to avoid statutory interest.

As per the provisions of the Act, FPIs are required to pay taxes in advance during the financial year on its total income according to the below-mentioned instalments and entire tax liability by 31 March to avoid levy of statutory interest:

<i>Due date for instalments</i>	<i>Amount payable</i>
On or before June 15	15% of the total tax payable
On or before September 15	45% of the total tax payable
On or before December 15	75% of the total tax payable
On or before March 15	100% of the total tax payable

Since it is practically not possible for an FPI to estimate capital gains likely to be earned during the financial year, section 234C of the Act (interest on deferment of advance tax), specifically provides that if there is any shortfall in the payment of advance tax on account of the failure to estimate or underestimation of the amount of capital gains and the assessee has paid the whole of the tax as part of the remaining instalments of advance tax that are due or where no such instalments are due, by the 31st day of March of the financial year, the statutory interest shall not be leviable.

Further, for FPI investing in debt securities mainly government securities, where no tax withholding is practically undertaken by the Public Debt Office of the Reserve Bank of India, the FPI, based on its holdings in government securities, may consider estimating the interest income and discharging advance taxes on such income.

Filing of income tax return

As per the provisions of the Act, every assessee is required to file an annual tax return with the Indian tax authorities reporting the income earned during a financial year (except in certain cases where specific exemptions are provided). Thus, an FPI earning income from Indian investments is also required to file an income tax return in India.

The due dates for filing the tax return are as follows:

<i>Entity</i>	<i>Due dates</i>
Non-corporate assessee	31st July following the financial year end
Corporate assessee	30th September (31st October proposed by Finance Bill, 2020) following the financial year end and 30th November following the financial year end, if transfer pricing provisions are applicable

However, there are certain management companies (non-investing FPIs) that are mandated by the SEBI to obtain PAN. These entities do not make any investments in Indian securities and thus, a question arises as to whether they are required to file a tax return in India. One should be able to argue that since no income is earned by the management entity, merely holding a PAN should not mandate it to file a tax return in India. Conservatively, a few management companies do file tax returns in India declaring “Nil” income.

3. Other topical issues

3.1 Physical settlement of stock derivatives

From October 2019, SEBI has mandated physical settlement of all stock derivatives whereby settlement of such derivatives is undertaken by the actual delivery of underlying equity shares as against settlement in cash that was prevalent. The above principle applies to stock futures contract, which on expiry date, is not “squared-off,” i.e. this contract remains outstanding on expiry date. Similarly, the physical settlement rule applies to “in-the-

money” stock Options contract remaining outstanding as on the expiry date.

Illustratively, an FPI bought 10 Futures contracts of ABC Limited of lot size 100 each with February expiry in January 2020. This position was not squared-off until the close of trading as on 27th February 2020. In this case, it will be incumbent upon the FPI to take delivery of 1,000 shares of ABC Limited as on 27th February 2020.

In order to clarify the levy of STT on the buying/selling of equity shares arising as a result of physical settlement of stock derivatives, the CBDT issued a note on 27 August 2018 to the Income-tax Department, Mumbai, stating that STT shall be applicable to delivery-based derivative transactions. According to the CBDT, the transaction of derivative contract being settled by physical delivery of shares is not any different from transaction in equity shares where the contract is settled by actual delivery or transfer of shares. Following the CBDT note, National Stock Exchange issued a circular to the effect that in addition to the existing STT levied on derivative transactions, STT at the rate of 0.1% shall also be applicable on the physical settlement of derivatives.

As regards taxation of physical settlement of stock derivatives, the question that arises is whether both the transactions i.e. (1) settlement of stock derivatives physically and (2) transfer of equity shares arising as a result of physical settlement, should be considered as separate taxable transactions for India tax purposes or whether the entire transaction should be treated as a single transaction and taxed accordingly. There are arguments in support of both the views. Depending on whether the physical

settlement of stock derivatives is considered as a single transaction or two separate transactions, the tax treatment could significantly vary. Additionally, most of the tax treaties provide for exemption from capital gains on transfer of derivatives.

Since, the taxation on physical settlement of stock derivatives is relatively new and untested, specific guidance on the tax treatment on physical settlement of derivatives from the CBDT could provide a much-needed clarity on this emerging issue.

3.2 Overseas transfer provisions

Overseas transfer provisions were introduced in the Act to tackle cases where the share or interest held in India were transferred outside India through layered structures to avoid the taxation of such income in India. These provisions are likely to impact India focused funds investing in Indian securities subject to certain exemptions provided under the Act. These provisions are contained in section 9(1)(i) of the Act and are popularly known as “overseas transfer provisions”.

Section 9(1)(i) of the Act provides, amongst others, that income from transfer of capital asset situated in India shall be deemed to accrue or arise in India.

Explanation 5 to section 9(1)(i) of Act provides that an asset or a capital asset being any share or interest in a company or entity registered or incorporated outside India shall be deemed to be and shall always be deemed to have been situated in India, if the share or interest derives, directly or indirectly, its value substantially from the assets located in India.

Explanation 6 to section 9(1)(i) of Act provides that shares or interest shall be

deemed to derive its value substantially from the assets (whether tangible or intangible) located in India, if, on the specified date, the value of such assets:

- (a) exceeds the amount of INR 10 crore; and
- (b) represents at least 50% of the value of all the assets owned by the company or entity, as the case may be.

There are certain relaxations provided with respect to the applicability of overseas transfer provisions. These provisions are not applicable to shareholders not holding the right of management or control or to small shareholders holding less than 5% of the voting power/share capital/interest in the offshore entity or on dividend pay-outs by the offshore entity. Further, investments held by non-residents in Category I and Category II FPIs according to SEBI (FPI) Regulations, 2014, are exempt from overseas transfer provisions.

The Finance Bill, 2020 proposes a carve out for investors in Category I FPI under the FPI Regulations 2019 from applicability of these provisions. No carve-out is proposed for certain Category II FPIs that were earlier exempt from applicability of overseas transfer provisions. However, it is proposed that investment in the erstwhile Category I and II FPIs prior to repeal of FPI Regulations 2014 i.e. 23rd September 2019 shall be grandfathered. Thus, investors in regulated broad-based funds from non-FATF member countries such as Cayman Islands, Mauritius, etc. which were earlier enjoying the exemption from applicability of overseas transfer provisions on account of investment in Category II FPIs could now potentially be subject to overseas transfer provisions.

In case offshore transfer provisions are applicable based on the facts of the case, capital gains earned by the investor shall be taxable on a proportionate basis at the time of transfer/ redemption of share/ units in the offshore entity. Subject to the availability of DTAA benefits, the capital gains shall be taxable at rates which could vary between 10% to 40% (plus surcharge and health and education cess) depending on whether the asset is “short term” or “long term” in nature. Further, the offshore entity is obliged to withhold appropriate taxes before paying redemption proceeds to such investor.

3.3 Onshoring fund management to India

India has introduced safe harbour provisions (i.e. section 9A of the Act) to encourage offshore fund managers who are of Indian origin and managing offshore funds to relocate to India. These provisions essentially provide that fund management activities carried out through an eligible fund manager shall not constitute a “business connection” of that fund in India nor shall the offshore fund be considered as a resident in India merely because the fund manager undertaking the fund management activities is situated in India.

The benefits of safe harbour provisions will be available to offshore funds and fund managers who fulfil certain specified conditions. Applications in this regard are required to be made to the CBDT three months before the beginning of the previous year for which the fund seeks the approval. The CBDT has already granted approvals to certain FPI applicants (that satisfy the required conditions) in the last two years.

Since some of the conditions (such as resident investment in the fund should

not exceed 5% of the corpus of the fund, the monthly average of the corpus of the fund shall not be less than INR 100 crore, investor diversification conditions, etc.) are onerous, there are fewer cases of applications being made to avail benefits under this regime. Also, the FPI needs to seek approval from its home country regulator prior to delegating portfolio management function to the Indian manager. This has been an issue for funds domiciled in certain jurisdictions such as Luxembourg.

3.4 GAAR

Non-residents availing benefits under the relevant DTAA are subject to Indian GAAR provisions under the Act. As per the GAAR provisions, the Indian tax authorities have been granted the power to declare an “arrangement” entered by an assessee as an “impermissible avoidance arrangement (IAA)”.

The expression IAA essentially means a step in or an arrangement, whose “main purpose” is to obtain a tax benefit and the arrangement, amongst others, lacks or is deemed to lack commercial substance in whole or in part.

The burden of proof is on to the assessee to establish that obtaining a tax benefit was not the main purpose of the arrangement; else the arrangement shall be presumed to have been entered into, or carried out, for the main purpose of obtaining a tax benefit. Hence, GAAR provisions are expected to bring a significant change in the tax treatment of the assessee including eligibility of foreign investors to claim DTAA benefits.

Certain relaxations and clarifications have, however, been provided with respect to the application and implementation of GAAR provisions. For example, these provisions are not applicable in the following cases:

- Where the tax benefit from an arrangement in a relevant financial year does not exceed INR 3 crore;
- FPIs that do not avail any DTAA benefits;
- Investments made by a non-resident by way of offshore derivative instruments or otherwise, directly or indirectly, in an FPI;
- Gains arising from transfer of investments made up to 31st March 2017; and
- If the jurisdiction of FPI is finalised based on non-tax commercial considerations and the main purpose of the arrangement is not to obtain tax benefit.

Once the arrangement is declared as IAA, the Indian tax authorities could possibly, amongst others, deny DTAA benefits, disregard, combine or recharacterise any step in any arrangement, or recharacterise equity into debt and vice versa, treat place of residence, situs of asset or transactions at different place, etc.

In the context of the fund industry, selecting a jurisdiction for pooling of funds and management of funds is often based on various commercial considerations such as good regulatory framework, low compliance/ operational cost, availability of skilled and disciplined work force, stable political structure and extensive DTAA

networks. The main reason for selecting a particular jurisdiction may not be obtaining tax benefits.

However, an FPI investing in India from a tax efficient jurisdiction will have to demonstrate non-tax commercial reasons for investing from such jurisdiction from a GAAR provisions perspective.

3.5 **Multilateral Instrument to implement Tax Treaty Related Measures to prevent base erosion and profit shifting (MLI)**

The MLI seeks to help governments efficiently implement Base Erosion and Profit Sharing (BEPS) related measures to eliminate double taxation, counter abuse of treaties and improve dispute-resolution mechanism without the need to bilaterally renegotiate every DTAA. India is among the many jurisdictions that have signed the MLI.

On 25 June 2019, India deposited its instrument of ratification with the nominated authority under the MLI with its final MLI positions. This means the date on which India's entry into the MLI will come into force is 1 October 2019. In view of this, the MLI will take effect from 1 April 2020 (FY 2020-21) for Indian Tax Treaties if:

- (a) India has listed the treaty in its final MLI position as a Covered Tax Agreement (CTA).
- (b) The treaty partner is a signatory to the MLI.
- (c) The treaty partner has deposited its instrument of ratification on or before

30 June 2019.

- (d) The treaty partner has listed India in its final MLI position as a CTA.

Accordingly, for some of the popular fund jurisdictions such as Singapore, Ireland, Luxembourg, etc., having treaties with India, the provisions of MLI will come into effect from 1st April 2020.

The MLI, amongst others, includes a "principal purpose test," wherein tax treaty benefits can be denied if one of the principal purposes of an arrangement or a transaction was, directly or indirectly, to obtain a tax benefit, unless it is established that granting that benefit would be in accordance with the object and purpose of the provisions of the relevant tax treaty.

To prevent the granting of DTAA benefits in inappropriate circumstances and to align it with the MLI, an amendment is proposed to sections 90 and 90A of the Act by the Finance Bill, 2020, which provides that the Central Government shall enter into tax treaties for the avoidance of double taxation without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance (including through treaty-shopping arrangements aimed at obtaining reliefs provided in the said agreement for the indirect benefit to residents of any other country or territory).

FPIs availing benefits under the DTAA may have to take a relook at their structures from an MLI perspective.

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Taxation of Asset Management Companies and Mutual Funds



CA Vitthal Dehadray

Introduction

India's mutual fund industry over the past many years have shown remarkable growth and provided an efficient and investor friendly option for channelizing savings. Assets Under Management (AUM) of the Indian mutual fund Industry have grown from ₹ 11.81 trillion as on 31st January, 2015 to ₹ 27.86 trillion as on 31st January, 2020, about 2 ½ fold increase in a span of 5 years.

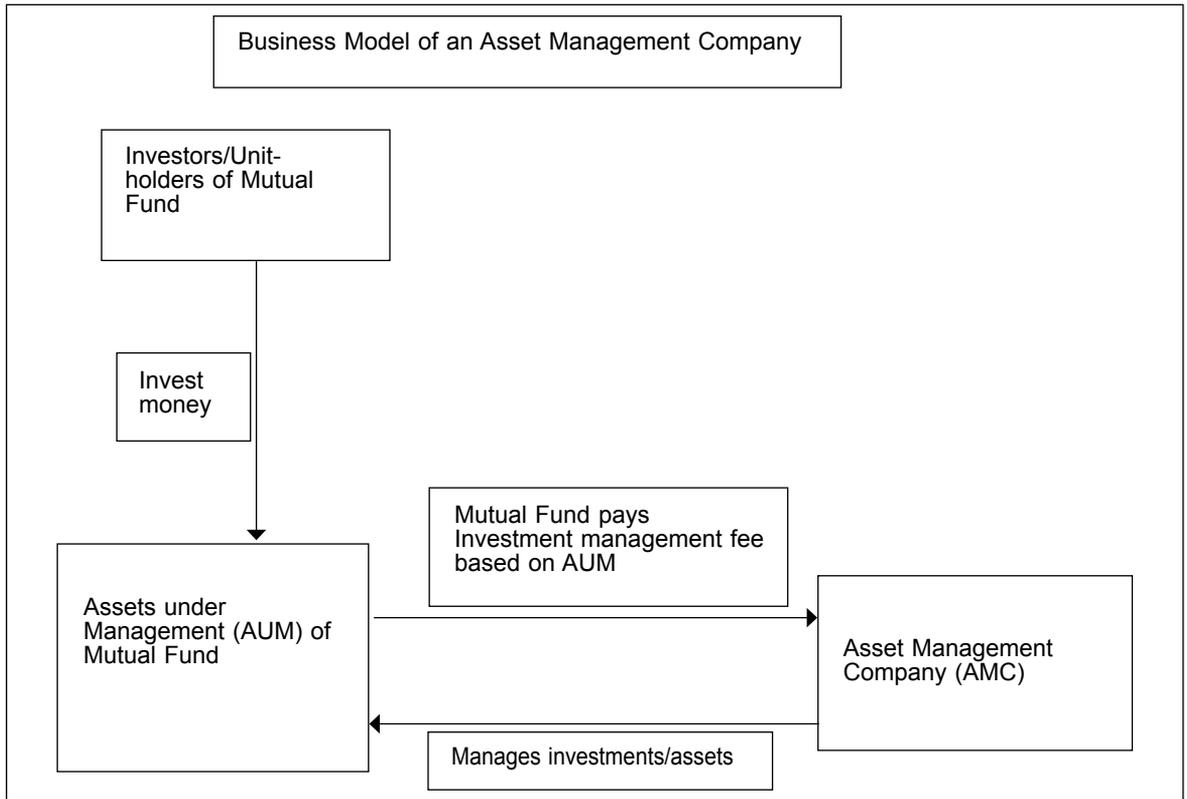
The total number of accounts (or folios as per mutual fund parlance) as on January 31, 2020 stood at 8.85 crore (88.5 million), while the number of folios under Equity, Hybrid and Solution Oriented Schemes, wherein the maximum investment is from retail segment

stood at 7.80 crore (78 million). This is the 68th consecutive month witnessing rise in the number of folios.

This tremendous financial growth and size of the industry warrants more clarity in taxation matters of the industry players such as asset management companies, funds and also of the investors. Some of the prominent aspects in this regard are covered in subsequent paragraphs:

Relevant aspects of the business model of an asset management company (AMC)

The business model of Asset Management Company may be depicted in the following diagram:



1. A Mutual Fund is a trust formed by a sponsor and a trustee Company. Upon formation of the trust, the Trustee Company ("Trustees") appoints an Asset Management Company ("AMC"), which is approved by the Securities and Exchange Board of India ("SEBI"). The Trustee enters into an Investment Management Agreement ("IMA") with the AMC.
2. The said AMC acts as an investment manager of the Mutual Fund and receives investment management or advisory fees as a consideration. Typically, such fees are calculated as percentage of the assets managed and are subject to maximum limits of expenses that may be charged to a mutual fund scheme as provided in Securities and Exchange Board of India (Mutual Fund) Regulations, 1996 (hereinafter referred to as "SEBI Regulations" or "the Regulations") and/or the clauses of the IMA. AMC's do take into account various business considerations like competitive pressures, industry practices, fund performance, etc. while finalising the investment management fee rate that can be charged to a mutual fund scheme. However, the maximum cap remains to be the expense cap under SEBI Regulations and rates mentioned in the IMA.
3. Thus, for providing investment management services, an AMC needs to have assets in the mutual fund to manage and higher assets for earning higher revenues. For mobilizing the higher assets to manage, an AMC needs to carry out (*inter alia*) various activities such as:

- a. launching various products consisting of schemes of the mutual fund and manage them in such a manner that aims to give maximum returns to the investors in the mutual fund with the minimum possible risks
- b. developing and maintaining relationship with existing & potential clients/investors/distributors of mutual fund units
- c. providing information to clients about the new financial products, update on financial performance of existing products and prevailing market scenario
- d. marketing, sales promotion and advertisement keeping in mind the target customers
- e. knowing investment needs of customers/clients/investors so as to offer them suitable financial products

Peculiar aspects of an AMC's business model
Separate books of the AMC and the mutual fund

As we see, the product that is launched by an asset management company is the scheme of the mutual fund managed by it. The assets/funds that are gathered in each scheme of the mutual fund are, however, recorded in the books of the mutual fund and not in the books of the AMC. Separate financial statements, such as balance sheet and statement of income (called revenue account), are prepared for the mutual fund and they are no way connected with the financial statements of the AMC except for *inter se* transactions such as investment management fees or expenses. The ultimate beneficial owners of the assets of the mutual fund schemes are investors in the schemes of mutual funds, called unitholders. The trustees are legal owners thereof.

Tax exemption on mutual fund's Income: The entire income of any mutual fund, which is registered under SEBI Regulations, is exempt

from income-tax under section 10(23D) of the Income-tax Act, 1961 ('the Act'). The rationale is to provide an almost unconditional pass thru to the fund in income tax matters. This is a very important exemption to entire mutual fund industry, which, for the mutual funds, metaphorically acts like oxygen to human life! The clarity of taxation of mutual funds is vital as the unitholders in each scheme of mutual fund can change on a daily basis and any tax demand from an adverse tax proceeding, which may be determined in future, may be very difficult to recover. The investors/unitholders are liable to pay tax on redemption of units of mutual fund.

Consequent tax issues faced by AMCs: Because the financial transactions of the AMC's product (i.e. mutual fund transactions) are not recorded in the books of the AMC, a layman's view, unless the business model is clearly understood, may create an impression that AMC's expenses should not be incurred for the mutual fund, which is a separate entity, that too exempt from tax. This lack of understanding has given rise to many direct tax issues in the industry in the past, important ones are as under:

1. ***Initial issue or scheme launch expenses:*** Whenever AMCs launch schemes of the mutual fund, the AMCs incur various expenses such as commission for distribution of mutual fund units, marketing expenses, etc.
2. ***Fund expenses:*** AMCs have borne some expenses relating to the funds because those were in excess of limits of expenses allowed to be charged to mutual fund under regulations or the IMA. In some cases, such expenses were voluntarily borne by the AMCs considering industry practices, competitive pressures and overall business scenario, etc.

Obviously, each of the expenses mentioned in points 1 & 2 above were incurred by the AMCs for sales/promotion of their products i.e. mutual fund schemes and thus

were claimed as deduction in tax returns of the AMC's in the year of incurrence.

3. ***Notional investment and advisory fees:***

Sometimes, tax assessing officers have added the difference between:

- i. the maximum investment management fees as allowed to be charged under SEBI Regulations and
- ii. the actual investment management fees charged by the AMC's

as the income of the AMC's implying that AMC's must necessarily charge the maximum fees per SEBI Regulations to the mutual funds.

Many a times, assessing officers reject the deduction of these expenses and/or also add the notional investment management and advisory fee, based on following major arguments:

- a. Expenses on launch of a scheme is similar to expenses on issue of shares in a company and therefore a capital expenditure.
- b. The expenses cannot be considered as incurred wholly and exclusively for the purpose of carrying on the business of the AMC. The expenses pertain to mutual fund, which is a separate entity, having separate permanent account number, filing separate returns than the AMC.
- c. Because expenses were relating to mutual funds, it's compulsory for the AMC to charge those expenses to the mutual fund. In some extreme cases, the assessing officers took a position that AMC's need to charge the expenses/fees to the funds to fullest extent possible under the Regulations.

However, various rulings by Income Tax Appellate Tribunal and the High Court have consistently rejected these grounds of the tax authorities and have allowed these expenses as deduction in the hands of the AMC's. These rulings were based on following principles:

- a. It is the business of the AMC to introduce new products (i.e. mutual fund schemes) in the markets. Launching scheme after scheme is regular feature of the business of the AMC. Therefore, expenses on launch of a scheme are not capital expenditure.
- b. Merely an option was provided in the SEBI Regulations to charge the expenses to the mutual fund but that does not by itself make the expenses incurred by the AMC to be treated as incurred on behalf of the mutual fund.
- c. It is not open for the tax department to prescribe what expenses an assessee (i.e. the AMC) should incur and in what circumstances.
- d. The expenses are business expenditure of the AMC and thus allowed under section 37(1) of the Act.
- e. On the addition of notional fee income, it was held that there was no accrual of notional fee income and the fees were charged as per prevailing business practice adopted by industry players. There is no real income and thus this addition of notional fee income is not required.

Relevant case laws relied upon while Mumbai Tribunal arrived at these principles are as under:

- ***Dy. Commissioner of Income Tax vs. M/s. Templeton Asset Management (India) P. Ltd., Mumbai (ITA 2890, 2891, 2892/MUM/2007 dated 2 July 2009), Mumbai Tribunal***

- *India Finance and Construction Co. P. Ltd. vs. B.N. Panda [1993] 200 ITR 710, 713 (Bombay High Court)*
- *CIT vs. A. Raman and Co. [1968] 67 ITR 11, 17 (Supreme Court)*
- *CIT vs. Dhanrajgirji Raja Narsinghbhirji [1973] 91 ITR 544 (Supreme Court)*
- *Sassoon J David & Co. Pvt. Ltd. vs. CIT [1979] 118 ITR 261 (Supreme Court)*
- *Alliance Capital Asset Management India Pvt. Ltd. vs. DCIT (ITA 6328 and 6331/Mum/2003 dated 27 May 2008), Mumbai Tribunal*
- *ACIT Cent. Cir.-34, Mumbai vs. M/s. Templeton Asset Management (India) P. Ltd. (ITA 4697/ MUM/ 2006 dated 27 August 2008), Mumbai Tribunal*
- *Birla Sunlife (AMC) Ltd. vs. ACIT, Mumbai (ITA No. 5980/Mum/2000 dated 4 June 2004), Mumbai Tribunal*

While the law on these aspects in AMC's tax assessments have gained certainty, subsequent to the above-mentioned decisions, SEBI has made some announcements on the way the expenses relating to the funds should/should not be borne by the AMCs. It would be reasonable to expect that the above-mentioned principles should still hold good and expenses incurred by the AMCs should be allowed as deduction without any specific/additional justifications.

Taxability of income for investors on sale/redemption of units

Taxability of transactions in securities, whether treated as 'business income' or as 'capital gains' is a fact-based exercise and thus no ready formula is always available. Assuming that approach is concluded, the below paragraphs provide the tax implications from investor's perspective in each approach.

Units held as stock-in-trade (i.e. business income)

- Taxed at the rates at which the normal income of the investor is taxed
- On sale of equity oriented mutual fund on a recognised stock exchange or to the Mutual Fund, the investor will also be charged with securities transaction tax ('STT')
- STT paid in respect of taxable securities transactions entered into the course of business shall be allowed as deduction in computing "business income" in respect of such taxable securities transactions

Units held as investments (i.e. capital gains income)

Equity Oriented: mutual fund scheme that invests predominantly in equity stocks

- Short Term: Held for ≤ 12 months
- Capital gains tax at 15 %* [applicable to all investors including Foreign Portfolio Investors (FPI)]

- Long Term: Held for > 12 months
- Capital gains tax at 10%*, where such capital gains $> ₹ 1$ lakh [applicable to all investors including Foreign Portfolio Investors (FPI)]

Note: For computing capital gains from redemption of units acquired prior to 1st Feb 2018, one can replace net asset value as of 31st Jan 2018 with actual cost, provided no tax loss is created.

Non-Equity Oriented

Short Term: Held for ≤ 36 months

Long Term: Held for > 36 months

- o FPI: 30%*
- o Others: normal tax rates as applicable to the investor

- o FPI: 10%* (without indexation)
- o Other Non-Residents:
 - listed securities: 20%* (with indexation)
 - unlisted securities: 10%* (without indexation)
- o Residents: 20%* (with indexation)

*Plus applicable surcharge and health and education cess

Withholding tax/Tax deducted at source (TDS) in respect of the capital gains

Resident Investors

No TDS to be deducted from capital gains arising at time of redemption of units

Non-Resident Investors

Under section 195, TDS plus applicable surcharge and health and education cess to be deducted from sale proceeds, in addition to STT, as follows:

Foreign Portfolio Investors (FPI)

Under section 196D(2), no TDS to be deducted from capital gains arising at the time of redemption of units

<p>Non-Resident Indian ('NRI') Investors</p>	<p>Short Term</p> <ul style="list-style-type: none"> o Equity Oriented: 15% o Non-Equity Oriented: 30% 	<p>Long Term</p> <ul style="list-style-type: none"> o Equity Oriented: 10% o Non-Equity Oriented listed units: 20% (with indexation) o Non-Equity Oriented unlisted units: 10% (without indexation)
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<p>Non-Resident Corporates/ Other Investors</p>	<p>Short Term</p> <ul style="list-style-type: none"> o Equity Oriented: 15% o Non-Equity Oriented Corporates: 40% o Others: 30% 	<p>Long Term</p> <ul style="list-style-type: none"> o Equity Oriented: 10% o Non-Equity Oriented listed units: 20% (with indexation) o Non-Equity Oriented unlisted units: 10% (without indexation)
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1. All the above-mentioned non-resident investors may also claim the tax treaty benefits available, if any.
2. As per the provisions of section 206AA of the Act, mutual fund would be obliged to withhold tax at penal rates of TDS in case of payments to investors who have not furnished their PAN to the mutual fund. The penal rate of TDS is 20% or any higher rate of TDS, as may be applicable, plus applicable surcharge and cess. This shall not apply to non-resident, not being a foreign company, or a foreign company in respect of payments made to them in the nature of interest, royalty, fees for technical services and payments on transfer of any capital asset, if the non-resident provides the following details to the payer:
 - o name, e-mail id, contact number;
 - o address in the country or specified territory outside India of which the non-resident or foreign company is a resident;
 - o a certificate of his being resident in any country or specified territory

outside India from the Government of that country or specified territory if the law of that country or specified territory provides for issuance of such certificate;

- o Tax Identification Number of the deductee in the country or specified territory of his residence and in case no such number is available, then a unique number on the basis of which the deductee is identified by the Government of that country or the specified territory of which he claims to be a resident.

TDS applicability on commission paid to mutual fund distributors/ brokers under section 194H

Commission or brokerage has been defined as per explanation (i) to section 194H of the Act which specifies that TDS would not be applicable in case commission or brokerage is being paid for selling of securities as defined in Securities Contracts (Regulation) Act, 1956 ('SCRA'). As per provisions of section 2(h) of SCRA, securities include units of mutual fund and accordingly, no

TDS is applicable on commission or brokerage paid for selling of units of mutual fund.

TDS applicability on income earned or received by the Mutual Fund

Income of a mutual fund is exempt from income tax under Section 10(23D) of the Act. In view of the provisions of Section 196(iv) of the Act, no income tax is deductible at source on the income earned by the mutual fund.

Tax implication on income distributed by the mutual fund, commonly known as dividend (until 31st March 2020 assuming changes introduced by the Finance Bill 2020 take effect)

As per provisions of the Act (Section 115R), mutual fund is required to pay dividend distribution tax ('DDT'), including surcharge and health and education cess as follows:

Equity Oriented: DDT to be paid at 11.648%

Non-Equity Oriented: DDT to be paid at following rates:

- income distributed to any individual or a Hindu Undivided family: 29.12%
- income distributed to any other person: 34.944%
- income distributed under an infrastructure debt fund scheme to a non-resident or a foreign company: 5.824%

Income distribution tax payable by the mutual fund is at the rates specified above on the net amount of dividend distributed **i.e. the taxes would be grossed up.**

However, the Finance Bill 2020, has proposed changes in the way dividend/ income distributed by mutual fund are taxed, summarized below:

Position up to March 31, 2020	Position from April 1, 2020*
<ul style="list-style-type: none"> • DDT payable by mutual fund: Yes • Tax payable by unit holder/investor: No, exempt u/s. 10(35) 	<ul style="list-style-type: none"> • DDT payable by mutual fund: No • Tax payable by unit holder/investor: Yes

Major change in pipeline for dividend/income distribution by mutual fund: Such amount declared, distributed or paid after 1st April 2020, shall be subject to withholding tax at applicable rates as under*:

- In the hands of the payer:
 - o 10% for resident shareholders/unitholders in excess of ₹ 5000;
 - o Rates in force (i.e., Finance Act) for non-resident shareholders, subject to tax treaty relief, if any; and
 - o 20% for non-resident unitholders

- In the hands of the recipient
 - o Incidence of taxation shifted to recipients i.e. unitholders
 - o Only interest expense will be allowable as deduction against dividend income; maximum deduction capped at 20% of the dividend income

*Based on the assumption that provisions in the Finance Bill 2020 as introduced on February 1, 2020 are approved as is.

Capital gains on sale of units due to consolidation/merger of schemes

- Merger or consolidation of schemes in order to recategorise existing schemes as per SEBI orders do not attract any capital gains tax, either short-term or long-term, in the hands of the investor.
- Merger of equity mutual funds does not affect the holding period of investments in the scheme.

Segregated Portfolios of Mutual Fund

Based on the assumption that provisions in the Finance Bill 2020 as introduced on February 1, 2020 are approved as is.

- **Segregated Portfolio:** a portfolio, comprising of debt or money market instrument affected by a credit event, that has been segregated in a mutual fund scheme.
- **Main portfolio:** portfolio excluding the segregated portfolio.
- **Total portfolio:** portfolio including the securities affected by the credit event.

Capital gains tax treatment upon the sale of Units in the Main Portfolio and the segregated portfolio in the hands of the unitholder:

In order to rationalize the tax provisions in line with the applicable SEBI Regulations, the Finance Bill 2020 proposed that:

- The period of holding for which original units were held in the main portfolio shall be included while determining the period of holding for the units held in segregated portfolio
- Cost of acquisition of units in segregated portfolio = cost of acquisition of units in total portfolio * net asset value of the asset transferred to the segregated portfolio / net asset value of the total portfolio immediately before the segregation of portfolios

- Cost of acquisition of units in main portfolio = Cost of acquisition of units in total portfolio – Cost of acquisition of units in segregated portfolio

Alternative Investment Funds (AIFs)

AIF is a pooling vehicle, permitted to be established or incorporated in India as a trust, company, limited liability partnership or a body corporate which is a privately pooled investment vehicles with Indian or foreign investors (Contributors) and registered with SEBI under the SEBI (AIFs) Regulations, 2012.

Taxation of AIFs

The Indian tax law grants special tax “pass through” status to Category-I and Category-II AIFs, which provides that incomes earned by an AIF will be taxed in the hands of the investors in the AIF as if the investment had accrued to the investors directly at rates generally applicable to such investors. This is applicable even if the profits have not actually been distributed by the AIF to the investors.

There is a suggestion that “pass-through” tax status may be extended to Category-III AIFs:

- a. While the rate of tax may be decided based on the nature of income, a pass-through status will not affect the revenue of the government.
- b. The investment strategy need not be a consideration for determining the pass-through status and even if it has to be considered, Cat-III AIF may be considered at par with Cat-I and II AIF for taxation purpose.
- c. With the increase in surcharge tax rates proposed in Finance (No. 2) Act 2019, it becomes imperative to extend “pass-through” status for AIF CAT III Funds as the AIF Funds are pooled investment vehicles consisting of investors of varied taxable income slabs. For instance, each

fund may consist investors in one of the below taxable income slabs:

Up to ₹ 50 lakh

₹ 50 lakh to ₹ 100 lakh

₹ 100 lakh to ₹ 200 lakh

₹ 200 lakh to ₹ 500 lakh

Above ₹ 500 lakh

The surcharge rates for each of the above income slabs vary. However, at a fund level the total income would be more than ₹ 500 lakhs and hence surcharge at the highest rate would get applied which would adversely impact investors with lower taxable income with no provision to claim the excess tax paid. A “pass-through” status will ensure equitability and fairness in tax treatment.

India based fund manager (IBFM) under section 9A relating to fund management of offshore funds

Section 9A was introduced in the Income-tax Act, 1961 to provide tax immunity (other than tax paid as capital gains) to offshore funds which obtain fund management from IBFM. Sub-section 3 of Section 9A of Income-tax Act, 1961 (‘the Act’) has prescribed 13 conditions to be fulfilled by the offshore fund to qualify for exemption from a business connection risk and/or the risk of having a Permanent Establishment (PE) under the Act. However, this beneficial provision in tax laws has

seldom been availed any major industry player, mainly because of so many stringent conditions.

Other than certain pooling vehicles permitted by SEBI under SEBI (MF) Regulation, the only route for offshore funds to make investment in India is the FPI route. The H. R. Khan Committee has recommended that FPI route shall be the only route for offshore funds to make investments in India. The current tax law has clear provisions regarding taxation of FPIs. However, section 9A of the Act imposes additional restrictions on FPIs without offering any specific tax advantages to them. Consequently, FPIs do not opt for the services of resident Indian fund managers. Hence, the entire objective of section 9A of the Act seems defeated unless appropriate amendments are carried out in the section.

In order to make the IBFM regime attractive from tax perspective, it may be clarified that the eligibility conditions prescribed in section 9A of the Act will not be applicable to FPI’s and appointment of an Indian Fund Manager by SEBI registered FPIs will not alter the current tax structure prescribed for FPIs. Alternatively, amendments in major conditions prescribed in section 9A of the Act are expected so as to provide operational flexibility and make it attractive to the fund managers and the offshore funds.

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Man should not be degraded to worldly slavery but should be raised up to God.

– Swami Vivekananda

DIRECT TAXES

Supreme Court



Keshav B. Bhujle,
Advocate

1 | *Seshasayee Steels P. Ltd. vs. CIT;*
[2020] 421 ITR 46 (SC):
dated 4-12-2019

Capital gains – Transfer – When takes place – S. 2(47)(v) and (vi) of ITA, 1961 and S. 53A of TPA, 1882 – Agreement to sell in 1998 entitling parties to specific performance of agreement – Assessee giving "permission" to builder to start advertising, selling, construction on land – Licence to builder not amounting to possession of asset – Memorandum of compromise in 2003 under which agreement confirmed, and receipt by assessee of part of agreed sale consideration confirmed – Balance towards full and final settlement to be paid by post-dated cheques last two of which to be presented only upon receipt of discharge certificate from one PH – Assessee's rights in property extinguished on receipt of last cheque – Compromise deed was transaction which had effect of transferring property in question – Gains arose in previous year in which memorandum of compromise entered into, and taxable in that assessment year: (A. Y. 2004-05)

The assessee entered into an agreement to sell land, on 15-5-1998, with a builder (V Ltd.) for a total sale consideration of ₹ 5.5 crores. The agreement provided, *inter alia*, that both parties were entitled to specific performance of the agreement. Under the agreement the

assessee gave permission to the builder to start advertising, selling, and make construction on the land. Pursuant to the agreement, a power of attorney was executed on 27-11-1998, by which the assessee appointed a director of the builder-company to execute, and join in execution of, the necessary number of sale agreements or sale deeds in respect of the schedule mentioned property after developing it into flats. The power of attorney also enabled the builder to present before all the competent authorities such documents as were necessary to enable development on the property and sale thereof to persons. Subsequently, a memorandum of compromise dated 19-7-2003 was entered into between the parties, under which the agreement to sell and the power of attorney were confirmed, and a sum of ₹ 50 lakh was reduced from the total consideration of ₹ 6.10 crore. Clause 3 of the compromise deed confirmed that the assessee had received a sum of ₹ 4,68,25,644 out of the agreed sale consideration. Clause 4 recorded that the balance ₹ 1.05 crore towards full and final settlement in respect of the agreement entered into would be paid by seven post-dated cheques. Clause 5 stated that the last two cheques would be presented only upon due receipt of the discharge certificate from one PH. The assessee not having filed any return for the A.Y. 2004-05 the assessment of the assessee for this year was reopened. Since the assessee did not respond to notices and limitation was running out the Assessing Officer passed an order of best judgment assessment treating the entire sale consideration as capital gains and bringing it

to tax. The Commissioner (Appeals) dismissed the assessee's appeal. The Appellate Tribunal agreed with the Commissioner (Appeals) finding that on or about the date of the agreement to sell (15-5-1998), the conditions mentioned in section 2(47)(v) of the Income-tax Act, 1961 could not be stated to have been complied with, in that, the very fact that the compromise deed was entered into on 19-7-2003 would show that the obligations under the agreement to sell were not carried out in their true letter and spirit. It held that as a result of this, section 53A of the Transfer of Property Act, 1882 could not be attracted. The Tribunal held that the transfer took place during the A. Y. 2004-05 as the last cheque was dated 25-1-2004.

Three questions were raised by the assessee in its appeal before the High Court : whether the Tribunal was correct in bringing to tax long-term capital gains arising or accruing as a result of transfer of capital asset in the A.Y. 2004-05 based on the memorandum of compromise dated 19-7-2003, whether the Tribunal was correct in interpreting the documents relating to the transfer of the capital asset to sustain the levy of capital gains in the previous year relating to the assessment year 2004-05, and whether the Tribunal was correct in confirming the *ex parte* assessment dated 31-12-2009 in terms of section 144 read with section 147 of the Act. The Madras High Court adverted to the concurrent findings of the authorities, and answered the three questions of law in favour of the Department and against the assessee.

On further appeal by the assessee the Supreme Court upheld the decision of the High Court held as under:

“i) The expression "enabling the enjoyment of" in section 2(47)(vi) of the Income-tax Act, 1961 must take colour from the earlier expression "transferring", so that it can be stated on the facts of a case, that a *de facto* transfer of immovable property has, in fact, taken place making it clear that the *de facto* owner's rights stand extinguished.

- ii) In order that the provisions of section 53A of the Transfer of Property Act, 1882 be attracted, first and foremost, the transferee must, in part performance of the contract, have taken possession of the property or any part thereof. Secondly, the transferee must have performed or be willing to perform his part of the agreement. It is only if these two important conditions, among others, are satisfied that the provisions of section 53A can be said to be attracted on the facts of a given case.
- iii) Under the agreement to sell dated 15-5-1998, both parties were entitled to specific performance. The expression used in clause 16 was that the party of the first part gave "permission" to the party of the second part to start construction on the land. Clause 16 would, therefore, lead to the position that a licence was given to another upon the land for the purpose of developing the land into flats and selling them. Such licence could not be said to be "possession" within the meaning of section 53A of the Transfer of Property Act, 1882, which is a legal concept, and denotes control over the land and not actual physical occupation of the land. This being the case, section 53A of the 1882 Act could not possibly be attracted to the facts for this reason alone.
- iv) It was clear that as on the date of the agreement to sell, the owner's rights were completely intact both as to ownership and to possession even *de facto*, so that section 2(47)(vi) of the 1961 Act equally, could not be said to be attracted.
- v) The finding of the Tribunal was that all the cheques mentioned in the compromise deed had, in fact, been encashed. This being the case, the assessee's rights in the immovable property were extinguished on the receipt of the last cheque and the compromise deed could be stated to be a transaction which had the effect of transferring the immovable property in

question. The transaction fell u/s. 2(47)(ii) and (vi) of the 1961 Act.”

2 | *Special Leave Petitions*

2.1 **Capital gains or business income – Profits on sale of land by property dealer**

Supreme Court dismissed the Department's special leave petition against judgment dated 26-2-2019 of the Bombay High Court in I. T. A. No. 1720 of 2016 whereby the High Court held that the Tribunal was justified in treating the income received of ₹ 69 crores on sale of non-agricultural land as long-term capital gains instead of business income on the basis of a concurrent finding of fact that the land has been held by the assessee as investment, and that there was no bar in law for a person dealing in land to also have investment in land.

Principal CIT vs. Jogani and Dialani Land Developers and Builders; (2020) 421 ITR 01 (st): sated 9-1-2020.

2.2 **Depreciation – Carry forward and set off**

Supreme Court dismissed the Department's special leave petition against judgment dated 7-6-2019 of the Bombay High Court in I. T. A. No. 661 of 2017, whereby the High Court following 354 ITR 244, held that the Tribunal was right in allowing the carried forward and set off of unabsorbed depreciation of the A.Ys. 1994-95 to 1998-99 of the amalgamating company amalgamated on 1-7-2007 against the income for A.Y. 2008-09 of the amalgamated company.

Principal CIT vs. Supreme Petrochem Ltd.; (2020) 421 ITR 01 (st): dated 9-1-2020.

2.3 **Book profits – Minimum alternate tax – S. 115JB of ITA 1961 – Provisions**

whether applicable to insurance companies

Supreme Court granted special leave to the Department to appeal against judgment dated 14-6-2019 of the Madras High Court in T. C. A. Nos. 332, 335, 337 and 329 of 2019 whereby the High Court held that the Tribunal was justified in holding that the provisions of section 115JB of the Act which enables the companies to compute book profit may not be applicable to insurance companies.

CIT vs. United India Insurance Co. Ltd.; (2020) 421 ITR 12 (st): dated 27-1-2020.

2.4 **Business expenditure – Deduction only on actual payment – Leave encashment expenses claimed on accrual basis**

Supreme Court granted special leave to the assessee to appeal against judgment dated 20/09/2019 of the Delhi High Court in I. T. A. Nos. 843 and 844 of 2019 whereby the High Court held that the Tribunal was right in disallowance of the expenses on leave encashment claimed by the assessee on accrual basis.

T. V. Today Network Ltd. vs. Principal CIT; (2020) 421 ITR 13 (st): dated 24-1-2020.

2.5 **Business expenditure – Interest on borrowed capital – Interest-free loans to subsidiary companies**

Supreme Court dismissed the Department's special leave petition against judgment dated 22-7-2019 of the Bombay High Court in I. T. A. No. 489 of 2017 whereby the High Court held that the Tribunal correctly held that the assessee's decision to fund its subsidiaries driven by business exigency and in allowing assessee's claim for deduction of interest on borrowed funds.

Principal CIT vs. E-City Investments and Holdings Co. P. Ltd.; (2020) 421 ITR 13 (st): Dated 27-1-2020.

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DIRECT TAXES

High Court



Paras S. Savla, Jitendra Singh, Nishit Gandhi, *Advocates*

1 | ***Golden Times Services (P.) Ltd vs. DCIT,***
W.P.(C.) No. 402 of 2020, Delhi High
Court, Order dt. 31-1-2020

Rectification of order passed by Appellate Tribunal - starting point of limitation provided under section 254(2) has to commence from date of actual receipt of judgment and order passed by Tribunal which is sought to be reviewed. [A.Y. 2006-07]

The assessee before the Hon'ble Delhi High Court was a private limited company. The assessee filed its return of income for the AY 2006-07 on 30-11-2006, declaring a total loss of ₹ 42,67,698/-. Ld. A.O. finalised the assessment order dated 28-11-2008 under Section 143(3) of the Act determining total income of the assessee at ₹ 16,84,945/-, by making an addition of ₹ 59,52,643/-. The assessee being aggrieved with the aforesaid order, preferred an appeal before the Ld. CIT(A). The first appellate authority vide order dated 30-9-2014, granted partial relief by deleting addition of ₹ 34,17,138/- and directed the Ld. A.O. to grant further relief of ₹ 6,21,890/- after verification. However, the addition of ₹ 19,00,000/- was confirmed. Against the order of the CIT(A), the assessee filed an appeal before the Appellate Tribunal on 11-12-2014. The Appellate Tribunal, however,

passed an *ex-parte* order dated 18-10-2016 dismissing the appeal of the assessee which was heard on 30-8-2016. The Appellate Tribunal in its order observed that no one was present on behalf of assessee, at the time of hearing, in spite of notice being sent on 15-7-2016 at the address mentioned in the memo of appeal. It was further noted that notice had come back unserved with a report that the property was locked for quite some time. It was also noted that the earlier notice, sent on 1-6-2016 on the same address of the assessee had also been received back unserved with similar comments. The Appellate Tribunal thus held that the assessee was presumably not serious in pursuing the appeal and dismissed the same *in limine*. At the same time, the assessee was granted liberty to approach the Appellate Tribunal for a recall of the order if it was able to show a reasonable cause for non-appearance. Thus, there was no adjudication on the merits of the appeal.

When the assessee made an enquiry with the office of Appellate Tribunal on 8-2-2018 about the status of the appeal, it was informed that the appeal had been dismissed *ex-parte* for non-prosecution. Thereafter, on 8-3-2018, an application was filed for recall of the order dated 18-10-2016. The assessee filed the application giving grounds for non-appearance, with an

explanation that the absence was beyond its control. However, the Appellate Tribunal, dismissed the application filed by the assessee *vide* order dated 30-8-2019, on the ground that the same is barred by limitation under Section 254(2) of the Act.

The assessee being aggrieved filed a Writ Petition before the Hon'ble Delhi High Court. The High Court observed that on 18-10-2016, Tribunal dismissed the appeal *ex-parte*, without deciding the issue on merits. In fact, on the said date, Revenue had sought an adjournment, but such a request was rejected. The Court held that the Tribunal lost sight of the main provision as enshrined in Rule 24 of the ITAT Rules, which required the ITAT to dispose of the appeal on merits after hearing the respondent. Since it did not proceed to do so, and specifically gave an option to seek recall of its order, the Court held no justification for dismissing the application for recall on the ground of limitation. Rule 24 of the ITAT Rules, enjoined the ITAT to decide the appeal on merits. The appeal filed in 2014, had ripened for final disposal only in 2016 and therefore, dismissal of the appeal without deciding the merits of the case, merely on the ground for non-prosecution, was certainly unwarranted. After referring to few decisions, the High Court held that it has been time and again reiterated that in the absence of the party, the ITAT should proceed to decide the matter on merits and it cannot defeat the rights of the parties on its whims and fancies or by procedural wrangles and uncertainties. The High Court further noticed that in the impugned order, the ITAT has not gone into the question as to what would be the date on which the order was passed for determining the limitation period. The record before the ITAT did not conclusively show that proper service was effected on the Petitioner company-assessee. Notices that were being issued were being returned back unserved with the comments that

the house was locked. It has proceeded to reject the application by considering the date of the order passed by the ITAT as the starting point of limitation in submitting the miscellaneous application and not the date of the receipt of the order, which according to the assessee was 8-2-2018, the date wherefrom it gained knowledge of the order. Thus, no attempt was made by the ITAT to ascertain the date of actual receipt of the order passed by the ITAT and the ITAT has proceeded to hold the application to be barred by limitation as provided under Section 254(2) of the Act. Section 254(2) of the Act was amended by the Finance Act, 2016 with effect from 1-6-2016 and the words "*four years from the date of the order*" were substituted by "*six months from the end of the month in which the order was passed*". The explanatory notes to the provisions of the Finance Act, 2016, do not throw much light for the purpose of the amendment, except for stating that the period of limitation has been shortened in order to bring certainty to the orders of the ITAT. The Court held that the real question was what would be the relevant date for the purpose of commencement of period of limitation. To hold the date of the order to be the relevant date for the purpose of calculating the period of six months envisaged under Section 254(2) of the Act, can lead to several absurd and anomalous situations. An order passed without the knowledge of the aggrieved party, would render the remedy against the order meaningless as the same would be lost by limitation while the person aggrieved would not even know that an order has been passed. Such an interpretation would not advance the cause of justice and would not be the correct approach and thus cannot be countenanced. A person who is aggrieved or concerned with an order would legitimately be expected to exercise his rights conferred by the provision and unless the order is communicated or is known to him, either actually or constructively, he would not

be in a position to avail such a remedy. The words “six months from the end of the month in which the order was passed” therefore, cannot be given a narrow and restrictive interpretation. There are several decisions of the Apex Court and other High Courts, where similar question came up for consideration. The Courts have always leaned in favour of an interpretation which would enable an aggrieved party to avail its remedy in a meaningful manner, so that the right conferred by a provision does not remain fanciful or illusory. The Court opined that the limitation would begin to run when the affected person has the knowledge of the decision. The date when the order was passed cannot be solely determined by referring to the date when the same was signed by the ITAT. The Court further found that under Section 254(3) of the Act, the law stipulates that the ITAT shall send a copy of the order passed by it to the assessee and the Principal Commissioner. Further, Rule 35 of the ITAT Rules also requires that the orders are required to be communicated to the parties. It emerges that the Section and the Rule mandates the communication of the order to the parties. Thus, the date of communication or knowledge, actual or constructive, of the orders sought to be rectified or amended under Section 254(2) of the Act becomes critical and determinative for the commencement of the period of limitation. The ITAT has not applied its mind on this aspect and has been swayed by the literal and mechanical construction of the words “six months from the end of the month in which the order was passed”. The ITAT failed to even delve into the question whether the affected party, either actually or constructively, was in knowledge of the order passed by the ITAT.

The Court further held that for the assessee to file an appeal under the provision of the Act, before a High Court, it is required to satisfy that the case involves a substantial question of law. As the order is not touching upon the merits of

the case, it deprives the Court to evaluate, if any, substantial question of law under Section 260A of the Act arises on merits, thereby impinging upon assessee’s right to get the issue decided by the final fact finding authority. Thus, the approach adopted by the ITAT in dismissing the application for recall of an order, cannot be countenanced, particularly, since Rule 24 of the ITAT Rules, mandates the ITAT to decide the appeal on merits. Accordingly, the writ petition was allowed. The order dated 30-8-2019 was quashed and the matter is remanded back to the ITAT with a direction that they shall hear and dispose of appeal on merits.

2 | *Pr. CIT vs. AMI Industries (India) Ltd,*
Income tax appeal no. 1231 of 2017, Bombay
High Court, Order dt. 29-1-2020

Unexplained cash credit - Section 68 of the Income-tax Act, 1961 - share application money - assessee furnished evidences to prove the identity, genuineness and creditworthiness of creditors - addition not justified. [A.Y. 2010-11]

The assessee before the Hon’ble Bombay High Court is a private limited company. During the course of assessment proceedings, Ld. A.O. observed that the assessee had received funds from three Kolkata based companies as share application money. Ld. A.O. issued notice to the assessee on the ground that whereabouts of the above companies were doubtful and their identity could not be authenticated. Thus, genuineness of the companies is questionable. Ld. A.O. accordingly proposed to treat the share application money as unexplained cash credit under Section 68 of the Act. After considering the reply submitted by the assessee, Ld. A.O. finalized the assessment *vide* order dated 28-3-2013 passed under Section 143(3) of the Act treating the share application money of ₹ 34 crore as unexplained cash credit under Section 68 of the Act.

On appeal the first appellate authority deleted the addition on the ground that assessee had discharged its burden under Section 68 of the Act by proving the identity of the creditors; genuineness of the transactions; and credit worthiness of the creditors. The department being aggrieved by the order passed by Ld. CIT(A) preferred an appeal before the Income Tax Appellate Tribunal, Mumbai. The Appellate Tribunal upheld the order passed by Ld. CIT(A). The department being aggrieved by the order of the Appellate Tribunal, filed an appeal before the Hon'ble Bombay High Court.

Hon'ble High Court observed that assessee had furnished PAN, copies of the income tax returns of the creditors as well as copy of bank accounts of the three creditors in which the share application money was deposited in order to prove genuineness of the transactions. Court observed that the CIT(A) held that it was not necessary that share application money should be invested out of taxable income only. It may be brought out of borrowed funds and further that non-responding to notice would not *ipso facto* mean that the creditors had no credit worthiness. In such circumstances, the CIT(A) held that where all material evidence in support of explanation of credits in terms of identity, genuineness of the transaction and credit-worthiness of the creditors were available, without any infirmity in such evidence and hence additions were deleted. The Court observed that the Tribunal noted that Assessing Officer had referred the matter to the investigation wing of the department at Kolkata for making inquiries into the three creditors from whom share application money was received. Though report from the investigation wing was received, Tribunal found that the same was not considered by the Assessing Officer despite mentioning it in the assessment order, besides not providing a copy of the same to the assessee. In the report

by the investigation wing, it was mentioned that the companies were in existence and had filed income tax returns for the previous year under consideration but the Assessing Officer recorded that these creditors had very meager income as disclosed in their returns of income and therefore, doubted credit worthiness of the three creditors. In so far credit worthiness of the creditors were concerned, Tribunal recorded that bank accounts of the creditors showed that the creditors had funds to make payments for share application money and in this regard, resolutions were also passed by the Board of Directors of the three creditors. Though assessee was not required to prove source of the source, nonetheless, Tribunal took the view that Assessing Officer had made inquiries through the investigation wing of the department at Kolkata and collected all the materials which proved source of the source. The Supreme Court's decision in case of *Pr. CIT vs. NRA Iron & Steel Pvt Ltd., (2019) 103 taxmann.com 48*, was distinguished on the ground that facts were different as the field report in that case clearly revealed that the shareholders were either non-existent or lacked credit-worthiness. The Court further held that assessee is not required to prove source of source. The departmental appeal was thus dismissed.

3

Manambur Service Co-Operative Bank Limited vs. Income Tax Officer & Ors.,
W.P.(C.) No. 601 of 2020 (A), Kerala High Court, order dt. 22-01-2020

Stay of demand - Rectification application pending – No coercive steps to be taken till the rectification application is disposed off. (AY 2015-16)

The Assessee was a primary co-operative society who filed return of income for the assessment year 2015-16 declaring total income at Nil after claiming eligible deduction u/s. 80P of the Income-tax Act, 1961. The assessing officer

completed the assessment u/s. 143(3) by order dated 29-11-2017 disallowing eligible deduction u/s. 80(P) of the Income-tax Act, 1961 and computed total income as ₹ 41,28,889/-. Assessee filed an appeal before CIT(A) challenging the assessment order. The CIT(A) allowed the appeal by granting deduction u/s. 80(P). After one year of the order, CIT(A) *suo motu* initiated rectification proceedings u/s. 154 of the said Act stating that there is apparent mistake. Assessee filed objection and also enlightened CIT(A) about the clarification Circular No. 133/6 dated 9-5-2017 issued by the Central Board of Direct Taxes that a co-operative society, irrespective of its classification or nomenclature, is eligible for deduction u/s. 80P. But without considering any of the objections raised, CIT(A) unilaterally allowed the rectification petition. Consequent to that, the Assessing officer issued order giving effect to the rectified order. Aggrieved by rectified order, Assessee had filed rectification application before the CIT(A). Meanwhile, coercive steps are initiated to recover the disputed tax amount from the society. The similar issues occurred for Assessment Years 2013-14 and 2008-09. Rectification applications were pending before the CIT(A). Hence the Assessee filed the writ petition before the High Court.

Taking note of the facts and circumstances of the case, the High Court directed that the rectification applications to be taken up for consideration by CIT(A) without much delay. The High Court further directed that reasonable opportunity of being heard to be granted to the Assessee through authorized representative/counsel, if any, and the CIT(A) may pass orders thereon without much delay preferably within a period of 4 to 6 weeks from the date of production of a certified copy of this judgment. The Court further directed that until such orders are passed, coercive steps for enforcement, shall be kept in abeyance by officers concerned.

4***Pr. CIT vs. M/s. JSW Steel Ltd.,****Income Tax Appeal No. 1934 of 2017,
Bombay High Court, Order dt. 5-2-2020*

Assessment u/s. 153A in case of search or requisition – new claim – once assessment gets abated, it is open for the assessee to lodge a new claim (AY 2008-09)

The assessee was a widely held public limited company engaged in various activities including production of sponge iron, galvanized sheets and cold-rolled coils through its steel plants located at Dolve and Kalmeshwar in Maharashtra. The assessee filed original return of income on 30-9-2008 for Assessment Year 2008-09 declaring loss at ₹ 104,17,70,752/- under the provisions of Section 139(1) of the said Act. The Assessee's case was selected for scrutiny u/s. 143(2) of the said Act on 3-9-2009. During pendency of the assessment proceedings, a search was conducted under Section 132 of the Income-tax Act on the ISPAT Group of companies on 30.11.2010. Following the search, notice u/s. 153A of the Act was issued. In response, assessee filed return of income declaring total loss at ₹ 419,48,90,102/- on 29-3-2012, wherein it made a new claim for treating gain on pre-payment of deferred VAT/sales tax on Net Present Value (NPV) basis for an amount of ₹ 318,10,93,993/- as "capital receipt". This new claim of assessee was disallowed by the Assessing Officer while finalising assessment u/s. 143(3) r.w.s. 153A *vide* the order dated 25-3-2013 by considering the same as "revenue receipt" instead of "capital receipt". The AO held that the assessee had availed of sales tax deferral scheme and the State Government had permitted premature repayment of deferred sales tax liability at the NPV basis. Therefore, according to the AO, assessee treated this as capital receipt even though the same was credited to the assessee's profit and loss account being difference between the

deferred sales tax and its NPV. AO further held that the assessee could not raise a new claim in the return filed u/s. 153A which was not raised in the original return of income filed under Section 139(1). On appeal, the CIT(A) upheld the order passed by the A.O. In further appeal, the Tribunal, allowed the Assessee's appeal and set aside both the orders passed by the A.O. and CIT(A).

The High Court, referring to the section, observed that section 153A(1) provides that where a person is subjected to a search under Section 132, the assessing officer is mandated to issue notice to such person to furnish return of income in respect of each assessment year falling within six assessment years immediately preceding the assessment year. Such returns of income shall be treated to be returns of income furnished under Section 139. Once Section 153-A(1) is invoked, assessment for 6 assessment years immediately preceding the assessment year in which search is conducted or requisition is made becomes open to assessment or reassessment. The High Court observed that two aspects are crucial here. One is use of the expression "notwithstanding" in sub-section (1); and secondly, that returns of income filed pursuant to notice under Section 153-A (1)(a) would be construed to be returns under Section 139. The use of *non obstante* clause in sub-section (1) of section 153-A is indicative of the legislative intent that provisions of Section 153-A(1) would have overriding effect over the provisions contained in Sections 139, 147, 148, 149, 151 and 153. The Court referring to second proviso noticed that pending assessment or reassessment proceedings on the date of initiation of search or making of requisition shall abate. The Court observed that in the present case, search was conducted on the assessee on 30-11-2010. At that point of time assessment in the case of assessee for the assessment year 2008-09 was pending scrutiny since notice under Section

143(2) of the Act was issued and assessment was not completed. Therefore, in view of the second proviso to Section 153A of the said Act, once assessment got abated, it meant that it was open for both the parties, i.e. the assessee as well as revenue to make claims for allowance or to make disallowance, as the case may be, etc. That apart, assessee could lodge a new claim for deduction etc., which remained to be claimed in his earlier/regular return of income. This is so because assessment was never made in the case of the assessee in such a situation. It is fortified that once the assessment gets abated, the original return which had been filed loses its originality and the subsequent return filed under Section 153A of the said Act takes the place of the original return. In such a case, the return of income filed under Section 153A(1) of the said Act, would be construed to be one filed under Section 139(1) of the Act and the provisions of the said Act shall apply to the same accordingly. If that be the position, all legitimate claims would be open to the assessee to raise in the return of income filed under Section 153A(1). The Court thus dismissed the department's appeal.

5 *Pr. CIT vs. Vaman International Pvt. Ltd.,*
Income Tax Appeal No. 1940 of 2017,
Bombay High Court, order dt. 29-1-2020

Bogus Purchases – Addition u/s. 69C – addition deleted. (AY 2010-11)

Assessee is a company engaged in the business of trading and sale of furniture and allied items on wholesale basis. For the Assessment Year under consideration assessee filed e-return of income declaring total income of ₹ 13,80,371/- and book profit under Section 115JB of the Act at ₹ 14,55,806/-. The case was selected for scrutiny and notices under Sections 143(2) and 142(1) of the Act were issued. In the course of the assessment proceeding, Assessment Officer

doubted the expenditure of ₹ 4,75,42,385/- stated to be on account of purchase from two parties i.e., Impex Trading Co. for an amount of ₹ 2,90,80,292/- and Victor Intertrade Pvt. Ltd. for an amount of ₹ 1,84,62,093/-. Assessing Officer acted on the basis of information received from the office of Director General of Income Tax (Inv), Mumbai and from the Sales Tax Department that in the list of bogus sales parties the names of the aforesaid two parties were included which rendered the purchase transaction doubtful. Assessing Officer observed that the assessee did not produce lorry receipts and other related documents to reflect movement of goods sold and purchased which were crucial for determining genuineness of the purchase transaction. In the absence thereof, Assessing Officer drew a negative presumption and by the assessment order dated 22-3-2013 passed u/s. 143(3) of the Act, Assessing Officer added the said amount to the total income of the assessee u/s. 69C treating the expenditure as bogus purchases. On appeal the CIT(A) allowed the appeal and directed the Assessing Officer to delete the addition of ₹ 4,75,42,385/-. The Tribunal confirmed the CIT(A)'s order and dismissed the department's appeal.

On further appeal the High Court observed that the CIT(A) while deleting the addition had held that Assessing Officer did not doubt the sales and stock records maintained by the assessee. By submitting confirmation letters, copies of invoices, bank statement, payment order, payment by account payee cheques etc., assessee had proved that sale and purchases had taken place. By highlighting the fact that all the payments against the purchases were made through banking channel by way of account payee cheques, the CIT(A) held that source of expenditure was fully established by the assessee

beyond any doubt. It was further noticed that during appellate proceedings the assessee had furnished complete quantitative details of the items of goods purchased during the year under consideration and their corresponding sales. Similarly the Tribunal had giving a finding of fact that assessee had filed copies of purchase bills, copies of purchase/sale invoices, challan cum tax invoices in respect of the purchases, extracts of stock ledger showing entry/exit of the materials purchased, copies of bank statements to show that payment for such purchases were made through regular banking channels, etc., to establish the genuineness of the purchases. Thereafter, Tribunal held that Assessing Officer could not bring on record any material evidence to show that the purchases were bogus. Mere reliance by the Assessing Officer on information obtained from the Sales Tax Department or the statements of two persons made before the Sales Tax Department would not be sufficient to treat the purchases as bogus and thereafter to make addition under Section 69C of the Act. Tribunal has also held that if the Assessing Officer had doubted the genuineness of the purchases, it was incumbent upon the Assessing Officer to have caused further enquiries in the matter to ascertain genuineness or otherwise of the transaction and should have given an opportunity to the assessee to examine/cross-examine those two parties *vis-a-vis* the statements made by them before the Sales Tax Department. Without causing such further enquiries in respect of the purchases, it was not open to the Assessing Officer to make the addition under Section 69C of the Act. The High Court observed that there was concurrent finding of fact by the two lower appellate authorities and thus dismissed the department's appeal holding that there was no error or infirmity in the view taken by the Tribunal.

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Reported Decisions

1 *Sudip Rungta vs. DCIT*
[ITA 2370/Kol/2017] (Assessment
Year:2011-12), Order dated 10-1-2020,
[2020] 113 taxmann.com 295 (Kolkata -
Trib.)

Section 10(13A) r.w.s 2A(h) – Performance bonus does not form part of the “Salary” for the purpose of computing exemption under section 10(13A) of the Act

Facts

The Assessee is an Individual and filed his return of income for the impugned assessment year declaring total income at ₹ 2.62 crore. During the assessment proceedings, on perusal of the Form 16, the AO noticed that the Assessee had claimed an exemption u/s. 10(13A) for House Rent Allowance of ₹ 8,47,742/-. Thus, the Assessee was asked to provide the details of Rent and calculation of the exemption u/s. 10(13A). In response to the same, it was explained that the total rent paid during the year was ₹ 8,20,000/- and the Basic Salary was ₹ 30,00,000/-. Further, it was also submitted that only basic salary was included for calculating an exemption u/s. 10(13A). Thus,

the rent paid over 10% of the basic salary is to be allowed as an exemption u/s. 10(13A). The AO further, noticed that the Assessee had received performance bonus of ₹ 1,50,00,000/- which was not included in the salary. The AO was of the view that performance bonus is part of the salary and the same cannot be comprehended as an allowance or perquisite as defined in Rule 2(h) of the Fourth Schedule. Thus, the Assessee's salary was computed at ₹ 1,80,00,000/- [i.e ₹ 30,00,000/- plus ₹ 1,50,00,000] for the purpose of computation of an exemptions u/s. 10(13A). Further, the AO held that the rent paid by the Assessee is ₹ 8,20,000/- which is much less than 10% of salary i.e ₹ 18,00,000/-. Thus, the AO was of the view that the Assessee is not entitled to claim any benefit u/s. 10(13A). The AO therefore, denied the benefit u/s. 10(13A) of the Act. On appeal, the CIT(A) upheld the action of the AO. Being aggrieved by the appellate order, the Assessee preferred an appeal before the ITAT. After hearing submission of both the sides, the ITAT held as under.

Held

The ITAT considered the arguments and also perused the decisions on the subject matter. It referred to the decision of the Kerala High

Court in the case of “*CIT vs. B.Ghosal [1980] 125 ITR 744 (Ker.)*” and noticed that the performance bonus does not form part of the “salary” as defined in clause (h) of Rule 2A for the purpose of computation of an exemption u/s. 10(13A) of the Act. In the present case, total rent paid by the Assessee during the year is ₹ 8,20,000/-. The basic salary for the purpose of computation of HRA is ₹3,00,000/- (10% of ₹ 30,00,000/- being basic salary). Therefore, excess of rent paid over 10% of salary comes at ₹ 5,20,000/- (₹ 8,20,000/- minus ₹ 3,00,000/-). The ITAT further held that the Assessee is entitled for HRA of ₹ 5,20,000/- u/s. 10(13A) of the Act. Thus, the ITAT directed the AO to allow the exemption of HRA at ₹ 5,20,000/-.

2 | *JCIT vs. Karnataka Vikas Grameena Bank*

[ITA 1392/Bang/2016] (Assessment Year:2012-13), Order dated 23-1-2020, [2020] 113 taxmann.com 530(Bangalore - Trib.)

Section 40a(ia) – submission of form 15G/15H is a procedural aspect and disallowance u/s. 40a(ia) is not warranted merely on the reason that the Assessee did not submit those forms to commissioner within time prescribed

Facts

The Assessee is a rural regional bank engaged in the business of banking. As per the provisions of sec. 194A of the Act, the Assessee is under obligation to deduct tax at source where interest paid is in excess of ₹ 10,000/- per annum. During the assessment proceedings, it was noticed by the AO that the Assessee had paid total interest of ₹ 41,12,954,190/- during the FY 2011-12 (relevant to AY 2012-13). Out of the above a sum of ₹ 80,49,49,266/- was interest paid above ₹ 10,000/- to each

of the depositors but there was no deduction at source on the reason that the depositors had furnished Form No. 15G/15H. With regard to non-deduction of Tax at source, the Assessee submitted that depositors have sought exemption from TDS on payment of interest by submitting declaration in form No. 15G/H and in those cases, the various branches have not deducted TDS based on 15G /H submitted by the depositors. However, the AO was of the view that apart from obtaining declaration in Form No. 15G/H, the Assessee ought to have furnished those forms to Commissioner of Income Tax, within the prescribed period that was not done in the facts under consideration. Since the Assessee failed to do it, the AO held that disallowance u/s. 40(a)(ia) of the Act has to be made. The AO therefore disallowed the interest expense of ₹ 80,49,49,266 u/s. 40(a)(ia) of the Act. Being aggrieved, the Assessee filed an appeal before the CIT(A) and succeeded. The CIT(A) deleted the addition as made by the AO by holding that there was no breach committed by Assessee by not filing Form No.15G/H before the CIT and also on the ground that the sums in question did not remain payable as on the last date of the relevant previous year by following the decision of the Special Bench, Visakhapatnam in the case of Merylyn Shipping & Transports (supra). Being aggrieved, the Revenue filed an appeal before the ITAT. After hearing both the sides, the ITAT has decided as under:

Held

The ITAT observed that the identical issue has come up before it in the Assessee’s own case in which the ITAT held in favour of the Assessee and against the Revenue. In the said judgment, the ITAT deleted the addition on the observation that submission of Form 15G and 15H is only a procedural aspect and does not result in any disallowance. Following the said judgment, the ITAT observed that

the CIT(A) was justified in deleting the disallowance of interest expenses u/s. 40(a)(ia) of the Act, to the extent the disallowance relates to interest paid to persons furnished Form 15G and Form 15H to the assessee as no disallowance can be made u/s. 40a(ia) of the Act. The ITAT in addition thereto referred to the judgment of the Karnataka High Court in the case of Sri Marikamba Transport Co and held that the requirement of filing of Form 15G and 15H with the prescribed authority is only procedural and that cannot result in a disallowance u/s. 40a(ia) of the Act. On the aforesaid observations, the appeal of the revenue was dismissed.

Unreported Decisions

3 | *M/s. Carestream Health INC. vs. Dy. CIT*
(ITA No.826/Mum/2016) (Assessment Year
2012-13), order dated 6-2-2020

Section 2(47) – Reduction of share capital amounts to transfer despite the fact that the Assessee remains a holding company even post reduction of capital and there is no change in percentage of holding in the scheme of capital reduction

Facts

The Assessee is a company incorporated in and a tax resident of United States of America (USA). It made investments to the extent of 6,47,69,142 equity shares of face value of ₹ 10 each of Carestream Health India Private Limited (CHIPL) that is a wholly owned Indian Subsidiary. During the year, CHIPL undertook a capital reduction of its share capital pursuant to a scheme approved by the Bombay High Court. Under the capital reduction scheme, 2,91,33,280 shares (out of total holding of 6,47,69,142 shares) as held by the assessee were cancelled and total consideration amounting to ₹ 39,99,99,934/-

was received by assessee for the same. This consideration sum of ₹ 39,99,99,934/- worked out to ₹ 13.73 for every share cancelled by CHIPL. As per the provisions of section 2(22)(d) of the Act, out of the total consideration of ₹ 39,99,99,934/-, the consideration to the extent of accumulated profits of CHIPL i.e. ₹ 10,33,11,000/- was considered as deemed dividend and the provisions of DDT were complied with. The Assessee also claimed an exemption with regard to this sum u/s. 10(34) of the Act. The balance consideration of ₹ 29,66,88,934/- was appropriated towards sale consideration of the shares and capital loss was accordingly determined by the assessee as prescribed in Rule 115A to ₹ 3,64,84,092/- that was disclosed in the return of income. During the course of the assessment proceedings, the AO perused the facts and came to the conclusion that there was no transfer as per the provisions of Sec. 2(47) as the Assessee continued to be the holding company of its subsidiary even post the scheme of reduction of capital. Against the same, the Assessee filed an objection before the DRP but did not succeed. The DRP held that the issue is covered by the decision of the Special Bench of Mumbai Tribunal in the case of *Bennett Coleman & Co. Ltd reported (133 ITD 1)* and in light of the same, no actual loss accrued to the Assessee. The AO passed an assessment order following the direction of the DRP and disallowed the said capital loss. Being aggrieved, the Assessee filed an appeal before the ITAT. After hearing both the sides, the ITAT held as under:

Held

The ITAT observed that the assessee had incurred capital loss only due to claim of indexation benefit and not otherwise. The benefit of indexation is provided by the statute and hence there cannot be any *mala fide* intention that could be attributed on the assessee in claiming the long-term capital loss

in the subject mentioned transaction. The ITAT further noted that the ale consideration of ₹ 39.99 crore were not taxed by the AO under any other head thereby accepting a claim of the Assessee that it was received in connection with a capital asset. Further existence of a capital asset being shares was nowhere disputed by the AO. The ITAT perused all the decisions cited from both the sides and categorically observed that the Supreme Court in the cases of “*Kartikeya vs. Sarabhai vs CIT 228 ITR 163 (SC)*” and “*CIT vs. G Narasimhan 236 ITR 327 (SC)*” laid down the ratio that reduction of capital amounts to transfer as per Sec. 2(47) of the Act. Further, the ITAT observed that the decision of the Special Bench of Mumbai Tribunal in the case of *Bennett Coleman & Co. Ltd. reported (133 ITD 1)* is distinguishable and has no application to the present facts. On the aforesaid observations, the ITAT accepted the claim of capital loss of the Appellant and allowed in its favour.

4 | *M/s. Multitude Infrastructure Pvt. Ltd. vs. Dy. CIT (ITA No. 2722/Del/ 2017) (Assessment Year 2012-13) order dated 13-12-2019*

Section 37(1)- onetime payment of the annual rent as per the lease deed is a revenue expenditure

Facts

The Assessee purchased a hotel constructed on a leased land obtained from Jaipur Development Authority (JDA) from Vishnu Apartments Pvt. Ltd. *vide* agreement dated 5-11-2008 and as per clause 28 of the sale agreement, the assessee was under an obligation to pay to the seller, the Government rate taxes and cess etc., from the date of agreement. Vide

letter, the JDA required Vishnu Apartment Pvt. Ltd. to pay a cumulative sum on account of Annual Lease Rent up to Year 2011-12 and lump sum payment of Annual Lease Rent. The Assessee proportionately computed the share for its liability of rent out of the total cumulative rent and accordingly, claimed the said payment as business expenditure u/s. 37(1). During the assessment proceedings, the AO disallowed the same on the ground that it is a capital expenditure relating to the land. Being aggrieved, the Assessee preferred an appeal before the the CIT(A) but did not succeed. Thereafter, an appeal was preferred before the ITAT. After hearing both the sides, the ITAT held as under:

Held

While allowing the appeal of the Assessee, the ITAT observed that the Assessee paid the annual lease rent at one time, without altering the nature of expenditure. The ITAT referred to the decision of the Supreme Court in the case of *CIT vs. Madras Auto Service (P.) Ltd. 233 ITR 468* and observed that the asset which was created belonged to somebody else and the company derived an enduring business advantage by expending the amount. The expenses have been looked upon as having been made for the purpose of conducting the business more profitably or more successfully. Asset created by spending the amounts did not belong to the assessee but the assessee got the business advantage of using modern premises at a low rent. On the aforesaid observations, the ITAT held that onetime payment of the annual rent as per the lease deed is allowable as revenue expenditure and not a capital expenditure as contended by the AO.

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A. HIGH COURT

1 | *Pr. CIT vs. Texport Overseas Pvt. Ltd.*
[TS-1222-HC-2019] (Karnataka) - ITA
No. 392 of 2018 and ITA No. 170 of 2019
for Assessment Year 2013-14 and 2014-15
respectively.

Clause (i) of section 92BA (dealing with Specified Domestic Transaction (SDT) of expenditure in respect of payment made to persons referred to in section 40A(2)(b)) deleted vide Finance Act, 2017 is to be interpreted as being deleted retrospectively and thus any reference made to the TPO for determining the ALP under the said clause would be invalid

Facts

i) The AO made a reference to the TPO for determining the ALP of certain transactions covered under clause (i) to section 92BA. The AO passed an order under section 143(3) r.w.s 144C(13) on 30th June, 2017 for AY 2013-14 and AY 2014-15 after taking into consideration the adjustments proposed by the TPO and the directions of the DRP. In the interim clause (i) to section 92BA was deleted vide the Finance Act, 2017 w.e.f. 1st April, 2017.

- ii) Before the ITAT, the Petitioner, by way of an additional ground, contended that since clause (i) to section 92BA was deleted vide Finance Act, 2017 it should be understood that the said clause had never existed in the statute itself and hence reference to the TPO for determining the ALP under the said clause is bad in law.
- iii) The Revenue argued that the clause (i) to section 92BA has been deleted w.e.f. 1st April, 2017 (i.e. applicable for AY 2017-18 and onwards) therefore it has a prospective effect and should not be interpreted retrospectively.
- iv) The ITAT observed that once a provision is omitted from the statute, it shall be deemed to be omitted from its inception unless the legislature have enacted some saving clause to make it clear that any pending proceedings under that provision would continue. Accordingly, the ITAT held that the orders passed by the AO, TPO and DRP were not sustainable in the eyes of law.
- v) Aggrieved, the Revenue filed an appeal before the High Court.

Decision

- i) The High Court relied on the decisions of the Hon'ble Supreme Court in the case of *Kolhapur Canesugar Works Ltd. vs. Union of India (AIR 2000 SC 811)* and in case of *General Finance Co. vs. ACIT [176 CTR 569 2002 (SC)]*, and upheld the observation of the ITAT that when a provision is omitted from the statute, it shall be deemed to be omitted from its inception unless the legislature have enacted some saving clause to make it clear that any pending proceedings under that provision would continue.
- ii) Further, the High Court also relied upon the decision of the co-ordinate bench in case of *CIT vs. GE Thermometrics India Pvt. Ltd. (ITA 424/2009 decided on 22nd March, 2018)*, wherein it was held that omission of sub-section (9) to section 10B with effect from 1st April, 2004 should be understood that the said section had never existed in the statute itself.
- iii) Accordingly the Court held that no question of law arose for the High Court's consideration and the ITAT order was affirmed.

B. AUTHORITY FOR ADVANCE RULINGS

2 | *Bid Services Division (Mauritius) Ltd.*
In re (AAR No. 1270/2011) [2020] 114
taxmann.com 434 (AAR-Mumbai).

Benefit under Article 13(4) of the India-Mauritius DTAA (i.e., exemption from taxation on capital gains accrued in India) shall not be available if the transaction/arrangement lacks commercial substance and its dominant purpose is to avoid taxes.

Facts

- i) The Applicant was incorporated in Mauritius and was a wholly owned

subsidiary of Bid Services Division (Proprietary) Limited, a company incorporated in South Africa (both the entities are part of the Bidvest Group). The Applicant held a valid Tax Residency Certificate ('TRC') and did not have a business connection or a permanent establishment in India.

- ii) Airports Authority of India ('AAI') floated tender inviting bids for undertaking development, operation and maintenance of Mumbai Airport. Initially, a consortium consisting of GVK Industries Limited, Airports Company South Africa (ACSA) Limited, Old Mutual Life Assurance Company and Bidvest Group Limited made a joint bid against the said tender.
- iii) Subsequently the Applicant was incorporated in Mauritius and two weeks thereafter, a final binding bid was submitted by the Applicant in consortium with GVK Airports Holding Pvt. Ltd. ('GAHPL') and ACSA Global Limited ('AGL').
- iv) After the final bidding process, AAI selected the Applicant in consortium with GAHPL and AGL as joint venture partners for the purpose of the said tender.
- v) A shareholders agreement dated 4th April, 2006 was entered between the Applicant, AAI, GAHPL and AGL for the purpose of governing the respective rights, obligations and the shareholding pattern in the JV i.e., namely Mumbai International Airport Private Limited (MIAL). The Applicant agreed to subscribe and acquire 27% of the paid up share capital of MIAL.
- vi) Subsequently, the Applicant entered into a Share Purchase Agreement with GAHPL for transferring its shares, held in the JV, to GAHPL in AY 2012-13. The Applicant sought ruling from the AAR in respect of its tax exemption claim on capital gains

arising on transfer of shares held in the JV (i.e., MIAL, an Indian Company), in light of the provisions of Article 13(4) of the India-Mauritius DTAA ('DTAA'), since it was a tax resident of Mauritius and held a valid TRC.

- vii) The Applicant placed reliance on Circular No. 789 dated 13th April, 2000 issued by the Central Board of Direct Taxes ('CBDT') which clarified that companies resident of Mauritius would not be taxable on income arising from transfer of capital assets, being shares of a domestic company, in India as per Article 13(4) of the DTAA.
- viii) The Applicant also placed reliance on the decision of the Apex Court in case of *Vodafone International Holdings B.V vs. Union of India & Anr. [2012] 17 taxmann.com 202 (SC)* wherein it was held that a TRC can be accepted as a conclusive evidence for accepting the residential status as well as the beneficial ownership of income for the purpose of applying the DTAA.
- ix) The Revenue contended that at the time of bidding for the tender, the consortium did not include the Applicant as a joint venture partner and further the Applicant was incorporated just two weeks prior to the submission of the final binding bid by the consortium (i.e., after the final screening of all the bidders to the tender). The Revenue further contended that the only reason as to why the Applicant was included in the consortium was for the purpose of obtaining a tax benefit under Article 13(4) of the DTAA and since the arrangement lacked commercial substance the benefit under the Article 13(4) of the DTAA should not be granted to the Applicant.

Decision

- i) The AAR held that the Applicant was not entitled to the benefit under Article 13(4) of the India-Mauritius DTAA since the entire

arrangement lacked commercial substance and its dominant purpose was to avoid taxes.

- ii) The AAR relied on the following factual matrix, while coming to the above conclusion:—
 - a. The Applicant was incorporated just two weeks before the final bid was submitted to the AAI.
 - b. All the pre-bidding activities such as site visits, discussion with Government agencies, filing of technical and financial bids etc. were done by the consortium (the Applicant was not in existence at that point in time).
 - c. The Applicant was not able to provide any cogent reasons or commercial rationale for incorporating it in Mauritius.
 - d. The Applicant was a shell company without any tangible assets, employees, office space, financial background, experience or other skills to facilitate the business venture of the JV.
 - e. The Applicant was used as a conduit for routing the funds for its holding company (i.e., company incorporated in South Africa) and the beneficial owner of the shares of the JV was the holding company of the Applicant.

C. TRIBUNAL DECISIONS

3

Roche Diagnostics India Pvt. Ltd. vs. ACIT

[TS-38-ITAT-2020 (Mum)]

Assessment Year: 2011-12

- I) **No TDS u/s. 195 on employees' participation fees for foreign conferences /seminars.**

Facts

- i) Roche Diagnostics India (assessee) is a private limited company, engaged in distribution of biomedical equipment, reagents and spares for such equipment in India. The main products for the critical care segment are Blood Gas and Electrolyte Analyzers. It also provides marketing support services for diagnostic equipments distributed by Roche Diagnostics Asia Pacific Pte. Limited ('RDAP').
- ii) During the course of assessment proceedings, the AO provided details of Form 15CA for foreign remittances reflected in Annual Information Report (AIR) downloaded from Income Tax System for the financial year (FY) 2010- 11, wherein tax was not deducted on certain payments.
- iii) In response to a query raised by the AO to show cause as to why payments on which tax was not deducted shall not be disallowed u/s. 40(a)(i), the assessee filed a reply submitting the details/documents. However, the AO was not convinced with the said reply of the assessee and proceeded with disallowing all payments of ₹ 2,88,76,050/- on which tax was not deducted.
- iv) However, the DRP vide its direction u/s. 144C(5), granted relief of ₹ 24,67,023/- towards income tax disallowance u/s 40(a)(i). Consequently, the AO passed final assessment order u/s. 143(3) r.w.s. 144C(5), disallowing expenses of ₹ 2,64,09,027/- u/s. 40(a)(i) on the ground of non-deduction of tax at source u/s 195 of the Act.
- i) The Tribunal noted that the assessee had made a remittance of ₹ 1,48,016/- to Duo Contrusting (Tax resident of Germany) and ₹ 1,97,529/- to Right Management (Tax Resident of Singapore) towards participation of its employees in conference/seminar held in Hong Kong and Singapore respectively. The Tribunal further noted that it had made payment to Duo Contrusting towards fees for its employees for participation in conference held in Hong Kong.
- ii) Further, the tribunal observed that the assessee had paid participation fees to Rights Management towards participation of its employee in seminar held in Singapore. Also, the tribunal agreed with the contentions of the assessee that:
- no income can be said to be accrued or deemed to be accrued in India on account of remittance towards participation fees for a conference held outside India;
 - the payment can be characterised as FTS u/s. 9(1)(vii), only when a person pays to another person a payment for rendering of services which is in the nature of consultancy, technical or managerial in nature; further, professional services are not covered by the definition of FTS u/s. 9(1)(vii).
- iii) The Tribunal held that the payments in the instant case cannot be characterized as FTS u/s. 9(1)(vii) as no services in the nature of consultancy, technical or managerial was provided to the assessee. The Tribunal relied on the Pune Tribunal's judgement in the case of *Bharat Forge Ltd (36 taxmann.com 574)* and Delhi Tribunal's judgement in the case of *M/s Utility Powertech Ltd [2008-TIOL-14-ITAT-Del]*.
- iv) The Tribunal held that Duo Constructing was a tax resident of Germany and as

Decision

On Appeal, the Tribunal held in favour of the assessee as follows:

such, provisions of India-Germany DTAA shall be applicable; the remittance towards participation in a conference did not specifically fall under any Article of India-Germany DTAA as the said remittance was not in the nature of royalty or FTS. The Tribunal also ruled that, the said remittance should be construed in the nature of business income of the payee and in absence of PE of the payee in India, the said sum should not be subject to tax in India.

- v) Thus, the tribunal held that *“as per Article 21 of the India-Germany DTAA dealing with 'Other Income', any income not dealt with any of the Article of DTAA can be taxed only in Germany.”* Accordingly, the Tribunal referred to the India-Germany DTAA, which stated that, items of income of a resident of a Contracting State, wherever, arising not dealt with in the foregoing Articles of this agreement shall be taxable only in that State.
- vi) With respect to the payment to the Right Management Singapore Pte Ltd., the Tribunal agreed with the contentions of the assessee that it was a tax resident of Singapore eligible to claim benefit under the provisions of India-Singapore DTAA and that as per Article 7 of the DTAA, business profits of Right Management could be taxed only in Singapore unless Right Management was carrying its business through a PE situated in India.
- vii) The Tribunal observed that, the Right Management did not have a PE in India in terms of Article 5 of the said DTAA and therefore, the business income of Right Management should not be subject to tax in India as per Article 7 r.w. Article 5 of the said DTAA. The Tribunal noted that, further, as per Article 12(4)(b) of the said DTAA, consideration towards technical knowledge, skill etc. would be considered

as FTS only if the technical knowhow, skill etc. was made available to the recipient of the services.

- viii) Thus, the tribunal ruled that, *“Right Management has not transferred or made available any technical knowledge or skills to the appellant and therefore, payments made to Right Management are not in the nature of FTS and not liable to tax in India having regard to the provisions of the said DTAA. Since participation fees for attending seminar is not taxable in India, the question of TDS on aforesaid payment does not arise.”*
- ix) With respect of payment to Roche Germany towards other reimbursement viz.. travel and stay, conference participation fees and web access charges of ₹ 5,01,969/-, the Tribunal observed that, in support of the reimbursement of expenses, the assessee had submitted copies of invoices, third parties transaction details, Form 15CA and Form 15CB which clearly showed that the payments were in the nature of reimbursements. Thus, the tribunal ruled that, *“it is a mere reimbursement of expenses and cannot be construed as a “fee” for services rendered since what is achieved by reimbursement is mere repayment of what has been already spent and is not a reward or compensation for services rendered.”* Further, the tribunal held that, *“the transactions relating to reimbursement of expenses to AE have been subject matter of TP assessment and the fact that the reimbursement of various expenses are at actual cost, with no profit element has been accepted by the TPO.”*
- x) Further, regarding reimbursement of cost of manager of ₹ 10,24,284/-, the tribunal noted that, as per the arrangement between the assessee and *Sanofi*, the assessee would provide the technical, scientific and marketing support including training of engineers, salesmen to *Sanofi* for sale of its products. The Tribunal also

observed that, Mr. Mostafa Jamal Anwar ('Mr. Mostafa') had been appointed in Bangladesh exclusively for advertisement and promotion of the assessee's products and for providing various services to the new customers (end-user) like providing guidance on usage of the products, its benefits etc. and Sanofi had recovered the actual salary cost of Mr. Mostafa and other related costs incurred by Sanofi from the appellant. Thus, the Tribunal held that, "even if the aforesaid payments are considered as FTS, the same should not be subject to tax in India in the absence of specific Article of FTS in India-Bangladesh DTAA."

(Note: The Tribunal also deleted various other additions made by the AO, being in the nature of Reimbursement of various kinds of expenses being Special Discount, promotional expenses, reimbursement of travel and hotel expenses, reimbursement of relocation expenses, salaries of foreign managers etc.)

4 *IRCON International Limited vs. DCIT* [TS-60-ITAT-2020 (DEL)] Assessment Years: 2004-05 and 2005-06

II) Computation of Book Profits u/s. 115JB – Income exempt under a Tax Treaty not entitled for reduction from 'book-profits' under MAT provisions

Facts

- i) IRCON International (assessee) is a limited company for the subject Assessment Year 2004-05. The assessee excluded DTAA income earned from its project in Bangladesh, Malaysia and United Kingdom on the ground that, the DTAA income was not taxable in India and consequently, the company was not obliged to pay tax under MAT on the said income.
- ii) The AO was of the view that the adjustment required to be done were specified in the provisions of section 115J

and there was no provision under the said clauses to reduce book profit from DTAA.

- iii) It was further observed that similar adjustments were made in AY 2001-02 to 2003-04 which were confirmed by the CIT(A). Accordingly, the AO, made an adjustment of ₹ 34.55 crore. On further appeal, CIT(A) upheld the AO's appeal.

Decision

On Appeal, the Tribunal held in favour of the Revenue as follows:

- i) The Tribunal noted and observed as follows:
 - (a) The assessee had reduced the income of ₹ 21,94,13,814/- earned in Malaysia as per the DTAA while computing its book profit u/s. 115JA. The CIT(A) rejected the assessee's contention that, since the income earned in Malaysia was not taxable in India by virtue of the DTAA between India and Malaysia, it was not required to pay tax even under MAT on such income. The CIT(A) held that the provisions of Section 115JA override all other provisions of the Act, since sub-section (1) thereof begins with the non-obstante clause stating as 'notwithstanding anything contained in any other provisions of this Act'.
 - (b) The CIT(A) noted that none of the DTAA's provided for computation of 'Book Profit' under the provisions of Section 115JA and hence, the basic tax laws in force in the country (115JA) would get attracted since there was no specific provision in the DTAA as regards the computation of 'Book Profit' for the purpose of levy of Minimum Alternative Tax (MAT).
 - (c) Accordingly, the CIT(A) held that, there was no merit in the claim of

the assessee since section 115JA imposed tax on the Book Profit, which was computed for the purpose of Companies Act. Further, the plain reading of Section 115JA, made it obvious that none of the clauses (i) to (ix) of the Explanation thereto provided for reduction in respect of the income which may be exempt by virtue of the application of the DTAA.

- (d) The CIT(A) noted that, the SC in the case of Apollo Tyres Limited, [TS-3-SC-2002], had held that the Book Profit as computed from the books of account maintained in accordance with the Companies Act was sacrosanct and it could be adjusted only for making increases and reductions as specifically provided in the *Explanation* to the said section and that, apart from the adjustment as provided in the *Explanation*, no adjustments could be made to the book profit as per the Companies Act.
- (e) The CIT(A) noted that, the exclusion of income under the DTAA was nowhere provided in the said *Explanation*. If it were the intention of the legislature to provide reduction in respect of the income under the DTAA, it would have been specifically provided by way of another clause below the said *Explanation* to the section 115JA.
- ii) Therefore, CIT(A) upheld AO's order and held that, the assessee was not entitled to claim reduction in respect of the income covered by DTAA (₹ 34,55,50,226/-). On perusal of facts and records, the tribunal agreed with the view of the CIT(A) and accordingly, held that, *“we do not find any error or infirmity which calls for our interference.”*

5 | *AGT International GmbH vs. DCIT*
[TS-57-ITAT-2020(Mum)]
Assessment year: 2015-16

III) India-Switzerland DTAA – Article 12(2) r/w Article 5(2)(1) and Article 7 of the DTAA and the Protocol to the Treaty - Tribunal accepts Non-Resident's FTS taxability on 'gross basis' @ 10% - Cites 'choice' under Indo-Swiss DTAA protocol – Held: In favour of the assessee.

Facts

- i) The assessee, AGT International GmbH, a tax resident of Switzerland had received ₹ 1,00,14,582, on account of fees for technical services from an Indian company by the name of TAS-AGT Systems Limited, and had offered the said income to tax @ 10%, on gross basis, under article 12(2) of the Indo-Swiss tax treaty.
- ii) It was noted by the AO that the Indian company had withheld tax @ 42.024% on the entire amount. The AO was also of the view that the services rendered by the assessee are such that they do not satisfy the criterion under Article 12(4) inasmuch as while Article 12(4) deals only with the “payments of any kind to any person in consideration for rendering of any managerial, technical or consultancy services, including the provision of such services by technical or other personnel”, so far as these services are concerned, “the role of the assessee is akin to buying and selling of services”.
- iii) The AO also held that the assessee had, on account of rendition of these services in India, a PE in India under Article 5(2) (1) of the Indo-Swiss tax treaty, i.e. service PE, that the expenses are allowable, on an estimate basis, @ 40% of total revenues, and that the remaining amount is taxable at

the normal income tax rates applicable to the foreign companies. On further appeal, DRP upheld the order of AO.

Decision

On Appeal, the Tribunal held in favour of the assessee as under:

- i) ITAT observed that the case of the AO was that the assessee had a PE in India inasmuch as the services rendered by the assessee were not of such a nature as to be covered by the definition of “fees for technical services” under Article 12. In this regard, ITAT noted that “The fundamental question, however, that we need to examine is whether an income, offered to tax under Article 12(2) as “fees for technical services” being taxed as an income attributable to a service PE under Article 5(2)(1) can place the assessee to a disadvantageous position so far as his tax liability is concerned.”
- ii) In this regard, ITAT accepted assessee's argument contending that, so far as the PE under article 5(2)(1) of Indo-Swiss tax treaty was concerned, i.e. service PEs, the assessee had a choice to be taxed on gross basis at the rates provided under Article 12(2) or on net basis under Article 7.
- iii) In this regard, ITAT interpreted that “A combined reading of the above provision of Article 5(2)(1) read with related protocol clause clearly shows is that the service PE being triggered on account of rendition of services by a Swiss entity in India, or *vice versa*, can never make the assessee worse off so far as the tax liability in source jurisdiction is concerned.” ITAT further explained that “Unless the assessee has a lower tax liability on taxability of PE on net basis under Article 7 *vis-à-vis* taxability of FTS on gross basis under Article 12(2), the PE being triggered is in fact tax neutral. Nothing, therefore, turns

in favour of the income tax department on account of service PE being triggered by the rendition of services.”

- iv) ITAT further took cognizance that “Of course, the words “at the request of the enterprise” appear in the above protocol provision but when the assessee is all along pleading for taxability under article 12(2), it's implicit in the contention that the assessee wants to be taxed at that rate.” Thus accepting assessee's plea, The Tribunal directed the AO to “tax the assessee, in respect of the receipts as fees for technical services- i.e. ₹ 1,00,14,582, @ 10% on gross basis and under article 12(2) of the Indo-Swiss tax treaty” and accordingly allowed assessee's appeal.

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INDIRECT TAXES



CA Rajkamal Shah & CA Sudarshan Gaykar

GST Gyan – Levy of Interest on payment of GST upon delay in furnishing of GSTR-3B and recovery thereof

Since its inception, GST law has been a roller coaster ride for the tax payers and professionals. The courts of the country are saddled with the cases challenging various provisions of the law. A good and simple tax has become a maze of controversies and complications. Each day passes with some new controversy in the law. Undue haste in framing the law, rudderless or inapt GST network (GSTN) and the high-handed implementation coupled with the pressure of achieving the revenue targets has resulted in chaos amongst the tax payers.

The case in point is of issue of payment of interest on delayed filing of monthly return in form GSTR-3B. The latest salvo is fired by CBIC in issuing letter dtd. 10th Feb, 2020 to all Principal Chief Commissioners and Chief Commissioners of GST across the country directing that action be taken for recovery of interest payable u/s. 50 of the of the CGST Act against those taxpayers who have filed their monthly returns belatedly and consequent delay in discharge of their tax liability. It goes on to state that as per S. 50 it is

very clear that interest liability is required to be paid on the tax liability that is paid belatedly, either through cash or through utilization of input tax credit (ITC). In other words, if the return is delayed, interest is required to be paid on gross tax liability as shown in FORM GSTR-3B. The filed formations have already started issuing nationwide notices and also initiated the process of recovery of such unpaid interest under the provisions of S. 79 (i.e. without issuing a show cause notice) of the CGST Act.

To the peril of tax payers interest is demanded though he has input tax credit in his Electronic Credit Ledger. The issue has arisen because the tax payers are not allowed to file the return (GSTR-3B) without payment of tax, though no such compulsion exists in the law. Section 50(1) allows the part payment of tax, but no such facility is provided in the return. Similarly, the taxpayer having balance in Electronic Cash Ledger is not considered as payment to the Government and interest is applied on that in case of delayed return.

The issues for consideration are:

- A. Whether interest is to be paid on the gross tax amount payable or it is to be paid on the net amount of tax payable after allowing the credit for the balance lying in the electronic credit ledger?
- B. Whether interest is to be paid on the gross tax amount payable or it is to be paid on the net amount of tax payable after allowing the credit for the balance lying in the electronic cash ledger?
- C. Whether the interest can be demanded under Section 75(12) read with Section 79 of the CGST Act, 2017 as automatic liability that the taxpayer should have computed himself and on failure of that the department would compute it and raise a notice of payment without issuing a show cause notice?

A. Whether the interest is applicable on gross tax liability before setting off the input tax credit?

The issue arise because of S. 50 relating to charge of interest is not happily worded. Let it be clear that monthly return of GST can be filed only with payment of tax. In other words, the return cannot be uploaded unless the entire tax liability is discharged. The issue is further aggravated by keeping the proviso to S. 50(1) as recommended by 31st GST Council in limbo. Had it been notified from the date of enactment of Finance Act (No. 2) i.e. 1-8-2019 and given retrospective effect from the beginning even as the GST Council felt iniquitous provision. The relevant extract from the minutes of the meeting of the 31st GST Council meeting is reproduced elsewhere in this article.

The Revenue's contention that in absence of return being filed, the tax payer is not entitled to input tax credit and it has to be compensated by payment of interest. The concept of delayed payment of tax with the belated returns needs to

be examined in the light of statutory provisions and judicial pronouncements.

A1. Relevant provisions of CGST Act

50(1) *Every person who is liable to pay tax in accordance with the provisions of this Act or the rules made thereunder, but fails to pay the tax or any part thereof to the Government within the period prescribed, shall for the period for which the tax or any part thereof remains unpaid, pay, on his own, interest at such rate, not exceeding eighteen per cent., as may be notified by the Government on the recommendations of the Council.*

Provided that the interest on tax payable in respect of supplies made during a tax period and declared in the return for the said period furnished after the due date in accordance with the provisions of section 39, except where such return is furnished after commencement of any proceedings under section 73 or section 74 in respect of the said period, shall be levied on that portion of the tax that is paid by debiting the electronic cash ledger". (This Proviso was inserted by the Finance Act (No. 2) after the 31st Meeting of GST Council held on 31st Dec. 2018, however the same is not yet notified).

2) *The interest under sub-section (1) shall be calculated, in such manner as may be prescribed, from the day succeeding the day on which such tax was due to be paid.*

A bare reading of above provisions shows that interest is payable on the unpaid amount of tax payable or part thereof. It don't say anything about whether payment can be made with cash, input tax credit or amount lying in Electronic Cash Ledger.

A2. Direct decision - Hon'ble Madras High Court in W.P - Refex Industries Ltd. dtd. 6-1-2020

In respect of payment through input tax credit, the Hon'ble Madras High Court has held that

when the payment is lying with it by way of input tax credit the State cannot say that it is deprived of the funds, viz. tax. Hence, interest can be levied only on that part of tax which is paid in cash. The proviso inserted from 1-8-2019 clearly seeks to correct an anomaly in the provision as existed prior to the institution. Also held that the proviso should be read as clarificatory and operative retrospectively.

Quote:

“The specific question for resolution before me is as to whether in a case such as the present, where credit is due to an assessee, payment by way of adjustment can still be termed ‘belated’ or ‘delayed’. The use of the word ‘delayed’ connotes a situation of deprivation, where the State has been deprived of the funds representing tax component till such time the Return is filed accompanied by the remittance of tax. The availability of ITC runs counter to this, as it connotes the enrichment of the State, to this extent. Thus, Section 50 which is specifically intended to apply to a state of deprivation cannot apply in a situation where the State is possessed of sufficient funds to the credit of the assessee. In my considered view, the proper application of Section 50 is one where interest is levied on belated cash payment but not on ITC available all the while with the Department to the credit of the assessee. The latter being available with the Department is, in my view, neither belated nor delayed”.

.....
.....
.....

*“The above proviso, as per which interest shall be levied only on that part of the tax which is paid in cash, has been inserted with effect from 1-8-2019, but **dearly seeks to correct an anomaly** in the provision as it existed prior to such insertion. It should thus,*

in my view, be read as clarificatory and operative retrospectively.”

A3. In Notification No. 23/2017-Central Tax dated 17th August 2017, it has been explained that “Tax payable” has not been defined in the CGST Act, the term “Tax payable under the said Act” is as under:

“Tax payable under the said Act” means the difference between the tax payable for the month of July 2017 as detailed in the return furnished in FORM GSTR-3B and the amount of input tax credit entitled to for the month of July 2017 under Chapter V and section 140 of the said Act read with the rules made thereunder”.

A4. Input tax credit is provision for facility of credit is as good as tax paid till tax is adjusted on future goods on the basis of the several commitments which would have been made by the assessee concerned [refer Eicher Motors Ltd.¹

A5. The interest is compensatory for withholding the payment of tax. The Hon’ble Supreme Court in Pratibha Processors²,

Quote:

“Interest is compensatory character and is imposed on an assessee who has withheld payment of any tax as and when it is due and payable. The levy of Interest is geared to actual tax withheld and the extent of delay in paying the tax on the due date.”

A6. In Tata Engineering & Locomotive Co Ltd vs. State of Maharashtra and Others (Bom)³ has held that, “Tax payable” refers to net tax payable after adjustment of applicable set-off, etc. This view is affirmed by the

1. [1999 (106) E.L.T. 3 (S.C.)]
2. UOI 1996 (11) SCC 101 (SC)
3. [(1992) 85 STC 507 (Bom.)]

Hon'ble Supreme Court in Associated Cement Co.⁴ Though the ruling is in the context of the Bombay Sales Tax Act, 1956 the ratio applies equally in case of delayed payment under GST.

A7. Retrospectivity of proviso to S. 50(1) - 31st GST Council Meeting dtd. 22-12-2018

The 31st GST Council Meeting dtd. 22.12.2018 has recognized the need of payment after utilization of input tax credit. The minutes of the meeting of the GST Council is worth-noting and determinative that whether the amendment can be said to be retrospective from July 17 only, as the intention was always to charge interest on net tax payable and not the gross amount. That GST is a tax on value addition and the law always provided for such adjustment. **It also conceded that thanks to GSTN the facility was not available on the common portal.**

The minutes of Agenda 7(xx)(1/2) is worth noting.

“Law permits furnishing of a return without payment of full tax as self-assessed. As per the said return but the said return would be regarded as an invalid return, however, no such facility has been yet made available on the common portal. This inflexibility of the system increases the interest burden.

“GST only on value addition”.

“Accordingly, in principle approval for amendment is sought so as to provide that:

“interest should be charged only on the net liability of the taxpayer, after taking into account the admissible credit, i.e. the amount payable through electronic cash ledger”.

“Interest would be charged on tax calculated on taxable value where invoices or debit notes are uploaded late”.

Thus, the GST Council is also of the view that the proviso to S. 50(1) should be applied retrospectively. There are the judgments of Supreme Court on similar line the same are not given here for space constraint.

B. Payment of tax by way of debit in Electronic Cash Ledger

On perusal of S. 49 it is clear that payment of tax, interest, penalty and other amounts shall be credited to the Electronic Cash Ledger. Sub-section (1) clearly provides that subject to the manner as may be prescribed, every deposit towards tax, interest, penalty or fees or any other amount shall be credited in Electronic Cash Ledger. Further, sub-section (3) provides that the amount available in Electronic Cash ledger may be used for payment towards tax, interest, penalty or fees or any other amount under the provisions of this Act or Rules made thereunder.

To effectuate S. 49(3), rule 87(1) prescribes the conditions of the deposits in Electronic Cash Ledger and the use thereof as follows:

“The electronic cash ledger under sub-section (1) of section 49 shall be maintained in FORM GST PMT-05 for each person, liable to pay tax, interest, penalty, late fee or any other amount, on the common portal for crediting the amount deposited and debiting the payment therefrom towards tax, interest, penalty, fee or any other amount”.

Thus, it is clear that amount lying in electronic cash ledger should also be treated as payment to the Government and no interest should be levied on such portion.

C. Whether payment of interest is automatic or the taxpayer is entitled to be heard?

The department insists that the interest liability should have been computed by the assessee.

4. [(1981)48 STC (466) (SC)]

In absence of such payment on his own, the department would compute the same and raise a demand notice without referring to the assessee. However, the assessee has right to dispute the same by way of grant of hearing and only after computing the interest justifiably, the demand should be raised. Principles of natural justice must be followed.

We have the direct decision of The Hon'ble Madras High Court in the case of *M/s Daejung Moparts Pvt. Ltd. [TS-1268-HC-2019(MAD)-NT]* dtd. 23-7-2019 held that, “*though the liability of interest under section 50 is automatic, quantification of such liability shall have to be made by doing the arithmetic exercise*”. While there is certainly some amount of ambiguity in this regard, not providing reasonable opportunity to the assessee to dispute the interest on the ITC component shall certainly be against principles of justice”. A clear cut fall out is that the assessee should ask for show cause notice if he wants to dispute the demand.

D. Finally, a million dollar question is that whether the provisions lack clarity on liability of payment of tax on the due date of filing of return? It would be interesting to examine the provisions of S. 49 and the relevant rules pertaining to payment of tax, interest, penalty and other amounts. The relevant portion of section 49 is reproduced hereunder:

“49. (1) *Every deposit made towards tax, interest, penalty, fee or any other amount by a person by internet banking or by using credit or debit cards or National Electronic Fund Transfer or Real Time Gross Settlement or by such other mode and subject to such conditions and restrictions as may be prescribed, shall be credited to the electronic cash ledger of such person to be maintained in such manner as may be prescribed.*

(2) *The input tax credit as self-assessed in the return of a registered person shall be credited to his electronic credit ledger, in accordance with [section 41 or section 43A], to be maintained in such manner as may be prescribed.*

(3) *The amount available in the electronic cash ledger may be used for making any payment towards tax, interest, penalty, fees or any other amount payable under the provisions of this Act or the rules made thereunder in such manner and subject to such conditions and within such time as may be prescribed.*

(4) *The amount available in the electronic credit ledger may be used for making any payment towards output tax under this Act or under the Integrated Goods and Services Tax Act in such manner and subject to such conditions and within such time as may be prescribed.*

(5) *The balance in the electronic cash ledger or electronic credit ledger after payment of tax, interest, penalty, fee or any other amount payable under this Act or the rules made thereunder may be refunded in accordance with the provisions of section 54”.*

Governing rules

In respect of input tax credit the governing rule is 86 which relates to the maintenance of the Electronic Credit Ledger. The relevant provisions are as follows:

“(1) *The electronic credit ledger shall be maintained in FORM GST PMT-02 for each registered person eligible for input tax credit under the Act on the common portal and every claim of input tax credit under the Act shall be credited to the said ledger.*

(2) *The electronic credit ledger shall be debited to the extent of discharge of any liability in accordance with the provisions of section 49”.*

As regards to payment through Electronic Cash Ledger, the mechanism is provided in R. 87. The relevant provision is contained in sub-section (1) is as follows:

“(1) *The electronic cash ledger under sub-section (1) of section 49 shall be maintained in FORM GST PMT-05 for each person, liable to pay tax,*

interest, penalty, late fee or any other amount, on the common portal for crediting the amount deposited and debiting the payment therefrom towards tax, interest, penalty, fee or any other amount”.

It is worth noting that S. 49(3) and 49(4) talks about the time of payment to be prescribed. However, none of the rule 86 & 87 prescribes any time limit.

Only provision as regards either to payment of tax can be found in S. 39(7) which read as follows:

“(7) Every registered person, who is required to furnish a return under sub-section (1) or sub-section (2) or sub-section (3) or sub-section (5), shall pay to the Government the tax due as per such return not later than the last date on which he is required to furnish such return:

Provided that the Government may, on the recommendations of the Council, notify certain classes of registered persons who shall pay to the Government the tax due or part thereof as per the return on or before the last date on which he is required to furnish such return, subject to such conditions and safeguards as may be specified therein”.

[The above section is substituted from the date of enactment of Finance Act (No.2), 2019 but not yet notified. The new sub-section reads as follows]:

“(7) Every registered person who is required to furnish a return under sub-section (1), other than the person referred to in the proviso thereto, or sub-section (3) or sub-section (5), shall pay to the Government the tax due as per such return not later than the last date on which he is required to furnish such return:

Provided that every registered person furnishing return under the proviso to sub-section (1) shall pay to the Government, the tax due taking into account inward and outward supplies of goods or services or both, input tax credit availed, tax

payable and such other particulars during a month, in such form and manner, and within such time, as may be prescribed:

Provided further that every registered person furnishing return under sub-section (2) shall pay to the Government the tax due taking into account turnover in the State or Union territory, inward supplies of goods or services or both, tax payable, and such other particulars during a quarter, in such form and manner, and within such time, as may be prescribed”.

Looking to the scheme of the Act and Rules shown above, it can be contended that though the payment or tax is linked to the filing of monthly return but does not provide that a return can be filed only after payment of entire tax liability mentioned therein. Therefore, S. 50 cannot trigger and impose any interest liability.

Conclusion

It is a matter of paramount importance to bring clarity and certainty in the tax provisions and levy of interest in case of late tax payment upon delayed filing of return. Had the Government not dithered on implementation of the all important proviso to S. 50(1) and substitution of S. 39(7), the controversy of payment of interest on account of credit lying in electronic credit and cash ledger on delayed return would not have arisen. The Government is responsible for the unexplained delay in implementing the provisions forthwith even after the GST Council expressing its reservation on the whole issue. The apathy of GST Network in not adequately translating the tax provisions into operation is also appalling. It would be in the interest of all concerned to give retrospective effect to the said proviso and to alleviate the hard feeling in the tax payers' mind and also to avoid the resultant spate of litigations. Lest the Madras High Court judgement be converted into law and bury the issue once for all.

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INDIRECT TAXES

GST – Recent Judgments and Advance Rulings



CA Naresh Sheth & CA Jinesh Shah

A. HIGH COURT DECISIONS

1. ***M/S. REFEX INDUSTRIES LIMITED VS. THE ASSISTANT COMMISSIONER OF CGST & CENTRAL EXCISE & ORS. – MADRAS HIGH COURT (2020-TIOL-382-HC-MAD-GST)***

Facts, issue involved and Contention of Petitioner

Petitioner has reportedly filed their GST returns belatedly for the period 2017-18. Respondent issued notice to the petitioner demanding interest on the entire (gross) tax dues. Petitioner was of the view that since they had sufficient Input Tax Credit ('ITC') balance available, interest could only be demanded on the cash component of the tax remitted belatedly and not on the entire tax dues.

Therefore, the legal issue before the High Court was whether payment of tax by utilizing ITC be termed as delayed payment and consequently interest on such portion of tax be recovered from the assessee.

Petitioner submitted that section 50, which provides for levy of interest on belated

payments, would apply only to belated payments of tax by cash and would not stand triggered in the case of ITC available, since such ITC represents credit due to an assessee by the Department.

Discussion by and Observations of HC

High court took a note of provisions of Section 50(1) and opined that liability to pay interest on delayed payment of tax is automatic and compensates the revenue for tax payment beyond stipulated period.

The specific question before High Court was, where the ITC was due to an assessee, payment by way of mere adjustment, can still be termed 'belated' or 'delayed'?

The use of word 'delayed' connotes a situation of deprivation, where the State has been deprived of the funds representing tax component till such time the return is filed accompanied by remittance of tax. The availability of ITC runs counter to this, as it connotes the enrichment of the state, to this extent. Thus, section 50, which is specifically intended to apply to a state of deprivation, cannot apply in a situation where

the State is possessed of funds to the credit of the assessee. ITC being available with the department can neither be termed as belated nor delayed.

Availment and utilization of ITC are two separate events. Both are subject to satisfaction of statutory conditions. ITC availed will be valid until it is invalidated by recourse to the mechanism provided under Statute and Rules.

Further, the above contentions are also supported by recently inserted proviso to Section 50(1) which clearly states that the interest shall be levied only on that portion of tax which is to be paid through Electronic Cash Ledger.

Though the above proviso came into effect from 1-8-2019, it clearly seeks to correct an anomaly in the provisions, as it existed prior to such situation. Thus, the same should be read as clarifactory and has to be considered as operative with retrospective effect.

High court took note of decision pronounced by Hon'ble Telangana High Court in case of *Megha Engineering and Infrastructures Ltd. vs. The Commissioner of Central Tax and Others (2019-TIOL-893)*. In this regard, the High Court observed that when the said decision was pronounced, the amendment brought *vide* proviso to Section 50(1) was at the stage of press release issued by Ministry of Finance. Therefore, Telangana High Court refrained itself from interpreting Section 50 in the light of the proposed amendment.

Decision of High Court

It was held that interest liability shall trigger automatically in case of delayed payment of tax. However, interest shall be calculated only on that portion of tax, which is to be paid through Electronic Cash Ledger.

B. APPELLATE AUTHORITY FOR ADVANCE RULING

2. *ROTARY CLUB OF MUMBAI QUEENS NECKLACE – AAAR MAHARASHTRA (2020-TIOL-09-AAAR-GST)*

Facts and Issue involved

Appellant/Club is an unincorporated association of individuals. The club is affiliated to Rotary International, a worldwide organization. Club brings together dedicated individuals to exchange ideas, build relationships and take action. It uses generous donations to fund projects by Rotarians and other partners in communities around the world. The main purpose of the Club is to promote integrity and advance world understanding, goodwill and peace. In addition, it works to fight diseases, provide clean water, sanitation, hygiene, support education, etc.

The members come together to form a rotary club. It is a non-profit institution and not a service club. The club has an annual budget of expenses. Money is pooled by the members in equal share. It does not render commercial services to its members nor it renders service to outsiders for a fee.

Appellant had sought advance ruling on following questions:

1. *Whether subscription fees and admission fees collected from members is liable to GST?*
2. *If answer to above is yes, whether Input Tax Credit (ITC) on banquet and catering services be availed?*

Appellant's submissions

Harmonious reading of provisions of supply, liability and consideration under GST provides that where a consideration is involved in a transaction, recipient is the person who pays

consideration to supplier. Hence, two different persons have been envisaged in law to tax a transaction as a supply.

Term ‘person’ as defined under GST does not contain deeming fiction to treat club and its members as different persons. Merely because association of person is included in definition of person it does not imply that members of such association are different persons. Article 366(29A) of the Constitution enables to tax deemed sale of goods. It does not enable to tax service as deemed service.

Members come together to form a Rotary Club, It is not an entertainment club or recreational service club. The events are held by club for holding lectures and fund raising. The club is not formed to provide services to members. Holding a meeting at good venue does not make it taxable.

Appellant further relied on decision of Maharashtra AAR in case of Lions Club of Kothrud, Pune wherein AAR has held that there is no supply *qua* the fees received. There is no occasion to visit the definition of supply under GST. Club is not liable to GST as it does not render any supply for the purpose of GST.

Discussions by and observations of AAR

Appellant has relied on case of ‘Lions Club of Poona Kothrud’ wherein Maharashtra AAR has ruled “club is not formed to provide any supply of goods or services to its members qua the fees received from them. Since there being no supply qua the fees received, there arises no occasion to visit the definition of ‘Supply’ under the GST Act.”

AAR observed that the Appellate Advance Ruling Authority overruled the Advance Ruling in the case of ‘Lions Club of Poona Kothrud’ and hence GST is payable by Lions Club of Poona Kothrud.

AAR concluded that since the Appellant has heavily relied on the AAR of Lions Club of Poona Kothrud and have submitted that the Appellant’s facts are similar to the case of Lions Club of Poona, the amount collected as membership subscription and admission fees from members is liable to GST as supply of services.

As per section 17(5) of CGST Act, ITC shall not be available in respect of food & beverages, outdoor catering, etc. except where an inward supply of such goods or services or both is used by a registered person for making as outward taxable supply of the same category of goods or services or both or as element of taxable composite or mixed supply.

ITC of food and beverages is specifically disallowed u/s 17(5) except where it is used for making an outward taxable supply of same category of goods or services. Provisions of section 17(5)(b) are crystal clear. Unless it is satisfied the Appellant is not entitled to ITC of food and beverages and outdoor catering.

Ruling of AAR

In respect of question raised by Appellant, the amount collected as membership subscription and admission fees from members is liable to GST as supply of services.

Further, Appellant is not eligible to claim ITC of tax paid on banquet and catering services for holding meetings or events.

Appeal to AAAR and further submissions made by appellant

Aggrieved by the above ruling of AAR, appellant preferred an appeal to AAAR Maharashtra. Appellant took cognizance of foreign jurisprudence in case of *English and Scottish Joint Co-operative whole society Ltd. vs. Commr. Agr. Of I.T. (1948) 16 ITR 270(PC)* where judicial committee stipulated three

conditions for establishing existence of doctrine of mutuality:

- The identity of contributors to the fund and recipients of the fund;
- The treatment of company, though incorporated as a mere entity for the convenience of the members and policyholders, in other words, as an instrument obedient to their mandate; and
- The impossibility that contributors should derive profits from contributions made by themselves to a fund which could only be expelled or returned to themselves.

The appellant also submitted the decision of apex court in case of Calcutta Club Limited/Ranchi Club Limited where principle of mutuality is upheld. Though the ruling is in context to applicability of service tax, the same principle will also be applicable in GST also as there is no change in legal position.

It further contended that under service tax regime, there was a deeming fiction that an unincorporated association or body of persons, as the case may be, and a member thereof shall be treated as distinct persons. The said clause is missing under GST. Hence, the intent in GST was never to treat club and members are separate persons.

It also contended that it does not offer any facilities or benefits to its members. Hence, its activities cannot be covered within the ambit of business.

The deeming fiction under Entry 7 to Schedule II of the CGST provides that goods supplied by unincorporated body of persons to a member thereof for cash, deferred payment or other valuable consideration shall be classified as goods under the GST law. No such deeming fiction has been created under Schedule II with respect to supply of services.

Further, the appellant also stated that even the provisions of Indian Contract Act, 1872 require consideration to be paid by one person to the other. However, applying the doctrine of mutuality, it supply made to self and consideration made to self would not qualify as consideration.

GST Act defines 'Person' under section 2(84) to include an association of persons or a body of individuals, whether incorporated or not, in India or otherwise. However, as per the said definition, there is no deeming fiction to treat association and its members as different persons. Hence, the key condition to treat a transaction as supply u/s. 7(1)(a) is not satisfied.

Discussions by and findings of AAAR

The Appellate Authority observed that an activity is treated as supply when same is undertaken in the course or furtherance of business.

Appellant is not providing any specific facility or benefits to its members against the membership subscription charged by it. The entire subscription amount is spent towards meeting and administrative expenditures only. Thus, it is held that appellant is not doing any business as envisaged u/s. 2(17) of CGST Act.

Once it is established that appellant is not doing any business in terms of section 2(17) of CGST Act, it can be concluded that activities carried out by appellant would not come under scope of supply.

If the impugned activities are held to be supply, then membership fees collected, which is reimbursement of expenses incurred by appellant to sustain and propagate their inherent programs, would be subject to double taxation as the amounts spent towards the meetings and administrative activities are already subject to tax in the hands of supplier of those inputs and

input services. Thus, doing so would be clearly against the legislature’s intention of formulation of GST.

Since it is held that the impugned activities of appellant are not construed as supply, the question of ITC on input services like catering and banquet services does not arise.

Ruling by AAAR

The Appellate Authority held that amount collected as membership subscription charges and admission fees from members is not liable to GST.

3. M/S. VAISHNAVI SPLENDOUR HOMEOWNERS WELFARE ASSOCIATION – AAAR KARNATAKA (2019-TIOL-10-AAAR-GST)

Facts, issue involved and contention of the appellant

Appellant is an association of apartment owners in the condominium known as “Vaishnavi Splendour”. The association collects contribution from each member towards maintenance of common area/facilities, providing lighting in common area, water, etc. upkeep of equipments etc. In addition they collect contribution towards corpus fund for future contingencies.

Appellant had sought advance ruling for the following:

1. Whether they are liable to pay CGST and SGST on the amount of contribution received from its members?
2. If the answer to 1 above is “yes”, whether it can avail the benefit of Notification No. 12/2017 dated 28-06-2017(SI. No. 77) read with notification No. 2/2018 dated 25-1-2018 which provide for exempting from tax, the value of supply up to an amount of ₹ 7500 per month per member?

3. If the answer to 2 above is “Yes”, whether it is required to restrict its claim of input tax credit?
4. Whether they are liable to pay CGST/SGST on amounts which it collects from its members for setting up a corpus fund?

Appellant’s Contention

Appellant contended that the transactions carried out by them with their members is governed by the principle of mutuality. They relied on decision pronounced by Apex court in the case of *State of West Bengal and Others vs. Calcutta Club Limited (2019-TIOL-449-SC-ST-LB)* wherein the principle of mutuality was upheld.

Contributions are used for maintenance and repairs of common areas and facilities in condominium. Surplus of member’s contributions over expenses, if any, belongs to the members and not the appellant. The appellant is only acting as an agent of members and contributions of members are mere reimbursement of the amount spent for outsourcing goods and services and not for consideration. Further, in absence of consideration, the activity shall not amount to ‘supply’ and consequently shall not be levied to GST.

Further, the appellant contends that statutorily the association cannot retain any amount from its members which are more than what is required to be spent for the upkeep of property. Therefore, amounts collected by them is in nature of mere reimbursements which are not taxable.

Regarding the availment of benefit of exemption under Notification No. 12/2017, the appellant contended that erstwhile Notification No. 8/2007 – ST provided exemption from whole of service tax where the total consideration received from individual members does not

exceed ₹ 3,000/- per month. However, the current/present notifications provide exemption from GST on contributions up to ₹ 7,500/- (₹ 5,000/- under service tax). The appellants contend that had the lawmakers intended to restrict the benefit of exemption only to members whose contribution is less than or equal to ₹ 7,500/- they would have phrased the notification in same manner as of Notification No. 8/2007-ST.

Appellant also submitted that departmental circulars clarifying the departmental stand on the matter cannot be the basis for decision by the authority. Also, the departmental circular shall operate prospectively by virtue of being in the nature of an oppressive circular.

They further contended that they source water and electricity, which are exempt supplies along with other supplies. Taxing the contribution (which includes electricity and water) would amount to taxing exempt supplies as well.

With regards to entitlement of input tax credit, the appellant contends that exemption of ₹ 7,500/- per month per member is a mere reduction in the value of supply and it does not convert the supply into an exempted supply. Therefore, they are entitled to full amount of input tax credit.

With regards to collection of amounts towards corpus fund, appellant contended that the amounts so collected are merely in nature of deposits. Further they are under the obligation to refund the corpus to its members if it is not spent. Therefore, it should not be liable to tax.

Discussions by and observations of AAR

The expression “supply” includes all forms of supply of goods or services or both such as sale, transfer, barter, exchange, license, rental, lease or disposal made or agreed to be made for a consideration by a person in the course or furtherance of business. Further, the activities

performed by the appellant are covered under the definition of business *vide* section 2(17)(e) of the Act.

The term “consideration” as defined in u/s. 2(31) of the Act, includes any payment made in respect of or in response to supply of services. Consideration in instant case is towards the supply of maintenance services provided by the applicant to its members. Hence, services provided by the appellant is the supply liable to GST.

Further, as per the Circular No. 109/28/2019-GST dated 22-7-2019 the exemption of ₹ 7,500/- is not available when the maintenance charges exceed ₹ 7500/- per month per member. Hence, exemption of ₹ 7,500/- per member is not available where the contribution exceeds the said monetary limit.

As per the section 17(2) of the CGST Act read with Rule 42 of CGST Rules, the amount of credit shall be restricted to so much of the input tax as is attributable to taxable supplies.

Amounts collected as corpus shall be regarded as deposit. The contributions made by members are not related to any services. Hence, corpus contributions are not liable to GST.

Ruling of AAR

AAR pronounced the ruling in respect of above questions as under:

1. The Appellant is liable to pay GST on contributions received from its members for maintenance of common property.
2. The benefit of exemption is available to the appellant only if maintenance charges do not exceed ₹ 7,500/- per month per member.
3. The appellant is eligible to claim input tax credit on the inward supplies of goods

and services subject to Section 17(2) r.w. Rule 42 and other restrictions, if applicable.

4. The appellant is not liable to pay CGST/SGST on amounts collected as corpus.

Appeal to the AAAR and Observations of AAAR

Aggrieved by the decision of AAR in case of question 1 and 2, the Appellant filed an appeal to AAAR.

Authority observed that an activity should qualify as supply only if there is supply of goods or services for a consideration and it is in course or furtherance of business. Activities performed by association of ensuring the maintenance and upkeep of property by procuring goods and services from third parties, benefits every member of the association and hence it can be regarded that services are provided by association to its members.

Further, section 2(17)(e) covers activity of providing facilities or benefits by association to its members within the ambit of 'business'.

The term 'person' as defined in GST law regards 'individual' as well as 'association of persons or body of individuals, whether incorporated or not, in India or outside India' as two different persons. Also, the contribution made by members to the association is in return for receiving the services of association.

It also observed that the decision of Supreme Court in case of Calcutta Club Limited is in context of service tax and since the levy provision in service tax as well as GST are different, the said decision cannot be applied in the case of appellant. Under Finance Act, service tax was leviable on services provided by one person to another. However under GST, supply of service should be necessarily in course or furtherance of business and business has been

defined to include facilities or benefits provided by club/association to its members.

Further, as far as availability of exemption under Notification No. 12/2017 is considered, authority took the stand of Apex Court judgment in case of M/s. Dilip Kumar & Company and Ors. which held that if there is ambiguity in the exemption notification, it should be interpreted in favour of revenue.

Appellate authority also disagreed with the appellant's contention regarding applicability of circular. It held that the circular shall operate retrospectively since it is clarificatory in nature and does not introduce any new levy.

Order of AAAR

AAAR upheld the ruling pronounced by AAR.

C. AUTHORITY FOR ADVANCE RULING

4. **VILAS CHANDANMAL GANDHI – AAR MAHARASHTRA (2020-TIOL-25-AAR-GST)**

Facts, issue involved and contention of the applicant

Applicant was an owner of the land situated within the limits of Pune Municipal Corporation (PMC) and wanted to develop the land jointly in collaboration with M/s. Amar Builders and Developers (Developer) and share profits through distribution of sale proceeds after development of the land by way of construction of residential/commercial project.

In terms of the said agreement entered into, between the applicant and the developer:

- Applicant assigned/transferred the development rights in land to the Developer for the purpose of construction of residential/commercial project on the land.

- Developer agreed to pay consideration in the form of 45% of the sale proceeds of the developed project.

In view of the above agreement, the applicant and developer were enjoying jointly, the rights in the land on which there was reservation, in light of Draft Development Plan for Pune City sanctioned by the Municipal Corporation of Pune City. Since the applicant and the developer realized that vacating/removing reservation may not be possible, they decided to surrender their rights in the said land. ***PMC gave them TDR's/Additional FSI, as consideration for surrendering the joint rights in land to PMC in terms of Development Control Regulations (DCR).***

Both the parties later decided to sell a part of the TDRs/Additional FSI to Vamona Developers Pvt. Ltd. (VDPL) and share the sale proceeds in agreed ratio. Consequently, Applicant entered into agreement/deed of assignment with VDPL.

In light of above, applicant has sought advance ruling for the following questions:

1. *Whether GST is leviable on sale of Transfer Development Rights (TDR)/Floor Space Index (FSI) received as consideration for surrendering the joint rights in land in terms of Development Control Regulations and granted in light of the article of agreement dated 18 December 2017 entered between the Applicant and Pune Municipal Corporation (PMC) read with Development Control Regulations?*
2. *If yes, what will be the classification under GST and what will be applicable rate of GST?*

Applicant's submissions

Goods as defined under CGST Act includes movable property. Anything other than goods is covered in ambit of services. Immovable property includes land and land includes benefit arising out of land (as defined under various

legislation). TDR/FSI are nothing but land as they are the benefits arising out of land. Hence, the transaction of sale of TDR/FSI can be treated as sale of land and covered under Schedule III to CGST Act and can neither be treated as supply of goods nor supply of services.

Applicant made an alternate submissions stating that their supply may be taxable under GST, as scope of the supply is very wide and it encompasses most of the commercial transaction undertaken during the course of business. The term service is wide enough and covers everything other than goods, money and securities. Hence, a view can be formed that supply of TDR/Additional FSI will be considered as supply of service liable to GST.

Department's contentions

The scope of supply of services is very wide and transaction of TDRs could be treated as "service". As per Notification No. 05/2019 C.T. (Rate) dated 29-3-2019, supply of TDRs is taxable under reverse charge mechanism. As per Notification No. 04/2018 C.T. (Rate) dated 25-1-2018, amended by Notification No. 23/2019 dated 30-9-2019 GST is leviable on supply of development Rights & liability to pay Central Tax shall arise at the time of transfer of the constructed structure to the person supplying Development Rights.

Discussions by and observations of AAR

Government of India, Ministry of Finance has issued FAQs (Part II) on real estate *vide* F. No. 354/32/2019-TRU dated 14th May, 2019. Relevant extract of FAQ at sr. no. 7 of the same is reproduced below:

Question: What is the rate applicable to output supply of TDR or FSI?

Answer: GST on transfer of development rights or FSI (including additional FSI) is

payable at the rate of 18% (9% + 9%) with ITC under Sl. No. 16, item (iii) of Notification No. 11/2017-Central Tax (Rate) dated 28-6-2017 (Heading 9972).

Notification No. 4/2018-Central Tax (Rate) dtd. 25-1-2018 specified the incidence of tax under GST for construction services provided in lieu of transfer of development rights.

Further as per Notification No. 5/2019-Central Tax (rate) dtd. 29-3-2019 supply of TDRs by any person to promoter was made taxable under reverse charge mechanism.

A reading of abovementioned notifications along with the FAQ, show that transactions of transfer of development rights/Additional FSI are taxable under GST at rate of 18% (9% CGST+ 9% SGST) under Sl. No, 16, item (iii) of Notification No. 11/2017-Central Tax (Rate) dated 28-6-2017 (Heading 9972).

Ruling by AAR

In respect of question (1), GST is leviable on sale of Transferable Development Rights ('TDR')/ Floor Space Index ('FSI').

In respect of question (2), classification of sale of TDR/FSI is to be done under Heading 9972 and the applicable GST rate is 18%.

5. M/s. ACHARYA SRI MAHASHRAMAN CHARTURMAS PRAVA TRUST (2019-TIOL-377-AAR-GST)

Facts, issue involved and query of the applicant

Applicant is a religious charitable trust registered under Section 12AA of the Income-tax Act. It is engaged in spreading knowledge and advancement of Jain Dharma, popularising Jain philosophy, spiritual activities etc.

Applicant has sought advance ruling on ***taxability of following services especially where the predominant object of trust is not to do business but is advancement of Jain religion:***

1. *Whether the applicant is liable to pay tax on renting of temporary residential rooms for consideration to the devotees and renting of space for shops and stalls for the purpose of religious programmes?*
2. *Whether the applicant is liable to pay tax on renting of temporary residential rooms as per various categories (1BHK/2BHK/Single Room/ Dormitories etc.) to the devotees to stay for the purpose of religious programmes where charges per room is less than one thousand per day, if answer to the question 1 is yes?*
3. *Whether applicant is liable to pay tax on renting of space for stalls, if answer to the question 1 is yes?*
4. *Whether the applicant is liable to pay tax on supply of food and beverages at subsidized rates to the devotees?*
5. *Whether the applicant is liable to pay tax on providing space for registered person without consideration for supply of food and beverages to the devotees, where consideration is received by trust directly from devotees?*
6. *Whether applicant is liable to pay tax for acting intermediary for booking hotel rooms to the pilgrims from outside?*

Applicant's submissions

Any transaction or activity shall be subject to levy of GST only if the sale of goods or provision of service is in course or furtherance of business.

Business as defined u/s. 2(17) of CGST Act includes trade, commerce, manufacture, profession, etc. and activities and transaction incidental to the aforesaid.

Applicant is of the view that activities conducted by the religious trust for the purpose of advancement of religion does not fall under the definition of business and is therefore not liable to GST. Activities conducted with predominant object of advancement of religion does not attract tax under GST law. They place reliance on decision of Apex Court in the case of *Commissioner of Sales Tax vs. Sai Publication Fund [2002] 2 SCC 7 (SC)* and the Hon'ble Apex Court in the case of *CIT vs. Gujarat Maritime Board [2007] 14 SCC 704 (SC)* wherein it was held that, if the primary object of the trust is charitable, then objects incidental or ancillary to the dominant object will also be considered as charitable.

Applicant was of the view that renting of residential rooms is only incidental to the main object, i.e. advancement of religion. Therefore the facility provided by applicant in the form of renting residential rooms and renting of spaces for shops and stalls for consideration does not attract GST.

Applicant further submitted that sr. no. 13 of Notification No. 12/2017 exempted services supplied by a person by way of renting of precincts of a religious place meant for general public, provided where renting of rooms charges are less than one thousand rupees per day.

Applicant further submitted that sr. no. 13 of Notification No. 12/2017 exempted services supplied by a person by way of renting of precincts of a religious place meant for general public provided where renting of shops or other spaces for business or commerce charges are less than ten thousand per month.

Applicant was of the view that the supply of food and beverages at subsidized rates to devotees is incidental to main object i.e. advancement of religion and hence does not attract GST.

Applicant states that one of the requirement for an activity or transaction to fall under the scope of supply is 'consideration'. Therefore, if an activity or transaction though falls in any one of the forms of supply, but without consideration does not fall under the scope of supply, thereby does not attract tax under GST. Hence providing space without consideration to another registered person for supply of food and beverages does not attract tax.

Applicant further states that they will receive an advance for booking hotel rooms on behalf of pilgrims from outside the state and after completion of stay, the actual amount will be paid to the respective hotels. Extra amount if any left out, will be returned back to the respective pilgrims. Therefore, applicant is of the view that having provided such intermediary services without consideration does not attract GST.

Discussions by and observations of AAR

Applicant is engaged in carrying out religious and charitable activities. It is pertinent to note that they are also engaged in providing accommodation services, renting out properties and booking accommodation, supplying food and beverages for consideration and are not directly related to religious activities.

Any activity to be exempted and covered under definition of charitable activities must be related to advancement of religion, spirituality or yoga. Applicant is constructing buildings and giving it on rent, which are not directly related to the advancement of religion. Hence the contention of the applicant that these are not in the course or furtherance of business cannot be accepted. What is not covered under the term business is the core activities propagating religious activity and not the commercial activity of receipt and supply of goods or services undertaken by a charitable trust. Though the main object of trust is charitable

activity which cannot be covered under the term ‘business’, not all activities of trust can be kept out of definition of supplies.

Regarding the second question, whether the services are covered under Heading 9963 or 9972 of the Notification No. 11/2017-CT (R) dated 28-6-2017 is the main question. Applicant is obtaining the land on lease and constructing the rooms and letting out for temporary accommodation. Applicant’s services is of renting of residential rooms where charges are less than one thousand per day per room and hence exempted under Entry No. 14 of Notification No. 12/2017 CT (R) dated 28-6-2017.

Regarding the third question, applicant is liable to pay tax on the renting of space for stalls, as per the reasons given in answering question no. one.

Regarding the fourth question, entry 7 of Notification No. 11/2017 CT (R) dated 28-6-2017 makes it clear that the supply of goods being food or any article for human consumption or drink by way of or part of any service or in any manner whatsoever is taxable. Applicant is charging consideration for supply of food and beverages and hence such supply even though at subsidized rates is taxable.

Regarding the fifth question, it is seen that the applicant is providing space for registered person without consideration for supply of food and beverages and the consideration for the food and beverages supplied by such registered person is received by them directly from the devotees. This would amount to a supply of usage rights of space without consideration and the devotees are consumers. Schedule I to the CGST Act which is related to the “activities to be treated as supply even if made without consideration” **does not** cover this item as long as the registered person and the applicant are not related persons.

Regarding the sixth question, the applicant is an intermediary who facilitates the supply of accommodation service to the pilgrims by the hotel. The applicant collects the advance for booking of rooms on behalf of pilgrims and pays the consideration to the service provider (hotel) at the end of the stay. The payment is made on behalf of the pilgrim and the applicant does not hold any title to the services so procured and supplied and hence acts as a “pure agent” of the recipient of supply, only if the supplies procured by the applicant from the third party are in addition to the services he supplies on his own account.

Ruling

1. Applicant is liable to pay tax in renting of temporary residential rooms for consideration to the devotees and renting of space for shops and stalls.
2. Applicant is liable to pay tax on renting of temporary residential rooms of all categories if the declared tariff of a unit of accommodation is ₹ 1000 or more per day or equivalent.
3. Applicant is liable to pay tax on renting of space for stalls.
4. Applicant is liable to pay tax on supply of food and beverages at subsidized rates to the devotees
5. Applicant is liable to pay tax on providing space for registered person without consideration for supply of food and beverages to the devotees, **only if** the applicant and such registered person are covered under the definition of “related persons”.
6. Applicant is liable to tax for acting as an intermediary for booking of hotel rooms to the pilgrims from outside, if he does not satisfy all the conditions prescribed for a

pure agent (i.e. in Rule 33 of CGST Act, 2017).

6. ISHAN RESINS AND PAINTS LTD – AAR West Bengal (2020-TIOL-13-AAR-GST)

Facts, issue involved and query of the applicant

Applicant intends to lease trucks/tankers without operator to Goods Transport Agencies (GTA) or any other persons. Applicant has sought an advance ruling in respect of following questions:

1. *Whether such supply would be exempt in terms of Sr. No. 22(b) of 12/2017-CTR dated 28-6-2017?*
2. *If not exempted what would be the appropriate classification and rate of tax in GST?*
3. *Whether the credit of Input Tax paid on purchasing of motor vehicles is admissible or not?*

Applicant’s contentions

As per the proforma agreement, applicant will lease out the vehicle entailing the transfer of the right to use. The lessee will enjoy possession of the vehicle and will bear operator cost, fuel cost, maintenance and insurance cost, etc.

Sr. No. 22 of the Exemption notification exempts services by way of giving on hire a means of transportation of goods to a GTA. Applicant, however, argues that leasing out a vehicle without operator where the control and possession is transferred to the lessee is different from giving the vehicle on hire. In support of its argument, Applicant placed reliance on the judgment of Uttarakhand High Court in case of *Commissioner of Customs & Central Excise vs. Sachin Malhotra [2015 (37) STR 684 (Uttarakhand)]*. The court in case of Sachin Malhotra has held that although both rent and hire may, in a different context, have the same

connotation, they signify two different classes of transactions in the context of imposing service tax under section 65(105)(o) of the Finance Act, 1994, as amended.

As the applicant intends to transfer the possession and control to the lessee, Sr. No. 22 of the Exemption Notification will not, therefore, apply to its transactions and the same will be taxable under Sl. No. 17 (Leasing or rental services, with or without operator) of Notification No. 11/2017-CT (Rate) dated 28-6-2017 at the same rate of central tax as would have applied on supply of like goods involving transfer of title in such goods.

Discussions by and observations of AAR

Hiring includes agreements where the control and possession of the goods are transferred to the hirer. It is known as the transfer of the right to use the goods. Sr. No. 22 of the Exemption Notification should, therefore, apply to all hiring of the means of transportation of goods, provided the hirer is a GTA and no other specific provision is made for taxing the transfer of the right to use such goods.

A specific provision, however, is made under SI No. 17(iii) of the Rate Notification. The service of transferring the right to use any goods for any purpose (whether or not for a specified period) is taxable under the said provision at the same rate as may apply to supply of the goods. Such a provision restricts the meaning of the term 'hire' in Sr. No. 22 of the Exemption notification only to those transactions that do not involve transfer of the right to use the goods.

Applicant intends to lease out vehicles like trucks, tankers etc. that are designed to transport goods. The control and possession of the vehicle will be transferred to the lessee, who will engage operator and bear the cost of repair, insurance etc. It is, therefore, not classifiable under SAC 9966, which is restricted to rental services of

transport vehicles with operator. The service is classifiable under SAC 997311 as leasing or rental services concerning transport equipment without operator. It amounts to the transfer of the right to use the goods and taxable under SI No. 17(iii) of the Rate Notification.

Section 17(5)(a) of the GST Act does not allow input tax credit on inward supply of motor vehicles of a specific category (those meant for transportation of persons having seating capacity not exceeding thirteen persons). The restriction, therefore, does not apply to the goods transport vehicles. Sr. No. 17(iii) of the Rate Notification does not prohibit claiming input tax credit on the goods given on lease.

Ruling of AAR

In respect of question (1) & (2), Sr. No. 22 of Exemption Notification No. 12/2017 CT (Rate) dated 28-6-2017 will not apply. Applicant's service of leasing goods transport vehicles is classifiable under SAC 997311 and taxable under SI No. 17(iii) of Notification No. 11/2017-CT (Rate) dated 28-6-2017.

In respect of question (3), Applicant can claim input tax credit in accordance with law on the goods transport vehicles so leased out.

7. TEAMVIEW DEVELOPERS LLP- AAR Karnataka (2019-TIOL-412-AAR-GST)

Facts, issue involved and query of the applicant

The applicant is in the business of building, developing, constructing and trading in immovable properties and TDRs, providing construction or real estate or property development related services. It had entered into a Joint Development Agreement on 11-2-2019 to develop commercial space on land measuring 57,974 sq. ft. with 60:40 share. The applicant was

entitled to 60% and the landowners was entitled to 40% of the built up area.

The applicant submitted that new rates of GST for construction service as recommended by GST Council in its 34th meeting:

- 1% without ITC on construction of affordable houses; and
- 5% without ITC on construction of -
 - a) All houses other than affordable houses in ongoing projects;
 - b) All houses other than affordable houses in new projects;
 - c) Commercial apartments such as shops, offices, etc. in a **residential real estate project (RREP)**.

In the light of the above, applicant has sought advance ruling on following questions:

1. *Whether the above rates are applicable to commercial constructions? If not, what is the rate of tax applicable both with ITC and without ITC?*
2. *Can the applicant utilize the ITC relating to the construction activity on supply of other goods and services?*
3. *Can input tax paid on inputs relating to construction activity be utilised against the output tax payable on letting out of the same space?*
4. *Is providing residential accommodation as paying guest to students outside the premises of the University/College/School campus taxable under GST? If yes, what is the rate of tax applicable?*

The applicant is of the view that the new rates of taxes recommended for housing projects are also available to their project of developing commercial complex.

The applicant, as a construction service provider, is eligible to utilize the ITC relating to the construction activities against the output tax payable on renting of commercial space.

The applicant stated that they are providing accommodation to students. The lodging or boarding services provided by the educational institutions is exempted from GST. The paying-guest accommodation is provided exclusively to students and it is a service related to education of the students. Hence the applicant is of the view that he is also eligible for exemption from GST on the paying guest accommodation charges.

The applicant requested to ignore the last question as there is no residential accommodation property sought to be developed.

Discussions by and observations of AAR

Authority observed that the applicant has entered into a joint development agreement with the landowner for developing a purely commercial property. The landowners shall be entitled to 40% of the built area and they are entitled to hold or sell, lease or otherwise dispose of their share of the built area along with 40% of the undivided interest in the property. The applicant shall be entitled to 60% of the built area with 60% share in the land and will have all rights for its share of property.

Hence the applicant is involved in the following supplies-

- (a) The supply of works contract construction service to the landowner;
- (b) The supply of works contract services to the prospective purchasers of constructed building with land in case he desires to supply the constructed building before completion to the prospective purchasers;

The applicant is also receiving the supply of development rights from the landowners.

The authority examined Notification No. 11/2017 - Central Tax (Rate) dated 28-6-2017, as amended by Notification No. 03/2019-Central Tax (Rate) dated 29-3-2019 and observed that the item 3(ib) of Notification is not applicable to the applicant as the project is not a Residential Real Estate Project. It found that item 3(if) of Notification is applicable in the instant case.

In the light of the above, the authority observed that the applicant is himself capitalizing the constructed commercial apartments and intending to use it for leasing/renting. Since no resale of the constructed portion is intended, the project is not covered under the definition of real estate project.

In this regard, it is pertinent to note the definition of "real estate project" which is defined in paragraph 4(xviii) of Notification No. 03/2019 - Central Tax (Rate) dated 29-3-2019 which gives reference to Section 2(zn) of the Real Estate (Regulation and Development) Act, 2016 (16 of 2016) defined as under:

"(zn) "real estate project" means the development of a building or a building consisting of apartments, or converting an existing building or a part thereof into apartments, or the development of land into plots or apartment, as the case may be, for the purpose of selling all or some of the said apartments or plots or building, as the case may be, and includes the common areas, the development works, all improvements and structures thereon, and all easement, rights and appurtenances belonging thereto;"

Since the applicant is not intending to sell any of the said commercial area, the project undertaken by the applicant cannot be covered under "Real Estate Project" and hence cannot be covered under item 3 (if) of the Notification.

Hence in view of the above, as the activity of providing construction services to the land owner is not covered under any sub-item of Serial No. 3, the same is to be covered under Serial no. 3(xii) which reads as under:

“(xii) *Construction services other than (i), (ia), (ib), (ic), (id), (ie), (if), (iii), (iv), (v), (va), (vi), (vii), (viii), (ix), (x) and (xi) above and the same is liable to tax at 9% under the CGST Act.*”

As far as the second question is concerned, the applicant is capitalizing his portion of the building as an immovable property and as per section 17(5)(d) of the CGST Act, 2017, the applicant is not eligible to claim input tax credit.

Regarding the third question raised by the applicant, since the input tax credit is not available relating to his portion of the constructed building, the same is not available for utilization against the output tax payable on letting out of the same space.

Ruling of AAR

In respect of question (1), tax rate applicable on the supply of construction service is 9% CGST and 9% KGST under entry no. 3(xii) of the Notification No. 11/2017-Central Tax (Rate) dated 28-6-2017. The applicant is eligible for input tax credit on the same.

In respect of question (2), the applicant is not eligible to claim input tax credit on the inputs and input services to the extent used for such construction u/s 17(5)(d) of CGST Act.

In respect of question (3), since the input tax credit is not available relating to his portion of the constructed building [as answered in (b) above], the same is not available for utilization of against the output tax payable on letting out of the same space.

Question (4) was not answered as the applicant had withdrawn the question.

8. SHEWRATAN COMPANY PRIVATE LIMITED – WEST BENGAL AAR (2019-TIOL-450-AAR-GST)

Facts, issue involved and query of the applicant

Applicant supplies stores like paint, rope, spare parts, electronic equipment etc. to foreign going vessels. The stores so supplied by the applicant can be either of the following:

- Stores imported and deposited in customs warehouse without payment of import duty; or
- Stores manufactured or produced in India

Applicant has sought an advance ruling in respect of following questions:

1. *Whether supply of stores to foreign going vessels is liable to GST?*
2. *Whether supply of stores to foreign going vessels be treated as zero-rated supplies?*

Applicant’s contentions

Customs frontier as defined in Section 2(4) of IGST Act means the limits of customs area as defined in Section 2 of Customs Act, 1962 (‘1962 Act’). This shall include ‘Warehouse’ licensed under 1962 Act. Section 88(a) of 1962 Act provides that any warehoused goods being stores (‘warehoused stores’) may be taken on board any foreign going vessel without payment of import duty if following conditions are satisfied:

- If shipping bill or bill of export has been presented in respect of such goods;
- Export duty has been paid in respect of such goods; and
- Proper officer has passed an order for clearance of such goods for exportation

Further, Section 89 of 1962 Act provides that goods manufactured in India and required as stores on any foreign going vessel may be exported free of duty.

Hence, on co-joint reading of the above provisions one can conclude that supply of stores on board a foreign going vessel shall qualify as zero-rated supplies as provided u/s. 16(1) of IGST Act.

Applicant further relied on ruling pronounced by Andhra Pradesh AAR in case of *M/s. Fairmacs Shipstores Private Limited [2018-TIOL-247-AAR-GST]* on similar issue.

Discussion by and observations of AAR

‘Export of goods’ as defined under Section 2(5) of IGST Act and 2(18) of 1962 Act shall mean taking goods out of India to a place outside India. Warehoused goods, as defined u/s. 2(44) of 1962 Act, refer to the goods imported and allowed to be deposited in a licensed warehouse. Section 69 of 1962 Act allows export of such warehoused goods without payment of import duty. Section 88(a) extends the same exemption to warehoused stores when they are taken on board a foreign going vessel subject to conditions stated above. The question is whether such stores, when taken on board any foreign going vessel, be construed as being taken to a place outside India.

The authority observed that supply of warehoused stores to a foreign going vessel, requires documentations like exports since they cross the limits of customs area.

Export of goods mean taking goods from India to a place outside India. Export under GST has much narrow meaning. Foreign going vessel anchored within the territory of India is not a place outside India and taking stores on board such a vessel does not amount to a location outside India. Hence, section 69 of 1962 Act cannot cover within the ambit of export the

case where warehoused stores are taken on board a foreign going vessel, unless it is marked specifically for a location outside India. Hence, such supplies do not amount to export of goods neither under the Customs nor under GST Act. Consequently, the same shall not be treated as zero-rated supplies.

The authority also made a remark that a special provision needs to be inserted u/s. 88(a) of 1962 Act to provide exemption from payment of import duty to warehoused stores when supplied on board a foreign going vessel.

Further, supply of warehoused goods to any person before clearance for home consumption is an activity or transaction listed out in paragraph 8(a) of Schedule III r.w. Section 7(2)(a) of CGST Act.

The applicant’s reference to the ruling pronounced by Andhra Pradesh AAR is misplaced. In the said case, the foreign going vessel was merely engaged in transporting the stores to a merchant ship located outside India. The stores were not to be consumed until the vessel crosses the territorial waters of India.

As far as, supply of stores (being manufactured in India) on board a foreign going vessel is concerned, applicant shall be liable to pay GST, unless it is marked specifically for a location outside India.

Ruling of AAR

Supply of stores to foreign going vessel, as defined u/s. 2(21) of 1962 Act, is not export or zero-rated supply, unless it is marked specifically for a location outside India.

However, supply of warehoused stores on board a foreign going vessel shall be treated neither as supply of goods nor supply of services in terms of paragraph 8(a) of Schedule-III r.w. Section 7(2)(a) of CGST Act.

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INDIRECT TAXES

Service Tax – Case Law Update



CA Rajiv Luthia & CA Keval Shah

1 | *M/s. Starcity Entertainment Pvt. Ltd. vs. CST, Mumbai*

2020 TIOL 222 CESTAT Mumbai

Background facts of the case

The appellant entered into conducting agreement dated 5th April 2002 executed with the 'conductor', M/s. Movie Time Cineplex Pvt. Ltd., for granting 'conducting rights'. The contract provides for an option to conductor for purchase, or lease of the theatre belonging to appellants for lump-sum consideration of ₹ 4 crores. M/s. Movie Time has paid ₹ 2.50 crores as interest free deposit & ₹ 43,250 per week as 'lease rental' till the transfer of property for 999 years on 14th August 2007 for 'lease rent' of ₹ 100 per annum and lump sum consideration of ₹ 1,25,00,000, which was adjusted from the security deposit, and on payment of an additional ₹ 50,00,000.

The SCN was issued on the finding that the transaction layered under misleading description for that very purpose, proposed to demand service tax renting of immovable property service between 1st July 2007 and 31st March 2009, on lease premium received and the lease receipts on which tax liability had not been discharged.

It was the contention of the appellant that amount received on account of lease for 999 years would not be taxable under Renting of immovable

property service be considered as a sale for all practical purposes. Hon'ble Supreme Court in case of *M/s. Ukhara Estate Zamindari (Pvt.) Ltd. vs. Commissioner of Income Tax, West Bengal* held that receipt of lease premium for 999 years is a capital income and not revenue income. The ITAT, Mumbai 'WT' Special Bench also in the case of, "*Voltas Ltd. vs. Assistant Commissioner of Wealth Tax, dated 16-11-2007*", had held that in the case of lease of any building for a term of not less than 12 years, by virtue of u/s. 269UA of the Income-tax Act, lessee shall be deemed to be the owner thereof in terms of the provisions of Section 4(8) of the Wealth Tax Act. Further, the lessee M/s. Movie Time Cineplex Pvt. Ltd. had paid stamp duty on entire value of consideration. And the amount of stamp duty payable for sale of a commercial property and lease of a commercial property exceeding 29 years is the same. Agreeing to the contentions of the appellant, the adjudicating authority dropped the demand of service tax. However, revenue preferred CCE(Appeals) and the OIO was reversed. Therefore the appellants have filed present appeal.

Arguments by the Appellant

- a) The transaction is nothing but a sale of immovable property and hence beyond the pale of taxability under Finance Act, 1994. While justifying that whether Service Tax is chargeable only on the lease rent

or also on one time premium amount charged in respect of long term leases, reliance was placed on the Apex Court in the case of **Commissioner of Income Tax, Assam and Manipur vs. Panbari Tea Co. Ltd.**, where a distinction between premium and rent observing that when the interest of the lessor is parted with for a price, the price paid is premium or salami, but the periodical payments for continuous enjoyment are in the nature of rent, the former is a capital income and the latter is the Revenue Receipt Thus, the premium is the price paid for obtaining the lease of an immovable property. While rent, on the other hand, is the payment made for use and occupation of the immovable property leased. Since taxing event under Section 65(105)(zzzz) read with Section 65(90a) is renting of immovable property, Service Tax would be leviable only on the element of rent i.e. the payments made for continuous enjoyment under lease which are in the nature of the rent irrespective of whether this rent is collected periodically or in advance in lump sum. Service Tax under Section 65(105)(zzzz) read with Section 65(90a) cannot be charged on the "premium" or 'salami' paid by the lessee to the lessor for transfer of interest in the property from the lessor to the lessee as this amount is not for continued enjoyment of the property leased.

- b) Reliance was also placed in **Greater Noida Industrial Development Authority vs. CST Noida [2015 (38) STR 1062 (Tri-Del)]**

Arguments by the Revenue

- a) Reliance was placed by Hon'ble High Court of Tripura in **Hobbs Brewers India Pvt. Ltd. vs. Union of India [2016 (45) STR 60 (Tripura)]** and in **RIICO Ltd. vs. Commissioner of Central Excise, Jaipur-I [2018 (10) GSTL 92 (Tri-Del.)]** wherein it is held that Service Tax on the premium received on leasing of land for the periods

of less than 30 years is leviable from 1st July, 2010.

Decision

- a) The appellant had initially contracted with M/s Movie Time for the use of theatre for 'conducting' and on exercise of option of purchase, transferred possession itself against annual 'lease rental' and one time premium components.
- b) The entire property, and its benefits thereof, had not been alienated by the appellant; the retention of right to built-up space above and around the contracted property was incorporated in the agreement. It could, therefore, by no means be determined to be a 'sale' agreement as commonly understood. Accordingly, the consideration is for the limited use of the property which squarely fall within the scope of section 65(105)(zzzz) of Finance Act, 1994
- c) The decision *in re* Hobbs Brewers India Pvt. Ltd. has made it abundantly clear that the claim of the petitioner therein for restricting the taxability to rent, and not the premium, was dismissed, thereby laying down the principle that 'premium' is nothing but an advance 'rent', and, therefore, taxable which was adopted by the Tribunal in RIICO Ltd. to hold that though premium was also taxable, an exception was carved out for lease tenor exceeding 30 years arising from the specific provision incorporated through section 104 in Finance Act, 1994. Admittedly, this provision does not apply to the present transaction.
- d) The decision in Greater Noida Industrial Development Authority that favours the appellant was vehemently contested by Learned Authorised Representative during the course of arguments *in re* RIICO Ltd.
- e) That the principle of taxability that found favour in Greater Noida Industrial

Development Authority was discarded in circumstances peculiar to that case and, the absence of challenge in such circumstances, is not to be presumed as acceptance of a contrary proposition. We, therefore, do not find any contradiction between the two decisions of the Tribunal warranting a different conclusion.

- f) Accordingly, the lump sum payment becomes liable to tax under Finance Act, 1994 in addition to the periodic payments

2 | *M/s. Aarms Value Chain Pvt Ltd. vs. CST, Bangalore*

2020 TIOL 354 CESTAT Bangalore

Background facts of the case

The appellants are engaged in providing Business Support Services and GTA Services. The appellant's unit was audited by the Departmental Audit Party on 22-2-2017 and 23-2-2017. During the course of Audit, it was observed by the Audit Party *inter alia* that the appellants, during the period from April 2011 to March 2016, had paid the Service Tax belatedly. The Audit Party quantified the interest on such delayed payment of Service Tax to the tune of ₹ 28,47,614/-. The Audit report was issued on 21st April, 2017.

The appellants partly paid interest amount of ₹ 47,178/-. The jurisdictional Assistant Commissioner was directed to recover the balance interest amount of ₹ 28,47,614/- under Section 87. Thereafter, the Range Officer issued various letters to the appellants to pay the interest amount forthwith. The appellants contended that the demand of interest is hit by time and they are liable to pay interest only from 2015-16 onwards and any amount due to the department should be demanded by way of issuing SCN and the same should go through the process of adjudication and finally, a speaking order needs to be passed.

The Lower Authority *vide* his letter, rejected the contentions of the appellants and held that non-payment of interest automatically becomes 'amount due' and hence the question of time bar

does not arise so also there is no need for issuance of SCN.

Aggrieved by the impugned letter issued by the Lower Authority, appellant filed appeal before the Commissioner who rejected the said appeal. Hence, the present appeal is filed.

Arguments by the Appellant

- a) The impugned order is not sustainable in law as the same has been passed without properly appreciating the facts and the law. That the impugned order has been passed merely to confirm the demand without considering the submissions put forth by them. He further submitted that it is a settled law that it is not enough if there is a section stating that a person shall pay the amount or tax. There should be machinery provisions to recover such amount due prescribing the procedure/process and such machinery provisions have to be followed.
- b) They contended that demand of interest can be raised only by way of issuance of SCN and period of limitation is applicable for demanding interest. It is evident that for recovery of interest under Section 75, the provisions of Section 73 would be applicable.
- c) That it is very much clear from the harmonious reading of the provisions of Sections 73, 75, 76, 78 of Finance Act, 1994 that to recover interest or penalty the issue of SCN is mandatory along with confirmation of demand of tax as well as appropriation if the same is paid. It is settled law, without confirmation of tax demand, calculation of interest cannot be done and penalty cannot be imposed. There is no SCN issued for demand of interest confirmed in the impugned order, which is not proper and legal.
- d) In the present case there is no demand of tax and therefore the provisions of Section 73(1B) read with Section 87 cannot be made applicable and further the audit objection of the Department is only on

recovery of interest and not service tax along with interest. Hence the provisions of Section 87 read with Section 73(1B) do not apply to the present case as tax is already paid and there is no recovery of tax.

- e) The substantial portion of the demand is barred by limitation. He further submitted that for demanding interest also, the period of limitation as prescribed under Section 73 would be applicable. He also submitted that in the present case, the demand is made for the period April 2011 to March 2016 and the same would be barred by limitation as no notice has been issued.

Arguments by the Revenue

- a) For the demand of interest, no show-cause notice is required as the recovery is proposed under Section 87. Further, submitted that in the present case the party has no objection to the liability of service tax and they paid it also but the payments were delayed and hence the interest is automatic when the duty is paid late.
- b) That interest liability is automatic and hence the issue of time limit prescribed for recovery of duty does not apply.

Decision

- a) Appellants have shown the tax arrears in their returns and subsequently paid the tax due. Subsequently, during the audit, the Department detected that there was a delay and the appellant is liable to pay the interest for the delay in payment of the tax.
- b) The original authority has given the decision in violation of the principles of natural justice and no opportunity whatsoever is given to the appellant to put forth his defence regarding the basis of calculation on which the interest payable is arrived.
- c) Section 73(1B) covers situation where self-assessed tax is not paid in part or in full, recovery of such tax with interest can be

made by invoking the provisions of Section 87 of the Finance Act, 1994 whereas in the present case there is no dispute regarding the payment of tax and the said payment of tax was paid much before the audit was conducted and there is no demand of tax in the present case.

- d) Reliance placed on the decision of *The Paper Products Ltd. vs. CCE, Mumbai - 2015-TIOL-559-CESTAT-MUM* wherein it is held that *Rules of natural justice are not embodied rules. Hence, it was not possible to make an exhaustive catalogue of such rules. Audi Alteram partem is a highly effective rule devised by the Courts to ensure that a statutory authority arrives at a just decision and it is calculated to act as a healthy check on the abuse or misuse of power.*
- e) As regards period of limitation, various decisions relied upon by the appellant cited supra and it has been consistently held that to demand interest also period of limitation is applicable. In the case of Kwalitiy Ice Cream Company, the Hon'ble Delhi High Court held that period of limitation prescribed for claim of principal amount should also apply to the claim for interest thereon.
- f) The impugned order is not sustainable in law and therefore, I set aside the same by allowing the appeal of the appellant.

3 | *Principal Commissioner, CGST Delhi South Commissionerate vs. M/s. Comparex India Pvt. Ltd.*

| *2020-VIL-26-CESTAT-DEL-ST*

Background facts of the case

The Respondent is engaged in the business of purchase and sale of software and software licenses. The respondent had procured the software from outside India and paid service tax under Reverse Charge Mechanism. As the

respondent had made substantial amount of exports, CENVAT Credit remained unutilized for which the refund has been claimed. In all there were refund claims for 6 periods out of which refund for 5 periods were sanctioned. The 6th refund was rejected on the grounds that the services provided by assessee do not qualify as export of service but rather they are intermediary services and not eligible for refund.

Revenue had preferred an appeal against the order granting refund and whereas the assessee had preferred an appeal against the order rejecting the refund. The Commissioner Appeals had passed all the Orders in favour of the assessee. The revenue preferred an appeal against the Order of Commissioner, Appeals contending that all 6 refund claims should had been rejected.

Arguments put forth

The revenue as the appellant submitted as under:-

- a) The Assessee is procuring branded/ packaged and customized software as per the requirements and purchase orders received from overseas customers. The nature of the provision of service in arranging and facilitating procurement of main services and transporting the same to the overseas domestic clients is, therefore, “intermediary” as defined in Rule 2(f) of the 2012 Rules.
- b) The sale of software is usually coupled with a condition of acceptance of software license agreement, which gives the buyer the “right to use” the software, subject to certain terms and conditions contained in the agreement.
- c) The nature of provision of service would, therefore, be “intermediary” and the place of provision of service would be the place of service provider, which is in India. The service would, therefore, not qualify as ‘export’ of service. The refund claim, therefore, deserves to be rejected.

The Assessee as the respondent submitted as under:-

- a) The respondent cannot be termed as an “intermediary” since in purchase and sale of software licenses it is providing services on its own account.
- b) It is neither a broker nor an agent of Microsoft India and nor does it work on commission basis. It independently negotiates the sale price with the overseas customers and price is not controlled by Microsoft India.
- c) In fact, it takes substantial risks as payment made to Microsoft India is independent of the payment made to the respondent by the overseas customers. The service rendered by the respondent qualifies as “export” of service.

Decision

- a) Respondent purchases the software from Microsoft and sells it either in the same condition or customized condition to the customers - no commission was paid by Microsoft to the respondent and in fact the respondent independently sold the license to the overseas customers, after purchasing them from Microsoft. Thus, the goods were supplied on its own account, thus the provision of service provided by the respondent has to be treated as “export of service” under Rule 6A of the 1994 Rules.
- b) Rule 9(c) provides that in the case of ‘intermediary services’, the place of provision shall be the location of the service provider. This Rule would not be applicable as the respondent is not an intermediary. On the other hand, Rule 3 that provides that the place of provision of a service shall be the location of the recipient of service. This Rule would be applicable and since the location of the recipient of service is outside India, the place of provision of the service would be outside India.

Accordingly, the appeal of the Appellant was dismissed.

4 | *Quick Heal Technologies Limited Vs Commissioner of Service Tax, Delhi*
2020-VIL-27-CESTAT-DEL-ST

Background facts of the case

The Appellant is engaged in sale of Antivirus Software to the users in packed CDs. Revenue contended that the Antivirus Software provided by the Appellant to the users in packed CDs falls under provision of service under “information technology software” and hence leviable to Service Tax prior to 1st July, 2012 as also after 1st July, 2012.

Arguments put forth

The Assessee as the appellant submitted as under:–

- a) The software developed by it can neither be manipulated nor does it provide any interactivity to a user and, therefore, does not satisfy the requirement of information technology software and so service tax was not required to be paid prior to or after 1st July, 2012 as the definition of ‘information technology software’ under section 65B(28) remained the same.
- b) Quick Heal Antivirus Software supplied in CD form, being a Canned Software, was goods and, therefore, not leviable to service tax and that the Appellant had been paying sales tax/VAT on sale of such Quick Heal Antivirus Software.
- c) Generation of license key/code was neither a manufacturing activity nor service and that license key was neither software nor could it function or work as Antivirus Software. The updates/upgrades were free, and the activity was without consideration and, therefore, not a service.

The Revenue as the respondent submitted as under:–

- a) The supply of Quick Heal *Anti-virus* Software under the EULA is a service classifiable under “information technology software”. Software that is supplied under EULA is not a pure sale because “Quick Heal” grants the licensee a nonexclusive and non-transferable right. The software and the accompanying written materials are the property of “Quick Heal”.
- b) The Adjudicating Authority observed that the first stage of the transaction relating to recording of the software on the CDs and making them marketable makes them goods chargeable to Central Excise Duty and so there was no dispute about duty payment at this stage. However, the second part of the transaction i.e., providing the CD containing the software to the end customer under the license agreement, was the subject matter of dispute and was liable to service tax.

Decision

- a) The Supreme Court in *Tata Consultancy Services* held that intellectual property, once it is put on the media and marketed could become goods and that a software may be intellectual property and such intellectual property contained in a medium is purchased and sold in various forms including CDs would be goods chargeable to sales tax/VAT and no service tax can be levied.
- b) The transaction in the present Appeal results in the right to use the software and would amount to deemed sale. It is, therefore, not possible to accept the contention of the learned Authorized Representative of the Department that the transaction would not be covered under sub-clause (d) of Article 366(29A) of the Constitution.

Accordingly, the appeal of the Appellant was allowed.





Makarand Joshi,
Company Secretary

Companies Act-1

Registrar of Companies, Kerala (Appellant) vs. Ayoli Abdulla (Respondent)– NCLAT, New Delhi – Order dated 4th December, 2019

Facts of the case

- Respondent Company was under the **management dispute since 2011**, which was **settled before NCLT**, Chennai bench by order dated **7th August, 2017**.
- Respondent was reinstated as MD by order and declared **all the documents filed after 27-4-2011 as null and void**.
- The above documents also **includes Annual Financial Statement and Annual returns** for FY *viz.*, **2003-04 to 2010-11** filed on 7th October, 2011 under Company Law Settlement Scheme (**CLSS**).
- NCLT, Chennai bench passed an order directing the ROC to restore the name of the Company in the Register of Companies.
- Further the Company whose name is to be restored was directed to file all the pending annual returns and balance sheets and also

directed the Registrar of Companies to waive the amount of additional fee.

- Appellant being aggrieved by order for waiver of additional fees in filing of statutory returns of the company, filed an appeal before NCLAT.

Arguments

Registrar of Companies, Kerala (ROC) contended **No objection in restoring name** of the Company in Register of Companies. ROC **raised objection** against the **order for waiver of additional fees granted by NCLT** Chennai bench stating following:

- **Sec. 403** of Companies Act, 2013 specifically mentions about documents required to be filed within time specified in the relevant provision on payment of such fees as may be prescribed and also says that if **documents not submitted within prescribed time then the same can be filed on payment of such fees as may be prescribed**.
- Similarly Rule 87-A(4) of the NCLT Amendment Rules, 2016, mentions that the appellant or applicant pay to ROC

his costs. Further it also states that “*The Company shall file pending financial statements and annual returns with the Registrar and comply with the requirements of the Companies Act, 2013 and rules made thereunder within such time as may be directed by the Tribunal.*”

Held

After considering the above submissions, held that:

- NCLT per se has no power to waive the filing fees and additional fees
- Hence NCLAT set aside order dated 7th March, 2019 passed by NCLT, Chennai Bench to the extent of waiver of additional fees for filing Balance Sheet and Annual Return.
- ROC is directed to charge minimum additional fees in view of circumstances described above.

Companies Act-2

Achintya Kumar Barua alias Manju Baruah and another (Appellant) vs. Ranjit Barthkur and another (Respondent) – National Company Law Tribunal, Delhi, order dated 8th February, 2018

Facts of the case

- Respondent moved application before the NCLT, Guwahati seeking facility of attending the Board meeting through video conferencing.
- NCLT allowed the application filed by respondent directing that the facility under Sec. 173(2) of the Companies Act, 2013 should be made available.
- Aggrieved by order of NCLT, appellant filed appeal on behalf of the company.

Arguments

Appellant on behalf of company contended that:

- Appellants has **apprehension** that when the respondent participates in the meetings through video-conferencing, **it would not be possible to ensure that nobody else is present** from where the respondent would be participating.
- Secretarial Standard on meeting of Board of Directors (SS-1) states that such participation can be done “*if the company provides such facility.*” it was stated that **option of video conferencing provided** under Companies Act, 2013 and rules thereof **should be resorted to only when the facilities are provided by the Company** to its directors.
- Use of word ‘**may**’ in the **Sec. 173(2)** of Companies Act, 2013 makes it clear that the provision is **directory and not mandatory** to be followed.
- Further **Rule 3(2)(e) of Company** (Meetings of Board and its powers) Rules, 2014 (Rules) casts **responsibility on chairperson** to ensure that no other person is attending or having access to the proceedings of the meeting through video conferencing.
- It is contended that it would **not be possible for chairperson** as the **chairperson would have no means to know as to who else is sitting in the room or place concerned.**

Held

- The provision related to attending meeting through video conferencing has been introduced under Companies Act, 2013 and these provisions would be in the **interest of the Companies as well as directors.**

It would **not be appropriate to shut-out** these **provisions on mere apprehension.**

- Further court took note that the Central Govt. (CG) by notification provides that which matters shall not be dealt with in a meeting through video conferencing.
- The word ‘**may**’ used in Sec. 173(2) only **gives an option to director** to choose whether he is participating in person or through video conferencing.
- The word ‘**may**’ **does not give option to the company to deny this right** given to director for participation through video conferencing.
- Further sub-rule (5) to (12) of Rule 3 deals with further aspect of regarding holding meeting, drafting minutes, circulation as well as recording in minutes book.
- Therefore it is clear that the **company shall comply with the procedure prescribed for convening and conducting board meeting through Video conferencing.**
- On argument that it is not possible for chairperson to ensure no other person is attending with concerned director, the court stated that **Rule 3(4)(d) also casts the responsibility on director participating through video conferencing**, therefore does not find force in submission.
- Section 173(2) of the Companies Act, 2013 **gives right to a director to participate in the meeting through video conferencing** and CG has notified **rules to enforce this right** and it would be in the **interest of the company to comply with the provision in public interest.**

- Guidelines provided under **SS-1 cannot override the provisions and the Rules.**
- **NCLT took note of the fact** that the **Company** in this matter **had the entire necessary infrastructure available** and found that the Company had **no reason not to provide the concerned facility.**
- The **appeal is disposed** of by directing company to provide the facilities as per Section 173(2) of the Companies Act, 2013 subject to fulfilling the requirements of Rule 3(3)(e) of the Rules.

Companies Act-3

Unfair Valuation by the Valuer

Ankit Mittal (Appellant) vs. Rama Investment Company Private Limited and Anr., National Company Law Appellate Tribunal (“NCLAT”), New Delhi dated 29th November, 2019

Brief Facts of the case

- In the year 2017, National Company Law Tribunal (NCLT) Chennai bench has approved amalgamation of 6 (six) companies into Rama Investment Company Private Limited (hereafter after referred as transferee Company).
- Further, 2 (two) more identified undertaking of other 2 (two) companies were also to be transferred to the transferee. (Hereinafter all these companies are referred as Respondent companies)
- Being aggrieved by the said Amalgamation Scheme Ankit Mittal (Appellant) approached NCLAT, Delhi.

Key Arguments

On part of Appellant

- The Appellant stated that the Respondent Companies have approached NCLT for amalgamation as stated above.

- Further the Regional Director (RD) Southern Region, raised concerns over the merit of the Amalgamation Scheme which were not properly addressed by the Respondents but NCLT, Chennai sanctioned the Amalgamation Scheme without ensuring the objections of the Regional Director are satisfied.
- The appellant also stated that Amalgamation Scheme is impermissibly promoter oriented and anti-minority/public shareholders and is illegal, unlawful, unjust and against the public policy in India
- Further, the Valuation report of the scheme is a completely unreasoned document. The swap ratio of shares is absolutely illegal unjust and one sided. The intrinsic value of the **individual shares was not considered while deciding the swap ratio.**

On part of Respondents

- The valuation and the swap ratio are correct and the process adopted by an expert to arrive at a value/swap ratio are in the wisdom of commercial experts and due principles of equity and valuation are considered.

Held

- NCLAT Highlighted the duties of valuer – as to make an impartial, true and fair valuation of any assets; exercise due diligence; make valuation in accordance with rules
- Noted that the valuer made a **valuation disregarding the methodology, share entitlement ratio**
- No valuation of each share of every company has been done to arrive at the

exchange ratio and only guess work has been done to arrive at share exchange ratio.

- Further noted that the swap ratio *inter se* Respondent 2 and Respondent 9 in the scheme of amalgamation is *prima facie* erroneous
- The exchange ratio can be termed as guess work by the valuer
- The scheme based on such a **valuation report loses its creditability.** It would be unfair to approve such scheme whose **foundation is seriously compromised**
- NCLAT held that the respondent has adopted cavalier approach. The objections raised by the RD were material and the NCLT order has given no good reasons to ignore the objections of RD
- The amalgamation scheme based on **faulty valuation report** cannot be termed as fair to all stakeholders and therefore NCLAT set aside NCLT order approving amalgamation scheme based on unfair valuation report.

SEBI-1

SEBI Adjudication Order – Understating of loans and manipulation of financials

Type of Proceedings: SEBI Adjudication Order

In respect of Shri Mani Oommen, Partner M/s. C.B. Moulli & Associates, Chartered Accountants (“Noticee”)

Facts of the case

- SEBI conducted investigation into the financial statements of Deccan Chronicle Holdings Ltd. (“the Company/DCHL”) for the financial years from 2005-06 to

2011-12. Investigation revealed that aggregate amount of outstanding loan term and short loans of the Company at the end of FY 2008-09 was ₹ 1,693.67 crore, whereas the Company in its annual reports for the FY 2008-09 had disclosed only ₹ 354.49 crore as outstanding long term and short term loans.

- DCHL had understated its outstanding loans to the tune of ₹ 1,339.67 crore for the year 2008-09. Similarly, the differences between the actual and reported outstanding loans for FY 2009-10 and FY 2010-11 were found to be ₹ 2,982.07 crore and ₹ 3,347.41 crore. DCHL had understated the interest and financial charges from financial year 2005-06 onwards and the cumulative amount of such understated amount stood at approx. ₹ 753.91 crore by the end of 2011-12 (up to September 2012). DCHL had entered into a settlement agreement with Deccan Chronicle Marketeters (“DCM”) under which DCHL was transferring major portion of its own outstanding loans and the financial charges thereon to DCM on the last of the financial year so as to understate the liabilities in its balance sheets and interest expenditure in its profit and loss accounts. So DCM agreed to own up those loans and financial charges that rightfully belonged to DCHL.
- DCHL has manipulated its financials and the announcement for buyback of its securities was made even in the absence of adequate reserves. Noticee was the Statutory Auditor of DCHL during the financial years 2008-09 to 2010-11 and Shri Mani Oommen, Partner, had signed the annual reports of the company in the capacity of Statutory Auditors.

Arguments

By Noticee

- The responsibility for preparation and presentation of the financial statements as well as designing, implementation and maintenance of internal controls relevant for the preparation and presentation of financial statements so that they are free from material misstatements, is of the management of the Company.
- **The responsibility of a Statutory Auditor is only to express an opinion on the financial statements based on Internal Audit (Standard on Auditing - 200).** There are standards prescribed by ICAI which clearly specify what an Auditor is expected to do reasonably to reduce the risk of any misstatement in the financials, but that would not imply that an Auditor could be charged with gross negligence or fraud where some misstatements remain undetected, though the Auditor has performed the procedures properly.
- That the **audit was carried out as per standards notified by the ICAI.** The Auditor’s report states that the evidence supporting the amounts and disclosures in the financial statements were examined on test basis and opinions expressed in the report has reasonable basis. Noticee further stated that as per information and explanation given to them by the Company during the course of auditing of books of account for FY 2011-12 most of the short term loans taken in the name of the Company and interest and finance charges thereon were not disclosed in the Trial Balance and Balance Sheet for the FY 2008-09, 2009-10 and 2010-11 **on account of internal accounting adjustment and arrangement.** Loans and interest/

finance charges for FY 2008-09 to 2010-11 were not reflected in Trial Balances and Balance Sheets. These Balance Sheets were prepared after netting-off loans against receivables and understated loans/liabilities which were not disclosed in the Balance Sheets and were also not part of ITRs.

- The transaction between *DCHL* and Deccan Chronicle Marketers (“*DCM*”) was not disclosed as related party transaction in the financial statements of *DCHL* since the transactions/arrangement were not recorded/disclosed in the register maintained under Section 301 of the Companies Act, 1956.
- The transactions and agreements between *DCHL* and *DCM* were brought to their notice for the first time during the audit of books of account for the FY 2011-12, as *DCHL* undertook an exhaustive review of its policies with regard to sale of its advertisement space and brand building strategies and discontinued arrangement with *DCM* w.e.f 1st April 2011. When they noticed the arrangement/transactions, the same was categorically qualified in the Auditors’ Report (page No. 22 & 23 of Annual Report for FY 2011-12).
- The above accounting adjustments (non-disclosure of loans by transferring to other entity) were brought to the notice of the auditors for the first time during the audit of the books of account for FY 2011-12 in the month of October/November 2012. The loans appearing in the Trial Balances furnished for FY 2008-09 to 2010-11 during the course of audit for the respective years have matched with the Balance Sheets submitted for the above financial years.
- In the year 2011-12, the management of *DCHL* undertook an exhaustive

review of its policies with regard to sale of its advertisement space and brand building strategies. Based on the review, management of *DCHL* discontinued the arrangement with *DCM* w.e.f. April 1, 2011 as *DCM* had reneged on its commitments and the Company had no other option but to reinstate the liabilities to protect its credibility with the lenders.

- The above adjustments may be considered as an omission to make suitable disclosure in the financial statements for the aforesaid financial years and cannot be treated as misleading financial information.

By SEBI

SEBI considered the contentions of Noticee devoid of any merit.

- ***Statutory Auditor owes responsibility to company:*** In this respect, SEBI referred Section 224 r/w Section 227 of the Companies Act, 1956. In terms of the above mentioned sections in case of a public listed company, the statutory auditors owe an obligation to the shareholders of a company to report the true and correct facts about its financials since it is not only appointed by the shareholders in the AGM of the company but at the same time required to report true and correct position to the member of the company. Undoubtedly an auditor is duty bound to be absolutely and completely diligent and cautious while preparing, signing and certifying Annual Accounts and/or any other Audit report.
- ***Auditor shall use professional skepticism:*** SEBI held that the statutory auditors should plan and perform an audit with an attitude of professional skepticism. While performing his job, a statutory auditor should not only comply with the

relevant accounting standards prescribed by the ICAI but also should identify and understand major classes of transactions in the entity's operations, how such transactions are initiated and also should examine the significant accounting records, supporting documents and specific accounts in the financial statements, the accounting and financial reporting process, and the significant transactions as well as the extraordinary events that might have taken place during the year which ought to be incorporated in the financial statements of the company.

- **O/s loans were significant:** The outstanding loans - short terms as well as long term, availed by a company, and interest and finance charges payable thereon which were not reported in the accounts prepared by the Company and its directors, by all standards had significant financial implications for the Company. Outstanding loan amount transferred to the books of DCM constituted 61.46% (approx. ₹ 800 crore) of the total outstanding loan amount of DCHL during the FY 2008-09.

During the next two financial years also, the percentage of loans taken by DCHL supposedly against the dues receivable from DCM *vis-à-vis* the total outstanding loans availed by the Company in its own name increased to 76.54% and 78.73%, respectively.

In such circumstances, the auditor certainly had an obligation to check the outstanding loan details from banks or other independent sources before being satisfied with the amount of outstanding loan presented by the management.

- **Audit evidence necessary:** Audit evidence as per Auditing and Assurance Standard

(AAS 5) is necessary to support the auditor's opinion and report.

Considering the materiality and the magnitude of outstanding loans, the auditor should have at least carried out some independent assessment based on documents other than the statements provided by the Company.

In this case, the loans were being transferred /adjusted by the *Company* reportedly from the year 2005-06 onwards, hence, the auditor was duty bound to understand the major sources of revenue generation and realisation of the revenue from that source. The auditor has stated in Auditors' Report that "*audit includes examining on a test basis*". The auditor has not demonstrated in his reply as to whether independent confirmation from the banks regarding outstanding loans was obtained by him at least on a test basis from some banks.

- **Auditor remained oblivious:** Auditors remained oblivious to the fact that the Company was borrowing from banks/FIs, year after year, to offset the amounts receivable from DCM against such borrowings and was doing such book entry transfer of liabilities on the last day of every financial year. It shows that the auditor miserably failed to identify and verify the loan accounts of the Company despite conducting statutory audit of the Company for a long period of three years, during which the other Noticees (*here mean DCHL, Chairman, Vice-Chairman, MD*) were continuously understating the accounts of the *Company*.

The contention of the auditor that they became aware of the adjustment of loan for the first time during their auditing exercise

for the financial year 2011-12 is highly improbable, and such an explanation rather indicates a high probability of complicity of the auditor with the Company in their strategy to manipulate the accounts and to understate the liabilities in the Balance Sheets of the Company.

- ***Lack of evidence to show that audit was done with due diligence:*** SEBI further held that *Shri Mani Oommen* has not disputed the fact that the interest amount on the loans taken by the Company was not being shown as expenditure in the Profit and Loss account of the Company. No explanation has been furnished by *Shri Mani Oommen* justifying as to why the loans and interest liability thereon was shown as transferred to the books of *DCM* on the last date of a financial year and again were brought back to the accounts of *DCHL* on the first date of the next financial year.

Shri Mani Oommen has not brought any evidence to show that he had audited the books of account with due diligence and care and that he had raised all possible queries expected to be raised by any prudent auditor to the management in the normal course of his work.

- ***Auditor colluded with the Company:*** SEBI stated that *Shri Mani Oommen*, by not pointing out the bogus transfer of loan liability to and fro between the books of *DCHL* and *DCM*, has not only failed to perform his basic duty of an auditor but at the same length has blindly allowed the forging of the books of account of *DCHL* to be continued for years together. Such a serious lapse on his part clearly suggests that the Company's auditor has actively colluded with the other Company and its directors.

Held

- ***Shri Mani Oomen shall not directly or indirectly issue any certificate of audit and render any other auditing services including issuances of certificates of compliances whatsoever, to any listed companies and intermediaries registered with SEBI in compliance with the requirements under the SEBI Act, 1992, the SCRA 1956, the Depositories Act, 1996, and those provisions of the Companies Act 2013 which are administered by SEBI under section 24 thereof and also the Rules, Regulations and Guidelines made under those Acts which are administered by SEBI for a period of one year. Noticee shall complete such ongoing audit assignments as expeditiously as possible but not later than 6 months from the date of this Order.***

Case referred: CA Rajesh Dudhwala vs. Disciplinary Committee (6th November 2012, Hon'able Gujarat High Court)

IBC

M/s. JSW Steel Ltd., (Appellant) vs. Mahender Kumar Khandelwal & Ors. (Respondents) dated 17th February, 2020 National Company Law Appellate Tribunal, (NCLAT) New Delhi

Facts of the case

- National Company Law Tribunal (NCLT) New Delhi has approved the 'Resolution Plan' submitted by 'JSW Steel Limited' ('Resolution Applicant') for the 'Corporate Insolvency Resolution Process' ('CIRP') of 'Bhushan Power & Steel Limited' ('Corporate Debtor').
- The Resolution Plan was approved by the NCLT under Section 31 of Insolvency and Bankruptcy Code, 2016 (IBC) by the

impugned judgement dated 5th September, 2019 with certain conditions.

- After the approval of plan, when Monitoring Committee was monitoring the change of management, on 10th October, 2019, the assets of Corporate Debtor were attached by Directorate of Enforcement of Central Government under Section 5 of the ‘Prevention of Money Laundering Act, 2002’ (PMLA).
- Resolution Applicant raised objection and challenged the jurisdiction of Directorate of Enforcement to attach the properties of the ‘Corporate Debtor’ after change of hands.
- Hon’ble the President of India promulgated an Ordinance on 28th December, 2019 making amendments in the ‘Insolvency and Bankruptcy Code, 2016’ (IBC) by inserting Section 32A which speaks about the Liabilities for offences prior to the CIRP.

Question for consideration

Whether it is open to the Directorate of Enforcement to attach the assets of the Corporate Debtor on the alleged ground of money laundering by erstwhile Promoters after approval of a Resolution Plan u/s. 31 of the IBC?

Arguments by the Appellant

- Once the Resolution Plan is approved by the NCLT it is binding on all stakeholders.
- Section 31 of the IBC which was amended by the Insolvency and Bankruptcy Code (Amendment) Act, 2019 on 16th August, 2019, makes it amply clear that a Resolution Plan is binding on Central Government (CG) and all statutory authorities.
- If any corporate debtor is undergoing investigation by the Central Bureau of

Investigation (“CBI”), Serious Fraud Investigation Office (“SFIO”) and/or the Directorate of Enforcement (“ED”), such investigations are separate and independent of the CIRP under the IBC and both run simultaneously and independent of each other.

- The erstwhile management of a company would be held responsible for the crimes, if any, committed under their regime and the new management taking over the company after going through the IBC process cannot be held responsible for the acts of omission and commission of the previous management
- In so far as the **corporate debtor or its assets are concerned**, after the completion of the CIRP, there cannot be any attachment or confiscation of the assets of the Corporate Debtor by any enforcement agencies after approval of the Resolution Plan
- The purpose and scheme of the CIRP is to hand over the company of the corporate debtor to a *bona fide* new Resolution Applicant.
- Any threat of attachment of the assets of the corporate debtor or subjecting the corporate debtor to proceedings by investigating agencies for wrong doing of the previous management will defeat the very purpose and scheme of CIRP, which *inter alia* includes resolution of insolvency and revival of the company, and the efforts of the bank to realise dues from their NPAs would get derailed.
- ED while conducting investigation under PMLA is free to deal with or attach the personal assets of the erstwhile promoters and other accused persons, acquired through crime proceeds and not the assets

of the Corporate Debtor which have been financed by creditors and acquired by a *bona fide* third party Resolution.

- In so far as a Resolution Applicant is concerned, they would not be in wrongful enjoyment of any proceeds of crime after acquisition of the Corporate Debtor and its assets, as a Resolution Applicant would have bona fide assets acquired through a legal process.
- Therefore, upon an acquisition under a CIRP, a Resolution Applicant, the Corporate Debtor and its assets are not derived or obtained through proceeds of crime under the PMLA and need not be subject to attachment by the ED after approval of Resolution Plan by the NCLT.

Arguments by the Respondent (ED)

- The NCLAT should call for declaration by way of an affidavit from the successful Resolution Applicant to make self-declaration that whether the benefits of section 32A(1) & (2) would be available to them and whether the Resolution Applicant was a promoter or in the management or in the control of the Corporate Debtor or a related party
- Section 32A was introduced on 28th December, 2019 and is prospective in nature and would not apply to Resolution Plan as the same has been approved u/s. 31 of the IBC on 5th September, 2019.

Held

- The plea of the ED cannot be accepted as there is no mandate in section 32A that the successful Resolution Applicant after the approval of the plan is required to give such declaration as to whether the benefit of section 32A will be applicable to them

or not. Only the competent authority can decide such matter.

- The Resolution Plan having been approved by impugned order dated 5th September, 2019, is binding on Corporate Debtor, its employees, creditors including the Central Government, any State Government or any local authority to whom a debt in respect of the payment of dues arising under any law for the time being in force.
- Attachment of property/assets order against the Corporate Debtor was passed u/s. 5 of the PMLA on 10th October, 2019 i.e., after one month seven days
- Due to contradictory views, between the CG Departments, after the deliberation with the CG, the ordinance was issued by the President on 28th December, 2018.
- The preamble suggests that a need was felt to give the highest priority in repayment to last mile funding to corporate debtors to present insolvency in case the company goes into CIRP or liquidation, to provide immunity against prosecution of the corporate debtor, to prevent action against the property of such corporate debtor and the successful resolution applicant subject to fulfilment of certain conditions and to fill the critical gaps in the corporate insolvency framework, it has become necessary to amend certain provisions of the IBC.
- As the attachment order was passed by the Deputy Directorate of Enforcement after the approval of resolution plan, the matter was taken to the Central Government to decide as to whether to provide immunity against the prosecution to the ‘Corporate Debtor’ or to take action against the ‘Corporate Debtor’ and the ‘Successful Resolution Applicant.

- The Ordinance having issued pursuant to direction of NCLT to the CG which on deliberation resulted into issuance of Ordinance, we hold that Section 32A will be applicable to the present case
- Interpretation that Section 32A of the IBC is prospective in nature and the benefit of such provision cannot be claimed by the Appellant is wrong and misplaced.
- A plain reading of Section 32A(1) and (2) clearly suggests that the Directorate of Enforcement/other investigating agencies do not have the powers to attach assets of a ‘Corporate Debtor’, once the ‘Resolution Plan stands approved and the criminal investigations against the ‘Corporate Debtor’ stands abated.
- Section 32A of the IBC does not in any manner suggest that the benefit provided thereunder is only for such Resolution Plans which are yet to be approved. Further, there is no basis to make distinction between a Resolution Applicant whose Plan has been approved post or prior to the promulgation of the Ordinance.
- In light of the above, the ED while conducting investigation under PMLA is free to deal with or attach the personal assets of the erstwhile promoters and

other accused persons, acquired through crime proceeds and not the assets of the Corporate Debtor which have been financed by creditors and acquired by a *bona fide* third party Resolution Applicant through the statutory process supervised and approved by the NCLT under the IBC.

- In so far as a Resolution Applicant is concerned, they would not be in wrongful enjoyment of any proceeds of crime after acquisition of the Corporate Debtor and its assets, as a Resolution Applicant would be *bona fide* assets acquired through a legal process. Therefore, upon an acquisition under a CIRP by a Resolution Applicant, the Corporate Debtor and its assets are not derived or obtained through proceeds of crime under the “PMLA” and need not be subject to attachment by the ED after approval of Resolution Plan by the NCLT.

Note: In the same judgment, ED also raised the question of Resolution Applicant being related party. The question would be taken in next publication. Curious readers may read the judgment in the meantime

<https://ibbi.gov.in/uploads/order/21db96b041a8c94300d9c73a89128265.pdf>

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Those who cannot work with their hearts achieve but a hollow, half-hearted success that breeds bitterness all around.

– A. P. J. Abdul Kalam



CA Mayur Nayak, CA Natwar Thakrar & CA Pankaj Bhuta

OTHER LAWS

FEMA – Update and Analysis

In this article, we have discussed recent amendments made in FEMA through Press Note, Clarification by DPIIT and FAQs issued by RBI. In addition to it, few selected recent compounding orders issued by RBI are also discussed.

A. Review of Foreign Direct Investment (FDI) Policy in Insurance Sector

The Department for Promotion of Industry and Internal Trade (DPIIT), upon review of the Consolidated Foreign Direct Investment (FDI) Policy, 2017, while keeping 49% FDI ceiling for Core Insurance Companies, has allowed 100% FDI in insurance intermediaries as detailed in Para 5.2.22.2.

Accordingly, Para 5.2.22 of FDI Policy stands amended as under-

<i>Sector/Activity</i>	<i>% Equity/FDI Cap</i>	<i>Entry Route</i>
5.2.22.1 Insurance Company	49%	Automatic
5.2.22.2 Insurance intermediaries including insurance brokers, reinsurance brokers, insurance consultants, corporate agents, third party administrators, surveyors and loss assessors and such other entities as may be notified by Insurance Regulatory and Development Authority (IRDA) from time to time.	100%	Automatic

The foreign investment in insurance sector shall be subject to following conditions-

- (a) Total foreign holding, including portfolio investments in Insurance Company shall not exceed 49%.
- (b) The foreign investment up to 49% under the automatic route is subject to approval/verification by the IRDA.

- (c) The foreign investment in this sector shall be subject to compliance with the provisions of the Insurance Act, 1938 and companies receiving FDI are required to obtain necessary licence/approval from the IRDA for undertaking insurance and related activities.
- (d) Ownership and control at all the times shall remain in the hands of resident Indian entities as determined by the Department of Financial Services/IRDA as per rules regulations issued by them from time to time.
- (e) Foreign Portfolio Investment in an Indian Insurance Company shall be governed by the provisions contained in sub-regulation (2), (2A), (3) and (8) of Regulation 5 of FEMA Regulations, 2000 and provisions of Securities and Exchange Board of India (Foreign Portfolio Investors) Regulations, 2014.
- (f) Any increase in foreign investment in an Indian Insurance Company shall be in accordance with the pricing guidelines specified by RBI under FEMA Regulations.
- (g) The foreign equity investment cap of 100 per cent shall apply on the same terms as above to insurance brokers, reinsurance brokers, insurance consultants, corporate agents, third party administrators, surveyors and loss assessors and such other entities as may be notified by IRDA from time to time.
- However, the condition of Indian owned and controlled, as specified in Clause (d) above, shall not be applicable to Intermediaries and Insurance Intermediaries and composition of the Board of Directors and key management persons shall be as specified by concerned regulators from time to time.
- (h) The foreign Direct Investment proposals shall be allowed under the automatic route subject to verification by the Authority and the foreign investment in intermediaries or insurance intermediaries shall be governed by the same terms as provided under Rules 7 and 8 of the Indian Insurance Companies (Foreign Investment) Rules, 2015 as amended from time to time.
- However, where an entity like a Bank, whose primary business is outside the insurance area, is allowed by the IRDA to function as an insurance intermediary, the foreign equity investment caps applicable in that sector shall continue to apply, subject to the condition that the revenues of such entities from their primary (i.e., non-insurance related) business must remain above 50 per cent of their total revenues in any financial year.
- (i) The insurance intermediary having majority foreign shareholding shall undertake the following:
- i) Be incorporated as a limited company under Companies Act, 2013;
 - ii) At least one from among the Chairman of the Board of Directors or the Chief Executive Officer or the Principal Officer or Managing Director of the Insurance intermediary shall be resident Indian citizen;
 - iii) Shall take prior permission of the authority for repatriating dividend;
 - iv) Shall bring in the latest technological, managerial and other skills;
 - v) Shall not make payments to the foreign group or promoter or subsidiary or interconnected or associate entities beyond what is necessary or permitted by the authority;

- vi) Shall make disclosures in the formats to be specified by the authority of all payments made to its group or promoter or subsidiary or interconnected or associate entities;
- vii) Composition of the Board of Directors and key management persons shall be as specified by the concerned regulator;
- (j) The provisions of paragraphs (i)(b) and (d) of Annexure 9 relating to “Banking - Private Sector” shall be applicable in respect of bank promoted insurance companies.

(Comments: Relaxation in FDI norms for insurance sector will open doors for foreign investors including insurance and insurance brokerage companies to buy stake in Indian companies. This will bring in global practices, new and varied insurance products resulting into healthy development of the sector.)

B. Clarification on FDI Policy on Single Brand Retail Trading (SBRT)

DPIIT had received representations from various business entities regarding clarification on FDI Policy on Single Brand retail Trading (SBRT) as contained in Para 5.2.15.3 of Press Note 4 (2019). In that regard, DPIIT has clarified that:

Issue: Whether sourcing of goods from units located in SEZ in India would qualify as sourcing from India, as per FDI Policy?

Clarification by DPIIT

- As per the extant FDI Policy, in respect of proposals involving foreign investment beyond 51%, sourcing of 30% of the value

of goods procured, will be done from India.

- As regards, sourcing of goods from units located in SEZs in India, it is clarified that sourcing of goods from such units would qualify as sourcing from India for the purpose of 30% mandatory sourcing from India for proposals involving FDI beyond 51%, subject to SEZ Act, 2005 (as amended from time to time) and other applicable laws/rules/regulations.
- It is further clarified that goods which are proposed to be sourced by an SBRT entity from such units have to be manufactured in India.

C. Updation through FAQ issued by RBI

- **Accounts in India by Non-residents**
RBI update on FAQ on Account in India by Non-residents as on 12th February 2020 contains the following changes:
- Answers to Question No. 6, 11 and 12 has been updated. (*update is highlighted in italics*)

Q.6 What is an SNRR account? How is it different from an NRO account?

Ans: Any person resident outside India, having a business interest in India, can open a Special Non-Resident Rupee Account (SNRR account) with an authorised dealer for the purpose of putting through *bona fide* transactions in rupees which are in conformity with the provisions of the Act, rules and regulations made thereunder.

The differences between SNRR account and NRO account are:

<i>Feature</i>	<i>SNRR Account</i>	<i>NRO Account</i>
<i>Who can open</i>	<i>Any person resident outside India, having a business interest in India for putting through bona fide transactions in rupees.</i>	<i>Any person resident outside India for putting through bona fide transactions in rupees.</i>
	<i>Opening of SNRR accounts by Pakistan and Bangladesh nationals and entities incorporated in Pakistan and Bangladesh requires prior approval of Reserve Bank.</i>	<i>Individuals/entities of Pakistan nationality/origin and entities of Bangladesh origin require the prior approval of the Reserve Bank of India. However, a citizen of Bangladesh/Pakistan belonging to minority communities in those countries i.e. Hindus, Sikhs, Buddhists, Jains, Parsis and Christians residing in India and who has been granted LTV or whose application for LTV is under consideration, can open one NRO account with an AD bank subject to the conditions mentioned in Notification No. FEMA 5(R)/2016-RB dated April 1, 2016, as updated from time to time.</i>
<i>Type of Account</i>	<i>Non-interest bearing</i>	<i>Current, Savings, Recurring or Fixed Deposit; Rate of interest – as per guidelines issued by Department of Regulation.</i>
<i>Permissible Transactions</i>	<i>Debits and credits specific/incidental to the business proposed to be done by the account holder</i>	<i>Credits: Inward remittances, legitimate dues in India, transfers from other NRO accounts and any amount received in accordance with the Rules/Regulations/Directions under FEMA, 1999. Debits: Local payments, transfer to other NRO accounts, remittance of current income, settlement of charges on International Credit Cards.</i>
<i>Tenure</i>	<i>Concurrent to the tenure of the contract/period of operation/the business of the account holder and in no case should exceed seven years, other than with approval of the Reserve Bank.</i>	<i>No such restrictions on tenure.</i>

<i>Feature</i>	<i>SNRR Account</i>	<i>NRO Account</i>
	<i>Restriction of seven years is not applicable to SNRR accounts opened for the purposes stated at sub-paragraphs (i) to (v) of paragraph 1 of Schedule 4 of FEMA 5(R).</i>	
<i>Repatriability</i>	<i>Repatriable</i>	<i>Not repatriable except for current income; and remittances by NRIs/PIOs up to USD 1 million per financial year in accordance with the provisions of FEMA 13(R).</i>

Q.11 Can a Portfolio Investor or a Foreign Venture Capital Investor open a foreign currency account in India?

Ans.: Yes, a Foreign Portfolio Investor or a Foreign Venture Capital Investor both registered with the Securities and Exchange Board of India (SEBI) under the relevant SEBI regulations can open and maintain a non-interest bearing foreign currency account for the purpose of making investment in accordance with ***Foreign Exchange Management (Non-Debt Instrument) Rules, 2019.***

Q.12 Who can open an Escrow Account in India and for what purpose?

Ans.: Resident and Non-resident acquirers can open Escrow Account in INR with an AD bank in India as the Escrow Agent, for acquisition/transfer of capital instruments/convertible notes in accordance with ***Foreign Exchange Management (Non-Debt Instrument) Rules, 2019*** as amended from time to time and subject to the terms and conditions specified under Schedule 5 of Foreign Exchange Management (Deposit) Regulations, 2016, as amended from time to time.

D. Analysis of recent compounding orders issued by RBI

1) Transfer or Issue of Security by a Person Resident Outside India (Inbound Investment) (FEMA 20/2000-RB)

Taking on record transfer of shares from resident to non-resident

Applicant	M/s W. Hunger Hydraulics India Private Limited
Compounding Application Number	C.A. No. 126/2019
Compounding Authority Name	Foreign Exchange Department, Kolkata
Amount imposed under Compounding Order	₹ 3,589/-
Date of order	31st January, 2020

<p>Facts of the case</p>	<p>Certain equity shares of the applicant company were initially held by Mr. B. K. Mukherjee, Kolkata. Upon demise of Mr. Mukherjee, the heirs of him voluntarily transferred these shares to Ms. Daniela Regina Hepp, Germany (one of the directors of the Indian company) in the year 2012. The transfer of shares was in the nature of gift without any consideration of money.</p> <p>Later, Ms. Daniela Regina Hepp expressed her desire to return those shares without consideration and the buy-back of those shares has been completed by the company with all regulatory formalities during the year 2019.</p>
<p>Contravention</p>	<p>Regulation 4 of FEM (Transfer or issue of security by a Person Resident Outside India) Regulations, 2000 notified <i>vide</i> Notification No. FEMA 20/2000-RB states as follows: “Save as otherwise provided in the Act, or rules or regulations made thereunder, an Indian entity shall not issue any security to a person resident outside India or shall not record in its book any transfer of security from or to such person:....”</p> <p>The applicant took on record transfer of shares from R to NR without consideration (in the nature of gift) and thus, the applicant contravened the provision of the notification <i>ibid</i>.</p>
<p>Comments</p>	<p>Though Foreign Exchange Management (Transfer or Issue of Security by a Person Resident Outside India) Regulations, 2000 has been replaced by FEM (Non-Debt Instruments) Rules, 2019; Rule 4 of extant FEM (Non-Debt Instruments) Rules, 2019 corresponds to Regulation 4 of erstwhile FEMA 20/2000-RB.</p> <p>The difference between date of taking on record of share transfer from resident to non-resident and the date of completing buy-back of those shares is considered as the number of days for which contravention was subsisted.</p>

2) Transfer or Issue of any foreign Security (Outbound Investment) (FEMA 120/2004-RB) Repatriation of disinvestment proceeds beyond the stipulated time period

<p>Applicant</p>	<p>Gemini Power Hydraulics Private Limited</p>
<p>Compounding Application Number</p>	<p>C.A. No. 5013/2019</p>
<p>Compounding Authority Name</p>	<p>Foreign Exchange Department, Mumbai</p>

Amount imposed under Compounding Order	₹ 1,42,571/-
Date of order	16th January, 2020
Facts of the case	<p>The applicant had set up a WOS namely Gemini Intertrade Pte. Ltd., in Singapore during the year 2008.</p> <p>It disinvested and closed down the WOS on 30th September 2017 while the disinvestment proceeds were repatriated only on 16th January 2018.</p>
Selected Contravention	<p><i>Repatriation of disinvestment proceeds beyond the stipulated time period:</i> Regulation 16(2) of Notification No. FEMA 120/2004-RB dated 07th July 2004 states as "Sale proceeds of shares/securities shall be repatriated to India immediately on receipt thereof and in any case not later than 90 days from the date of sale of the shares/securities and documentary evidence to this effect shall be submitted to the Regional office of the Reserve Bank through the designated authorized dealer."</p> <p>In this case, applicant could not repatriate the disinvestment proceeds within the stipulated time period of 90 days and thus, contravened the provision of Regulation 16(2).</p>

3) FEM (Remittance of Assets) Regulations, 2000 (FEMA 13/2000-RB) Remittance of Assets beyond the stipulated limit

Applicant	William Scott Pinckney
Compounding Application Number	C.A. No. 4995/2019
Compounding Authority Name	Foreign Exchange Department, Mumbai
Amount imposed under Compounding Order	₹ 3,18,829/-
Date of order	30th January, 2020
Facts of the case	<p>The applicant, Mr. William Scott Pinckney is an Australian Citizen who stayed in India for employment during the period from 1998 to 2015. During Feb 2015 to April 2017, the applicant had made multiple remittances to his overseas bank account in Australia.</p> <p>DoE initiated an investigation against the applicant in connection with the forex transactions undertaken by him and a SCN was issued to the applicant. DoE had stated that the applicant had remitted funds in excess of the prescribed limit viz. USD 1 mn., during the year 2015-16.</p>

	The applicant had submitted a reply mentioning that he had worked in India for 17 years till year 2015 and had relocated to Australia after retirement. Also, remittances were made by him out of the assets earned over the period in which he was in India. And subsequently filed the compounding application with RBI. The concerned Division has taken the transactions on record.
Contravention	<u>Remittance of Assets beyond stipulated limit:</u> Regulation 4(2) of FEM (Remittance of Assets) Regulations, 2000 permits a citizen of foreign state not being a citizen of Nepal or Bhutan who has retired from an employment in India to remit an amount not exceeding USD 1,000,000 per FY subject to payment of applicable taxes in India, if any. Applicant had remitted > USD 1,000,000 during FY 2015-16 and thus, contravened the provision of Regulation 4(2).
Comment	Though Foreign Exchange Management (Remittance of Assets) Regulations, 2000 has been replaced by revised regulations; Regulation 4(1) of extant FEM (Remittance of Assets) Regulations, 2016 corresponds to Regulation 4(2) of erstwhile FEM (Remittance of Assets) Regulations, 2000.

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The easiest way to get hold of the mind is to sit quite and let it drift where it will for a while.

– Swami Vivekananda

We live in a wonderful world that is full of beauty, charm and adventure. There is no end to the adventures that we can have if only we seek them with our eyes open.

– Jawaharlal Nehru

Look at the sky. We are not alone. The whole universe is friendly to us and conspires only to give the best to those who dream and work.

– A. P. J. Abdul Kalam

BEST OF THE REST



Rahul Sarda,
Advocate

Whether an unregistered partnership firm can maintain prosecution u/s Section 138 of the Negotiable Instruments Act, 1881 (for dishonour of cheque) against the drawer of a cheque?

The question before the Court was that whether prosecution of an accused under Section 138 of the Negotiable Instruments Act, 1881 (for dishonour of cheque), is hit by the bar created by Section 69(2) of the Indian Partnership Act, 1932 i.e., if the complainant was an unregistered partnership firm.

The Single Judge, relying on the judgment of the Andhra Pradesh Court in the case of ***Mr. Amit Desai & Anr. vs. M/s. Shine Enterprises and Anr. reported in 2000 CRI LJ 2386*** wherein it was held that bar of filing a suit by an unregistered firm is equally applicable to criminal cases.

As per section 69(2) of the Indian Partnership Act, 1932, no suit to enforce a right arising from a contract shall be instituted in any Court by or on behalf of a firm against any third party unless the firm is registered and the persons suing are or have been shown in the Register of Firms as partners in the firm.

Held, the object of introducing Sections 138 to 142 of the Negotiable Instruments Act, 1881 was specifically to enhance the acceptability of cheques in settlement of liabilities by making the

drawer liable for penalties in case of bouncing of cheques due to insufficiency of funds in the accounts or for the reason that it exceeds the arrangement made by the drawer. These are penal provision, the commission of which entails prosecution and conviction on proving of guilt. Once the offence under Section 138 is completed, the prosecution can be initiated for bringing the offender to penal liability.

Further held that there was no disagreement with the proposition that the 'debt or other liability' as has been referred in Section 138 of the Negotiable Instruments Act, 1881, is a 'legally enforceable debt or other liability'. However, by creating a bar to enforce a right arising out of contract by an unregistered firm, with the object to promote registration of the firms and to exempt the small firms from compulsory registration, the inherent character of enforceability of the 'right' did not get changed and it would still remain as a right enforceable by law. Once the bar was removed, the remedy would be revived.

The Court observed that the Larger Bench of the Andhra Pradesh Court, in the case of ***A. V. Ramanaiah vs. M. Shekhara reported in ALD (CRI) 2009 2 801*** came to the conclusion that the bar contained under Section 69 of the Act of 1932 would not get attracted for initiating action by or against an unregistered partnership firm

for the offence committed under Section 138 of the Negotiable Instruments Act, 1881 as Section 69 was intended to prevent an unregistered partnership firm from enforcing a right arising out of a contract against a third party, and that it was not intended to create any such bar for the purposes of enforcing rights arising out of statutes or for invoking the protection available under any other statute. Therefore, the bar under section 69(2) of the Indian Partnership Act, 1932 could not be stretched for securing immunity from criminal prosecutions.

The Court further observed that when a plaint was rejected being barred by Section 69(2) of the Indian Partnership Act, 1932, the same shall not preclude the plaintiff from presenting a fresh plaint in respect of the same cause of action but a similar kind of provision is neither available in Negotiable Instruments Act, 1881 nor in the Code of Criminal Procedure.

Narendra vs. Balbirsingh – Criminal Application (APPA) No. 748 of 2018 dated 7th February 2020 (Bombay High Court, Nagpur Bench)

Children born to a father before father's adoption – whether entitled to inherit property of the family in which the father was adopted?

One, Laxman was given in adoption to Saraswati on 2-11-1935. At the time of adoption of Laxman, he had three sons. After adoption, Laxman and his wife Padmavati joined the family of Saraswati along with his three sons. In the year 1938, a daughter Kalindi was born to Laxman. The natural father of Laxman, i.e. Pandurang effected partition in respect of his joint family property on 30-12-1948 wherein Laxman was excluded from any share as he had gone in adoption to Saraswati.

After the death of Saraswati, Laxman inherited the property of Saraswati which was the subject matter of the proceedings before the Court. After the death of Laxman on 10-1-1987, his daughter Kalindi applied for effecting the change in the

village revenue record for inclusion of her mother Padmavati and herself as owners.

Padmavati, i.e., wife of Laxman died on 10-10-1992 leaving a registered Will dated 21-5-1987 in which she had bequeathed her share to her three sons which were born prior to the date of adoption. One of the sons of Laxman and Padmavati (who was born before the date of Laxman's adoption) filed a suit for partition, separate possession and mesne profit against forcible possession by Kalindi. The main contest of the parties was on the question as to whether the three sons of Laxman born before adoption in 1935 were entitled to inherit the property in adoptive family of Laxman after his death. Kalindi also filed a suit wherein she took a plea that the sons born before adoption have no right, title or interest in the properties left behind by Laxman and she being a daughter born to Laxman after his adoption would inherit the entire property along with Padmavati, her mother. Both the matters were taken up for hearing together wherein the learned Single Bench relying upon Section 8 of the Hindu Succession Act, 1956 held that the son born before adoption is entitled to succeed to the property of their father. The suit filed by the Plaintiff-son was decreed in his favour.

In appeal, before the Supreme Court, it was argued on behalf of Kalindi that the wife of an adoptee passes with her husband to the adopted family but not the sons born to an adoptee before his adoption who continue to be members in the family in which their father was naturally born. The codified Hindu Law has not provided that the children born to an adoptee before adoption will be entitled to inherit the property in the adopted family, therefore, the children born before adoption will not pass with the adoptee in the adopted family and are not entitled to the share in the estate of the adopted family.

The Supreme Court observed that since Laxman died in 1987, the succession has to be in accordance with the Hindu Succession Act,

1956 and not as per Hindu Law as all text, rule or interpretation of Hindu law prior to commencement of the Act have ceased to have any effect as per section 4 of the said Act. The three sons and Kalindi were born to Laxman and his wife Padmavati. They are agnates and related by full blood in terms of Section 3(a) and 3(e) of the Act. As per the Schedule to the Act, the son and the daughter of a deceased Hindu male are class I heirs.

Held that in view of the provisions of the Act which do not make any distinction between the son born to a father prior or after adoption of his father and that there is no provision which bars the natural born son to inherit the property of his natural father, therefore, the High Court has rightly upheld the rights of the sons of Laxman. There was a full blood relationship between the three sons and the daughter who was born after adoption. All the children of Laxman are entitled to inherit the property of their natural father and mother in accordance with the provisions of the Act as succession has opened after the death of Laxman in 1987 and subsequently the mother in the year 1992.

Kalindi Damodar Garde (D) by LRS. vs. Manohar Laxman Kulkarni & Ors. – Civil Appeal Nos. 6642/43 of 2010 dated 7th February 2020 (Supreme Court)

Presence of purchaser of immovable property before the authority under the Registration Act – Whether necessary?

The main dispute involved in this appeal was the necessity of presence of a purchaser of immovable property before the authority under the Registration Act, 1908 at the time of effecting registration of a deed of conveyance.

In the suit, the plaintiff contended that he had come in possession of the suit property initially as a tenant and subsequently as the purchaser thereof. It was his case before the Trial Court that

he has been in possession of the suit property for about twenty years prior to filing of the suit. The basis of the plaintiff's claim was an agreement for sale executed on 10th April, 1981 between the plaintiff and one, Madegowda in respect of the suit property, which was executed on 28th May 1981.

The suit was being contested by the legal representatives of Madegowda as well as that of Manchegowda. It was the case of Manchegowda (and his legal representatives) that by a deed of sale dated 21st April 1981, he acquired the suit property.

A plea was taken by Manchegowda's legal representatives that the original owner, on 21st April, 1981, had executed a deed of sale in favour of Manchegowda (since deceased). However, the Trial Court sustained the plaintiff's case primarily on the ground that the sale deed through which legal representatives of Manchegowda staked their claim over the suit property was not genuine purportedly as Manchegowda, as a purchaser was not present at the time of execution of the sale deed before the Sub-Registrar and on that count the aforesaid finding was rendered. The High Court reversed the finding of the Trial Court.

Held, by the Supreme Court that there was evidence to the effect that Manchegowda had not come to the office of the Sub-Registrar at the time of execution of the sale deed. But as per law as it stood at the material point of time, there was no necessity of presence of purchaser at the Registration Office during the registration of sale deed. The deed was executed by Madegowda and that aspect has not been disputed. Section 32 of the Registration Act did not require presence of both parties to a deed of sale when the same was presented for registration.

H. P. Puttaswamy vs. Thimamma & Ors. – Civil Appeal No. 3975 of 2010 dated 24th January 2020 (Supreme Court)

□□□

THE CHAMBER NEWS



CA Ketan L. Vajani & CA Haresh P. Kenia,
Hon. Jt. Secretaries

Important events and happenings that took place between 1st February, 2020 to 29th February, 2020 are being reported as under:

I. ADMISSION OF NEW MEMBERS

- 1) The details of new members which were admitted in the Managing Council Meeting held on 20th February, 2020 are as under:-

Type of Membership	No. of Members
Life Member	10
Ordinary Member	01
Associate Member	01

II. PAST PROGRAMMES

1. DIRECT TAXES COMMITTEE

Workshop on "Direct Tax Provisions of Finance Bill, 2020" (Jointly with WIRC of ICAI) was held on 8th February, 2020 at The ICAI Regional Office, ICAI Tower, Bandra East. The workshop was chaired by CA Kishor Karia and the same was addressed by CA Geeta Jani and CA Yogesh Thar.

Lecture Meeting on "Intricacies Involved in the Direct Tax Vivad Se Vishwas Bill 2020" was held at 14th February, 2020 at Walchand Hirachand Hall, 4th Floor, IMC, Churchgate. The meeting was addressed by Shri Firoze Andhyarujina, Senior Advocate.

2. INDIRECT TAXES COMMITTEE

A Workshop on GST Law jointly with AIFTP (WZ), BCAS, GSTPAM, MCTC & WIRC of ICAI was held on 18th and 26th February, 2020 at GSTPAM, Mazgaon Library, 1st Floor,

VikrikarBhavan, Mazgaon. The workshop was addressed by CA S. S. Gupta, CA Sujata Rangnekar & CA Aditya Seema Pradeep.

3. IT CONNECT COMMITTEE

Workshop on "Advance Excel" was held on 22nd February, 2020 at Babubhai Chinai Hall, 2nd Floor, IMC, Churchgate. The workshop was addressed by CA Adarsh Madrecha.

4. MEMBERSHIP & PR COMMITTEE

Indoor Box Cricket Tournament (Jointly with Student Committee) was held on 15th February, 2020 at Dr. Antonio D'silva School, Kabutarkhana, Dadar West. 24 teams participated out of which 3 were girl's team.

The winners were:

Winning Team: Deloitte Haskins & Sells LLP

Runner-up Team: KNAV & Co.

Best Batsman: Mr. Nitin Mehta, KKC & Co.

Best Bowler: Mr. Dipesh Ruparelia, Deloitte Haskins & Sells LLP

Man of the series: Mr. Dhyey Ahalpara, KNAV & Co.

Winning Team (Girls): BDO India LLP

Runner-up Team: Hinesh R. Doshi & Co.

Best Batswoman: Ms. Diksha Raina, BDO India LLP

Best Bowler: Ms. Chandni Chaurasiya, BDO India LLP

Woman of the series: Ms. Diksha Raina, BDO India LLP

Half day Seminar on "Direct Taxes Provisions – Finance Bill, 2020 & Vivad se Vishwas Bill" (Jointly with Kalyan Tax Practitioners Association) was held on 15th February, 2020 at Saga Banquet Sring Time Club, Kalyan. The seminar was addressed by CA Ketan Vajani and Mr. Dharan Gandhi, Advocate.

Half day Seminar on "Direct Taxes Provisions – Finance Bill, 2020 & Vivad se Vishwas Bill" was held on 22nd February, 2020 (Jointly with Vapi Branch of WIRC of ICAI) at Vapi Branch premises. The seminar was addressed by CA Ketan Vajani and Mr. Dharan Gandhi, Advocate.

5. RESIDENTIAL REFRESHER COURSE COMMITTEE

The 43rd Residential Refresher Course was held from 27th February, 2020 to 1st March, 2020 at Le Meridien Coimbatore. The discussion papers at the RRC were written by CA Jagdish Punjabi, Shri Hiro Rai, Advocate and CA Vishal Gada. A presentation paper was presented by CA Amrish Shah. The trustees for Brain's Trust session were CA Gautam Doshi & CA Kishor Karia.

6. STUDENT COMMITTEE

A Musical event “Meri Aawaaz Hi Pehchan Hai” was held on 8th February, 2020 at Ravindra Natyamandir Mini Theatre, Prabhadevi. Chamber’s members attended the event along with their families and friends.

(For details of the future programs, kindly visit www.ctconline.org or refer The CTC News of March, 2020)

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STATEMENT AS PER PRESS AND REGISTRATION OF BOOKS ACT

Form IV
(See Rule 8)

THE CHAMBER'S JOURNAL

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I, Kishor Vanjara, hereby, declare that the particulars given above are true to the best of my knowledge and belief.

Date: 10th March, 2020

Kishor Vanjara
Signature of the Publisher

Live Screening of Union Budget, 2020 at Chamber's office on 1st February, 2020



Accounting & Auditing Committee

Webinar on "Quality control in Audit" was held on 7th February, 2020



CA Khurshed Pastakia

Webinar on "Engagement management - General principles and responsibilities" was held on 14th February, 2020



CA Hasmukh Dedhia

Webinar on "Audit planning & risk assessment in audit" was held on 21st February, 2020



CA Bhavin Kapadia

Pune Study Group

Pune SG Meeting on "Recent Amendments to Companies Act 2013" was held on 8th February, 2020 at Dr. Babasaheb Ambedkar Museum & Memorial, Next to Symbiosis main building, Pune - 411004



CS Anoop Deshpande
addressing the delegates

Direct Taxes Committee

ISG Meeting on "Recent Important Decisions under Direct Taxes" was held on 19th February, 2020 at CTC Conference room



Mr. Mandar Vaidya, Advocate
addressing the delegates

Indirect Taxes Committee

Webinar on "Recent developments in GST (including changes in Finance Bill 2020)" was held on 11th February, 2020

IDT Study Circle meeting on "Issues in Logistics Industry under GST" was held on 25th February, 2020 at Jaihind College, A.V. Room, Churchgate



CA Mandar Telang



Chairman CA A. R. Krishnan
addressing the delegates



Group Leader CA Yash Parmar
addressing the delegates

Hyderabad Study Group

Hyderabad SG Meeting on "Direct tax proposals under Budget 2020 - Clause by clause presentation" was held on 8th February, 2020 at Hotel Taj Tristar, 1-1-40, Telangana



CA T Rajendra Parsad
addressing the delegates

Study Circle & Study Group Committee

SC Meeting on "Finance Bill-Direct Tax Provisions" was held on 17th February, 2020 at Babubhai Chinai Hall, 2nd Floor, IMC, Churchgate



CA Ravikanth Kamath
addressing the delegates

International Taxation Committee

INT Study Circle meeting on "International tax amendments in the Union Budget 2020" was held on 15th February, 2020 at CTC Conference room



CA Bhautik Shah
addressing the delegates



CA Mahesh Nayak
addressing the delegates



CA Siddharth Parekh
addressing the delegates

SG Meeting on "Recent Judgments under Direct Taxes" was held on 18th February, 2020 at Babubhai Chinai Hall, 2nd Floor, IMC, Churchgate



Mr. Vipul Joshi,
Advocate addressing the delegates

Student Committee and Membership & PR Committee

Indoor Box Cricket Tournament was held on 15th February, 2020 at Dr. Antonio D'silva School, KabutarKhana, Dadar West.



Winning Team: Deloitte Haskins & Sells LLP



Runner-up Team: KNAV & Co.



Best Batsman: Mr. Nitin Mehta, KKC & Co.



Best Bowler: Mr. Dipesh Ruparelia, Deloitte Haskins & Sells LLP



Man of the series: Mr. Dhyey Ahalpara, KNAV & Co.



Winning Team (Girls): BDO India LLP



Best Batswoman: Ms. Diksha Raina, BDO India LLP



Best Bowler:
Ms. Chandni
Chaurasiya, BDO
India LLP



Woman of the
series:
Ms. Diksha
Raina, BDO
India LLP

Direct Taxes Committee

Workshop on "Direct Tax Provisions of Finance Bill, 2020" (Jointly with WIRC of ICAI) was held on 8th February, 2020 at The ICAI Regional Office, ICAI Tower, Bandra East.



Dignitaries on dais. Seen from L to R: CA Yashwant Kasar (Treasurer, WIRC), CA Nimesh Chotahni (Convenor – Direct Taxes Committee, CTC), CA Umesh Sharma (Vice-Chairman, WIRC), CA Kishor Karia (Speaker), CA Yogesh Thar (Speaker), CA Vipul K. Choksi (President, CTC) and Mr. Devendra Jain, Advocate (Chairman – Direct Taxes Committee, CTC)



CA Vipul K. Choksi
(President, CTC)
giving his opening
remarks



CA Priti Savla
(Chairperson, WIRC
of ICAI) welcoming
the speakers

Faculties



CA Kishor Karia
addressing the
delegates



CA Yogesh Thar
addressing the
delegates



CA Geeta Jani
addressing the
delegates

Lecture Meeting on "Intricacies Involved in the Direct Tax Vivad Se Vishwas Bill 2020" was held at 14th February, 2020 at Walchand Hirachand Hall, 4th Floor, IMC, Churchgate.



CA Vipul K. Choksi (President) giving his opening remarks



Mr. Devendra
Jain, Advocate
(Chairman)
welcoming the
speakers



Shri Firoze
Andhyarujina, Senior
Advocate addressing
the delegates



Delegates

Residential Refresher Course Committee

The 43rd Residential Refresher Course was held from 27th February, 2020 to 1st March, 2020 at Le Meridien Coimbatore



- CA Vipul K. Choksi (President), CA Kishor Vanjara (Advisor, RRC Committee and Past President) and CA Mehul Sheth (Chairman) inaugurating the RRC by lighting the lamp. Seen from L to R: CA Ahit Rohira (Past President), CA Parimal Parikh (Past President), CA Bhavesh Vora (Past President), CA Sujal Shah (Past President), CA Bhavik Shah (Vice-Chairman), CA Vipin Batavia (Past President) and CA Ketan Vajani (Hon. Joint Secretary)



Dignitaries at the inaugural session



CA Vipul K. Choksi (President) giving his opening remarks. Seen from L to R: CA Bhavik Shah (Vice-Chairman), CA Mehul Sheth (Chairman), CA Kishor Vanjara (Advisor, RRC Committee and Past President) and CA Ankit Sanghavi (Vice-Chairman)



Ganesh Vandana

CA Mehul Sheth (Chairman) welcoming the delegates



Mock Tribunal



Faculties



CA Jagdish Punjabi
addressing the delegates



CA Amrish Shah
addressing the delegates



CA Vishal Gada addressing
the delegates



Brain Trust Session by
CA Gautam Doshi and CA Kishor Karia



Group Discussion



Group Photo



President with the Past Presidents of Chamber



Group Photo of RRC Committee

IT Connect Committee

Workshop on "Advance Excel" was held on 22nd February, 2020 at BabubhaiChinai Hall, 2nd Floor, IMC, Churchgate.



CA Vipul K. Choksi (President) giving his opening remarks. Seen from L to R: CA Alok Jajodia (Vice-Chairman), CA Maitri Savla (Chairperson), CA Adarsh Madrecha (Speaker) and CA Murtuza Ghadiali (Convenor)

CA Maitri Savla
(Chairperson) welcoming
the speakers



CA Adarsh Madrecha
addressing the delegates



Membership & PR Committee

Half day Seminar on "Direct Taxes Provisions – Finance Bill, 2020 & Vivad se Vishwas Bill" (Jointly with Kalyan Tax Practitioners Association) was held on 15th February, 2020 at Saga Banquet Sring Time Club, Kalyan.

Half day Seminar on "Direct Taxes Provisions – Finance Bill, 2020 & Vivad se Vishwas Bill" was held on 22nd February, 2020 (Jointly with Vapi Branch of WIRC of ICAI) at Vapi Branch premises.



CA Ketan Vajani addressing the
delegates



Mr. Dharan Gandhi, Advocate
addressing the delegates

Membership & PR Committee and Student Committee

A Musical event “Meri Aawaaz Hi Pehchan Hai” for Chamber’s members along with their families and friends was held on 8th February, 2020 at Ravindra Natyamandir, Mini Theatre, Prabhadevi.



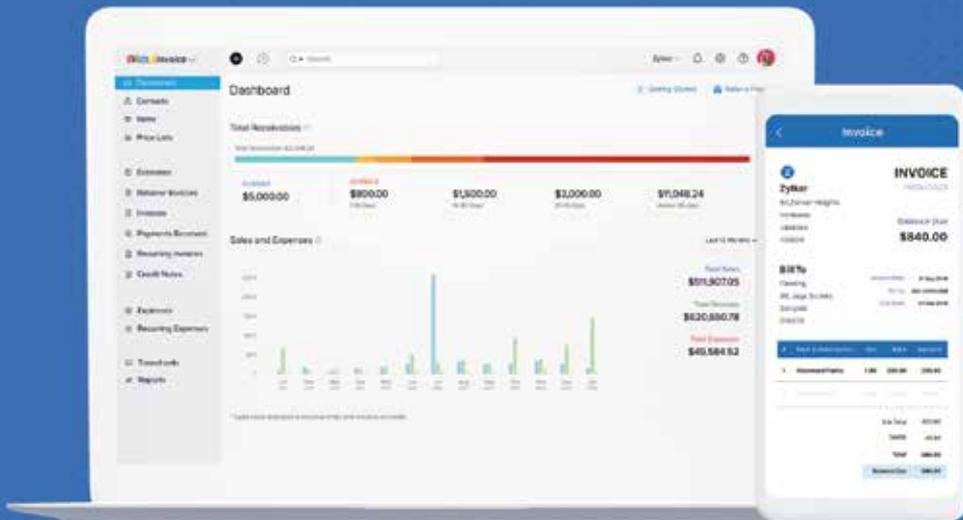
Membership & PR Committee and Student Committee





Online invoicing software for businesses

Online invoicing software that helps you craft professional invoices, automatically send payment reminders, and get paid faster online



Send professional invoices



Accept card payments



Manage petty expenses



Track time and manage projects



Set payment reminders



Generate insightful reports



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