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Article

Cross-border share sale – Eligibility for Tax Treaty benefit

By Harshit Khurana and Sonali Bansal

The article in this issue of Direct Tax Amicus seeks to examine the question as to whether treaty benefits should at all be provided if the non-resident seller of shares does not have much commercial substance. It in this regard observes that both as per General Anti Avoidance Rules ('**GAAR**') and the Principal Purpose Test introduced *via* MLI, treaty benefit should not be denied if the transaction has sound commercial rationale and providing such a benefit is in accordance with the object and purpose of the tax treaty. However, analysing how Courts in different countries have applied GAAR in tax treaty issues and what Courts in India have held applying judicial anti-avoidance test existing prior to the introduction of statutory GAAR, the authors opine that there is a lot of uncertainty surrounding the applicability of anti-abuse rules to cross border share acquisitions. According to them, while the fact of a SPV (with no other business) investing in an Indian company is not sufficient to hold that treaty benefit should be denied, it is also important to understand the object and purpose of the tax treaty. They suggest that the multi-national enterprises must ensure that there exists backup documentation to justify the commercial rationale for an arrangement.

Cross-border share sale – Eligibility for Tax Treaty benefit

Introduction

Over the past few years, the Foreign Direct Investments ('**FDI**') in India have been on a steep rise. As per the 2023 edition of the World Investment Report, the total FDI into India soared by 10 percent. Continued attraction of FDI into India has also resulted in many cross-border share sale transactions, wherein the existing foreign investors, as part of their exit strategy, sell their investment in the Indian company to another non-resident/ Indian resident investor.

While the cross-border share sale transaction involves numerous legal, commercial and regulatory implications, one of the most critical aspects which every MNE fret about is the income-tax implications in India.

In some of the tax treaties entered by India with countries such as Mauritius and Singapore, India does not have taxing rights upon sale of shares of an Indian company by non-resident investors if the investments were made before 1 April 2017. In certain other tax treaties such as with Netherlands, the taxing rights have been provided only in case shares derive value principally from non-business immovable property. On the contrary, as per Indian domestic law, sale of shares of Indian company are exigible to tax in the hands of non-resident investors.

Such exemption in tax treaties have made the Tax authorities question as to whether treaty benefits should at all be provided if the non-resident seller does not have much commercial substance? This article seeks to examine said question.

Anti-abuse rules in place

The General Anti Avoidance Rules ('**GAAR**') prevalent in the Indian domestic law as well as the Principal Purpose Test ('**PPT**') introduced *via* MLI in the tax treaties, seek to deny treaty benefit in cases where the principal purpose or one of the principal purposes of entering into the transaction is to obtain tax treaty benefit. However, both as per GAAR and the PPT, treaty benefit should not be denied if the transaction has sound commercial rationale and providing such a benefit is in accordance with the object and purpose of the tax treaty.

Considering that both GAAR and PPT have been recently enacted, there is not much jurisprudence on the same in India. Accordingly, what may qualify as reasonable commercial rationale and what may be in accordance with the object and purpose of tax treaty is yet to be tested.

To understand the same, it is worthwhile to look at how Courts in different countries have applied GAAR in tax treaty issues and also what Courts in India have held applying judicial

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anti avoidance test existing prior to introduction of statutory GAAR.

Key judicial precedents

In the case of *Alta Energy Luxembourg S.A.R.L.*[1], the taxpayer was incorporated in Luxembourg. A Delaware limited company sold the shares of group company, Alta Canada, to the taxpayer and the taxpayer in turn sold those shares to another company in Canada. The latter sale of shares got tax exempt under the treaty entered into between Canada and Luxembourg. Admittedly, taxpayer did not conduct any other business or held any other investments following the transaction in question. The Revenue invoked GAAR and rejected the treaty benefit in the hands of the taxpayer.

In the above set of facts, the majority bench of Canadian Supreme Court allowed the benefit of Luxembourg- Canada tax treaty to the taxpayer by observing that if the drafters intended to limit the benefit of treaty based on the economic benefit, they would have spelt out their intention. It is noteworthy that the dissenting judges held that the GAAR vests an unusual duty upon the courts to look beyond the words of applicable provisions to determine whether the transactions in question frustrate the underlying rationale. The Court also observed that the taxpayer had no genuine economic connection with Luxembourg as it was a mere conduit interposed to avail the tax exemption which frustrates the rationale of the relevant provisions of the treaty and therefore, should not be allowed treaty benefits.

In another case of *NetApp Denmark ApS, TDC A/S*[2], the Danish Supreme Court was posed with the similar question of whether treaty benefit should be allowed to an entity which has been demonstrated to have been created with the main object to take benefit under the relevant treaty. In the facts of the case, admittedly, NetApp USA created an entity in NetApp Cyrus to route dividends from NetApp Denmark without any tax withholding. The Hon'ble Court held that NetApp Cyprus was a pass-through entity and since, NetApp USA was the beneficial owner of the dividend income, NetApp Denmark was required to deduct tax at source.

The High Court of Bombay in the case of *Bid Services Division (Mauritius) Limited*[3] decided upon granting benefit of India-Mauritius tax treaty in the case of transfer of shares. In said case, at the time of acquisition of shares of Indian company, group company of taxpayer was involved in bidding process. However, just two weeks prior to acquisition, the taxpayer was incorporated who purchased shareholding interest in the Indian company. The fact about incorporation and introduction of taxpayer was informed to the government authorities involved in the bid evaluation process.

In said facts, the Court granted treaty benefit to the taxpayer. The Court noted that the concept of denying treaty benefit to

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[1] *Canada* v. *Alta Energy Luxembourg S.A.R.L.*, 2021 SCC 49 (Supreme Court).

[2] *Ministry of Taxation* v. *NetApp Denmark ApS* (Case 69/2021); *NetApp Denmark ApS* v. *The Ministry of Taxation* (Case 79/2021); *TDC A/S* v. *The Ministry of Taxation* (Case 70/2021) [Supreme Court].

[3] *Bid Services Division (Mauritius) Limited* v. *Authority of Advance Ruling (Income Tax) Mumbai Bench*, Writ Petition No. 713 of 2021.

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shell entity as specified in Limitation of Benefit clause in tax treaty is applicable from 1 April 2017. Accordingly, the same cannot be applied for cases prior to that. Also, the Court observed that where the entire bidding structure as well as the bid has been evaluated by Government authorities, taxpayer cannot be considered as a sham entity. The Court also noted that creation of taxpayer two weeks before the submission of the bid does not appear unusual or suggest that the same was to defraud the revenue or perpetrate any illegal activity especially when Government authority had permitted the use of such SPV.

Authors' comments

From the above judgements, it is evident that there is a lot of uncertainty surrounding the applicability of anti-abuse rules to cross border share acquisitions. A lot is left at the mercy of how the Courts look at the facts in a given situation.

In authors' view, the fact that a SPV (with no other business) invests in an Indian company is not sufficient to hold that treaty benefit should be denied. It is quite common in multinational groups to set-up investment holding companies and invest *via* said companies. The objective in such cases can be to separate the investing activity from the operational activity of the group, managing investments and obtain benefit of lesser compliances in SPV country. Therefore, there can be good commercial/administrative/regulatory rationale for investing into India *via* SPV structure. All the factors must be evaluated in totality before concluding on the applicability of anti-abuse provisions.

It is also important to understand the object and purpose of the tax treaty. For instance, if tax treaties provide for specific anti-abuse test, but the case at hand does not attract said provisions, then treaty benefit should be granted. In such cases, it can be reasonably said that the object and purpose of the treaty was to grant the benefit.

One will have to wait and watch as to how the Indian courts will apply GAAR and PPT. The MNEs must prepare themselves for the tussle by ensuring that there exists backup documentation to justify the commercial rationale for an arrangement.

[The authors are Principal Associate and Senior Associate, respectively, in Direct Tax Team at Lakshmikumaran and Sridharan Attorneys, New Delhi]

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Notifications & Circulars

- Valuation of perquisites – Income Tax Rules amended
- Life Insurance Policy – Exemption in respect of sums received – Clarificatory guidelines issued in respect of Section 10(10D)
- Life Insurance Policy – Rule notified for computation of income chargeable to tax for amount received under life insurance policy
- No TDS under Section 194-I on payment of lease rent for lease of ship to an IFSC unit
- Exchange rate for TDS on income payable in foreign currency to include payments to and from IFSC units
- Search and seizure – Procedure for requisition services under Section 132(2) and for making a reference under Section 132(9D) for valuation, prescribed
- Procedure for application under Section 155(20) prescribed
- Applicability of Safe Harbour rules extended to AY 2023-24

Notifications & Circulars

Valuation of perquisites – Income Tax Rules amended

Rule 3 of the Rules prescribes rules for valuation of perquisites provided by the employer directly or indirectly to an assessee, being an employee. The value of residential accommodation provided by the employer during the previous year is determined in accordance with sub-rule (1) of Rule 3.

The CBDT has, *vide* Income-tax (Eighteenth Amendment) Rules, 2023, substituted sub-rule (1) of Rule 3 of the Rules with effect from 1 September 2023. The amendments have been summarised hereinbelow for ease of reference–

- Where accommodation is provided by any employer other than the Central/ State Government, the changes in the value of unfurnished accommodation have been tabulated hereinbelow –
  - *Where the accommodation is owned by the employer*

Prior to 1 September 2023	Post 1 September 2023
• 15% of salary in cities having population exceeding 25 lakhs as per 2001 census;	• 10% of salary in cities having population exceeding 40 lakhs as per 2011 census;
• 10% of salary in cities having population exceeding 10 lakhs but not exceeding 25 lakhs as per 2001 census;	• 7.5% of salary in cities having population exceeding 15 lakhs but not exceeding 40 lakhs as per 2011 census;
• 7.5% of salary in other areas, in respect of the period during which the said accommodation was occupies by the employee during the previous as reduced by the rent, if any, actually paid by the employee.	• 5% of salary in other areas, in respect of the period during which the said accommodation was occupies by the employee during the previous as reduced by the rent, if any, actually paid by the employee.

  - *Where the accommodation is taken on lease or rent by the employer.*

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Prior to 1 September 2023	**Post 1 September 2023**
Actual amount of lease rental paid or payable by the employer or 15% of salary whichever is lower as reduced by the rent, if any, actually paid by the employee.	Actual amount of lease rental paid or payable by the employer or 10% of salary whichever is lower as reduced by the rent, if any, actually paid by the employee.

- Where accommodation is provided by the Central/State Government, there have been no changes in the determination of value of residential accommodation provided to the employees holding office or post in connection with the affairs of the Central/State Government. However, employees serving with any body/ undertaking under the control of Central/State Government on deputation, have been removed from the scope of SI No. (1) of Table 1 of Rule 3(1) of the Rules. In other words, the value of residential accommodation for employees on deputation under Central/State government will now be determined as per SI No. (2) of Table 1 i.e., where accommodation is provided by any other employer.

Further, the third proviso has introduced a capping on the value of perquisite, in case the same accommodation is continued to be provided to the same employee for more than one year. In such cases, the value of the perquisite shall be lower of the value as per the revised rules or the value as per the following formula:

*Amount calculated in the first year * (Cost Inflation Index for the previous year for which the amount is calculated / Cost Inflation Index for the previous year in which the accommodation was initially provided to the employee)*

While such a limit was made applicable *vide* Notification No. 65/2023 for only accommodation owned by the employer, CBDT has *vide* Notification No. 72/2023 expanded the scope of the same to include accommodation taken on lease or rent.

Life Insurance Policy – Exemption in respect of sums received – Clarificatory guidelines issued in respect of Section 10(10D)

Section 10(10D) of the Income Tax Act, 1961 ('**IT Act**') provides exemption in respect of sums received under Life Insurance policies (LIPs). It was provided *vide* Finance Act, 2021 that the following will not be exempt under Section 10(10D) with effect from 1 April 2021 (except any such sum received on the death of a person) -

- Any sum received under a unit linked insurance policy (ULIP), issued on or after 1 February 2021, if the amount of premium payable for any of the previous years during the term of such policy exceeds INR 2,50,000 *(fourth proviso)*.
- Any sum received for more than one ULIPs, issued on or after 1 February 2021, if the aggregate amount of premium payable

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for any of the previous years during the term of any of the policies exceeds INR 2,50,000 *(fifth proviso)*.

The Finance Act, 2023 further amended Section 10(10D) to provide that the following will not be exempt under Section 10(10D) with effect from 1 April 2024 (except any such sum received on the death of a person) –

- Any sum received under a life insurance policy (other than a ULIP), issued on or after 1 April 2023, if the amount of premium payable for any of the previous years during the term of such policy exceeds INR 5,00,000 *(sixth proviso)*.
- Any sum received under more than one life insurance policy (other than a ULIP), issued on or after 1 April 2023, if the aggregate amount of premium payable for any of the previous years during the term of any of the policies exceeds INR 5,00,000 *(seventh proviso)*.

Further, clause (xiii) was inserted in Section 56(2) and sub-clause (xviid) was inserted in Section 2(24) of the Act *vide* \ Finance Act, 2023 to include any such sum received under a life insurance policy (other than a ULIP), which is not exempt under Section 10(10D) in the computation of total income. In this regard, it is provided that the sum so received as exceeds the aggregate of the premium paid, during the term of such life insurance policy and not claimed as deduction in any other provision of the Act, will be chargeable to income-tax under the head 'Income from other sources'.

The ninth proviso to Section 10(10D) empowers CBDT to issue guidelines to remove any difficulty which arises while giving effect to the provisions of the said clause. In exercise of the powers under this proviso, the CBDT has issued guidelines *vide* Circular No. 15/2023 dated 16 August 2023.

The guidelines have provided the definitions of 'eligible life insurance policy', 'consideration' and 'current previous year'. Further, CBDT through several illustrative examples has provided a practical understanding of the conditions under which the exemption under Section 10(10D) will apply.

Further, the Circular has clarified that the premium/ aggregate premium payable for a life insurance policy(ies) (other than a ULIP), issued on or after 1st April 2023 for any previous year will be exclusive of the amount of Goods and Services Tax (GST) payable on such premium.

Additionally, the Circular has clarified that exemption under Section 10(10D) shall continue to be available for term life insurance policy and the proviso introduced by Finance Act, 2023 (denying exemption to certain ULIPs) shall not be applicable in respect of the same. A term life insurance policy is such where the sum insured is only paid to the nominee in case of death of the insured person during the term of policy and no amount is paid to anyone in case the insured person survives the policy. In other words, any sum received under a term insurance policy will be exempt under Section 10(10D) irrespective of the amount of premium payable in respect of such policy.

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Life Insurance Policy – Rule notified for computation of income chargeable to tax for amount received under life insurance policy

Clause (xiii) of sub-section (2) of Section 56 of the Act includes in the total income of an assessee, any sum received, including amount received as bonus, under a life insurance policy.

The CBDT *vide* the Income-tax (Sixteenth Amendment) Rules, 2023 inserted Rule 11UACA to the Rules to lay down the computation of the income chargeable to tax under Section 56(2)(xiii). The same has been summarized hereinbelow –

- Where the sum is received for the first time under a life insurance policy during the previous year (first previous year), the income chargeable to tax in the first previous year will be computed using the formula 'A *less* B', where –

  A= the sum/aggregate of sum received under the life insurance policy during the first previous year

  B= the aggregate of the premium paid during the life insurance policy till the date of receipt of the sum in the first previous year that has not been claimed as deduction under any other provision of the Act.

- Where the sum is received under a life insurance policy during the previous year subsequent to the first previous year (subsequent previous year), the income chargeable to tax in the subsequent previous year shall be computed using the formula 'C *less* D', where –

  C= the sum/aggregate of sum received under the life insurance policy during the subsequent previous year

  D= the aggregate of premium paid during the term of the life insurance policy till the date of receipt of the sum in the subsequent previous year not being premium which has been claimed as deduction under any other provision of the Act or is included in amount B or D in any of the previous years.

No TDS under Section 194-I on payment of lease rent for lease of ship to an IFSC unit

Section 80LA of the IT Act provides for deductions in respect of certain incomes of offshore banking units and International Financial Services Centre ('**IFSC**'). The CBDT *vide* Notification No. 57/2023 dated 1 August 2023 has provided that no deduction of tax will be made under Section 194-I of the IT Act on payments for lease rent/supplemental lease rent made by a person to a unit of an IFSC for lease of a ship, subject to the following conditions-

- The lessor shall furnish a statement-cum-declaration in Form No. 1 to the lessee giving details of the previous years relevant to the ten consecutive assessment years for which deduction is claimed by such unit under Section 80LA. Such statement-

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cum-declaration shall be furnished and verified in the manner specified in Form No. 1, for each previous year.

- The lessee shall not deduct tax on payment made/credited to the lessor after the date of receipt of copy of statement-cum-declaration in Form No. 1 from the lessor. Further, the lessee shall furnish particulars of all payments made to the lessor on which tax has not been deducted in the statement of deduction of tax referred to in Section 200(3) of the Act read with Rule 31A of the Rules.

Further, the said relaxation has been made available to the unit in IFSC only during those previous years relevant to the ten consecutive assessment years for which deduction is claimed by such unit under Section 80LA. The lessor will be liable to deduct tax on payment of lease rent for any other year.

The said notification has come into force from 1 September 2023.

Exchange rate for TDS on income payable in foreign currency to include payments to and from IFSC units

Rule 26 of the Rules laid down the rate of exchange for the purpose of deduction of tax at source on income payable in foreign currency. It stated that the rate of exchange for the calculation of the rupees value of the income payable in foreign currency to an assessee outside India will be the telegraphic transfer buying rate of such currency as on date on which the tax is required to be deducted at source.

The CBDT has *vide* Income-tax (Seventeenth Amendment) Rules, 2023 substituted Rule 26 of the Rules. The new rule has expanded the scope of Rule 26 to include the income payable in foreign currency to the following persons, in addition to an assessee outside India:

- To a unit located in IFSC;
- By a unit located in IFSC to an assessee in India.

Search and seizure – Procedure for requisition services under Section 132(2) and for making a reference under Section 132(9D) for valuation, prescribed

Section 132 of the Act pertains to search and seizure. Prior to 1 April 2023, sub-section (2) of Section 132 gave power to the authorized officer to requisition services of any police officer/ officer of the Central Government/ both, to assist him in the search and seizure action. The Finance Act, 2023, with effect from 1 April 2023, amended sub-section (2) to include *'any person or entity approved by the Principal Chief Commissioner/Chief Commissioner/ Principal Director General/ Director General'* in the list of persons whose services may be requisitioned by the authorized officer.

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Further, prior to 1 April 2023, sub-section (9D) of Section 132 gave power to the authorized officer to make a reference to the valuation officer during search and seizure/ within 60 days from the last date of search and seizure. Such valuation officer was to estimate the fair market value of the property and submit a report of the estimate to the authorized officer within 60 days of the receipt of the reference. The Finance Act, 2023, with effect from 1 April 2023, amended sub-section (9D) to include *'any person or entity or valuer registered under any law, as approved by the Principal Chief Commissioner/ Chief Commissioner/ Principal Director General/ Director General'* in the list of persons to whom reference may be made by the authorized officer.

CBDT has, *vide* Income-tax (Nineteenth Amendment) Rules, 2023, inserted Rule 13 in the Rules to prescribe the procedure for requisition services under Section 132(2) and for making a reference under Section 132(9D). By way of the same, CBDT has laid down that any person or entity whose services may be requisitioned under Section 132(2)(ii) or to whom reference may be made for the purposes of Section 132(9D)(ii) may make an application in Form 6C which has to be disposed off within six months from the end of the month in which the application is made. It is further provided that a designated approval number shall be provided to such person/entity if the application is approved. The services of a person/entity who is not approved under the above-mentioned provisions may be requisitioned if it is necessary or expedient to do so. The concerned officer is required to record reasons for such requisition and obtain approval for the same within thirty days of such requisition.

Further, CBDT inserted Rule 13A in the Rules for determining the valuation under Section 132(9D) of the Act. The manner for the same is summarised hereinbelow –

- The value of an immovable property (land/building/both) will be in accordance with the value adopted by any authority of Central/State Government for the purpose of stamp duty payment in respect of such property, along with the cost of construction and improvements (if any), on the date on which the property is required to be valued as per Section 132(9D);
- The value of jewellery, archaeological collections, drawings, paintings, sculptures, any work of art, shares or securities referred to in Rule 11UA, will be the value determined as per 11UA(1). For this purpose, the reference to the valuation date in the Rule 11U and Rule 11UA shall be the date on which such property is required to be valued as per Section 132(9D);
- The value of property other than those covered above, or where valuation as specified hereinabove is not feasible shall be the price that such property would ordinarily fetch on sale in the open market on the date on which such property is required to be valued as per Section 132(9D).

Procedure for application under Section 155(20) prescribed

Section 155(20) of the Income Tax Act, 1961 lays down that where an income is included in the income-tax return filed by an assessee in any assessment year, and TDS in respect of such income is paid

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to the credit of the Central Government in the subsequent assessment year, the assessee may make an application to the Assessing Officer within two years from the end of the financial year in which the tax was deducted at source. Further, it has been provided that that on receipt of such an application made by the assessee, the Assessing Officer shall amend the order of assessment/ intimation and allow the credit of such TDS to the assessee.

The CBDT has *vide* the Income-tax (Twentieth Amendment) Rules, 2023 inserted Rule 134 prescribing the procedure of the application to be filed by the assessee for the credit of TDS. It is laid down that the application shall be made in Form No. 71 electronically –

- Under digital signature, if the return of income is required to be furnished under digital signature.
- Through electronic verification code in a case not covered under clause (i)

The format of Form 71 has also been provided in the Notification.

Applicability of Safe Harbour rules extended to AY 2023-24

The CBDT, by enacting the Income-tax (Fifteenth Amendment) Rules, 2023, has extended the sunset period for applicability of the safe harbour rules from AY 2022-23 to AY 2023-24. This amendment has been made effective from 1 April 2023.

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Ratio Decidendi

- High Courts must formulate 'substantial question of law' before admitting appeal under Section 260A – Supreme Court
- Provisional attachment of property under Benami Transactions Act during judicial custody of directors is valid – Madras High Court
- Compensation for premature termination of contract is revenue expenditure – Bombay High Court
- Non-compete fees is capital expenditure akin to intangible asset and is eligible for depreciation under Section 32(1)(ii) – Bombay High Court
- Deemed dividend – Only registered shareholders of company as per Companies Act can be considered as shareholders of a company – Bombay High Court
- Tax Authorities cannot go behind Tax Residency Certificate – ITAT Delhi
- Compulsorily convertible preference shares are covered within the ambit of 'shares' in terms of Article 13(4) of the India-Mauritius DTAA – ITAT Delhi

Ratio Decidendi

High Courts must formulate 'substantial question of law' before admitting appeal under Section 260A

The appellant filed an appeal before the Delhi High Court against the judgement of Income Tax Appellate Tribunal (ITAT). The High Court heard the appeal on merits without initially formulating a substantial question of law and subsequently, formulated the question of law allowing the appeal on merits.

Aggrieved by the order, the appellant filed an appeal before the Hon'ble Supreme Court. The Apex Court in this regard observed that the High Courts have to follow the procedure laid down under Section 260A of the Income Tax Act. As per the Section, an appeal before the High Court is maintainable only on a substantial question of law (not a question of fact or only a question of law). The High Court when entertaining such an appeal must formulate that question and admit the appeal. Thereafter, on the question so formulated, the respondent must also be heard and consequently the matter must be disposed of depending on whether the substantial question of law is required to be answered for or against either of the parties or no such question of law would arise.

In the facts of the case, issuance of notice prior to admission without framing any substantial question of law was not in accordance with Section 260A of the Act. Hence, the decision of High Court was set aside and the matter was remanded back for re-consideration. [*Bikram Singh* v. *Principal Commissioner of Income Tax* – Order dated 29 August 2023 in SLP(C) No. 31854/2017, Supreme Court [TS-502-SC-2023]]

Provisional attachment of property under Benami Transactions Act during judicial custody of directors is valid

A company and its directors were booked for the offences of cheating, criminal breach of trust, and forgery under Sections 409, 420, 465 and 468 of the Indian Penal Code, 1860. Pursuant to this, the directors were taken for judicial custody. While the directors were in judicial custody, the initiating officer issued a notice under Section 24(1) of the Prohibition of Benami Property Transaction Act, 1988 to show cause as to why their properties be not treated as benami properties. These properties were provisionally attached subsequently while the directors were in judicial custody. The directors replied to the notices after being released from judicial custody and filed writ petitions before the Madras High Court challenging the provisional attachment of their properties. By way of a common order, the Madras HC has upheld the impugned provisional attachment order.

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The Court noted that there was nothing on record to indicate that the officer was aware of judicial custody of the Petitioners (directors) when the provisional attachment was made. Further, it held that mere suspicion that certain property could be involved in a benami transaction is sufficient for the initiating authority to form an opinion on provisional attachment. It was elucidated that the provisional attachment is valid since it was only preliminary, to secure the property which may be confiscated eventually. Therefore, the Court dismissed the writ petitions. [*M. Kumudhavalli* v. *Initiating Officer* – Order dated 16 August 2023 in W.P. Nos. 19819, 20303, 20362 & 18611 of 2023, Madras High Court]

i. Compensation for premature termination of contract is revenue expenditure

ii. Non-compete fees is capital expenditure akin to intangible asset and is eligible for depreciation under Section 32(1)(ii)

The Assessee was engaged in the business of advertising through its radio channel. It entered into an agreement with Star India Pvt. Ltd. (SIPL) for procuring advertisements from various clients. However, a dispute arose between the parties and the said Agreement was terminated. The Assessee paid INR 12.6 crore to SIPL as compensation for premature termination of contract, under the Advertisement and Agency Sales Termination Agreement (ASTA) and INR 19.4 crore as non-compete fee under Restrictive Covenant Agreement (RCA).

The Assessee treated these payments as revenue expenditure, but the Assessing Officer held that the payments were in nature of capital expenditure in terms of Section 28(va).

The Bombay High Court relying upon the decision of the Hon'ble Supreme Court in the case of *CIT* v. *Ashok Leyland Ltd.* [(1972) 86 ITR 549 (SC)] held that the compensation paid under the ASTA was revenue in nature as the Assessee did not acquire any enduring benefit or any income yielding asset by avoiding certain business expenditure due to termination of the agreement.

With respect to the non-compete fees paid under the RCA, the Court relied on the decisions of *CIT* v. *Piramal Gas Ltd.* [ITA No. 556 of 2017] and *India Medtronic Pvt. Ltd.* [ITA No.1453 of 2017] wherein it was held that rights acquired under a non-compete agreement provide enduring benefit to the Assessee by protecting its business against competence from a person who had closely worked with the assessee in the same business, thus it is eligible for depreciation under Section 32(1)(ii) read with Explanation 3 of the Act. Therefore, the Bombay High Court held that the non-compete fees paid by the assessee was capital in nature and the assessee is eligible to claim depreciation on the same as an intangible asset. [*Pr. Commissioner of Income Tax* v.

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Music Broadcast Pvt. Ltd. – Order dated 9 August 2023 in ITA No. 675 of 2018, Bombay High Court]

Deemed dividend – Only registered shareholders of company as per Companies Act can be considered as shareholders of a company

The assessees, three brothers in this case, each held 33% shares in various private limited companies engaged in the business of construction and hospitality. All the three brothers were married to their spouses under the Portuguese Civil Code, as applicable in the state of Goa. Under the said code, in the absence of any ante nuptial agreement between the spouses, each of them has 50% right to their common estate.

During the financial year 2011-12, a search was conducted on the premises of one of the companies in which the assessees held shares. During the search, it was observed that the companies had remitted intra group advances to each other. The assessing officer treated the said payments as deemed dividend in the hands of the brothers and made additions under Section 2(22)(e) of the Act. The assessees claimed that by virtue of application of Portuguese Civil Code, their wives are entitled to 50% of the shareholding and consequently, the balance 16.5% held by the individual assessees does not qualify the limit of 20% as required under Section 2(22)(e) of the Act.

On appeal before High Court, the Court observed that Companies Act is a separate code in itself. No person other than a member who has subscribed to the Memorandum has any rights or control or can intermediate with the affairs of the company.

According to the Court, the Companies Act, 1956 does not envisage a situation whereby virtue of a personal law applicable to a shareholder of a company, the spouse of such shareholder could claim voting rights in a poll to pass resolutions or, for that matter, claim a privity of contract to bind herself to the Memorandum of a Company and the Articles of Association of such company. Neither can such spouse claim, by virtue of being a moiety holder in the common estate, the management of a company in which her husband is a member or shareholder. Further, the Court held that under Section 2(22)(e), the words 'member', 'shareholder' and 'holder of a share' will mean the registered shareholder or registered beneficial owner of a share whose name is found in the register of members/shareholders of the company under Section 150 or register of beneficial owner under Section152A of the Companies Act, 1956.

For the above reasons, the Hon'ble Court rejected the claim of the assessees and held that Section 2(22)(e) of the Income Tax Act was applicable in the present case. [*Dattaprasad Kamat* v. *Assistant Commissioner of Income Tax* – Order dated 18 August 2023 in Tax appeal No. 51/2017 with Civil Application No. 136/2017, Bombay High Court]

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iii. Tax Authorities cannot go behind Tax Residency Certificate

iv. Compulsorily convertible preference shares are covered within the ambit of 'shares' in terms of Article 13(4) of the India-Mauritius DTAA

The assessee in this case was a resident of Mauritius, holding a valid Tax Residency Certificate (TRC). During the assessment year 2019-20, it sold its investment in the form of equity shares in two Indian companies which were acquired prior to 1 April 2017.

In its original income tax return, the assessee claimed an exemption from long-term capital gains in light of Article 13(4) of the DTAA which provides for exemption from gains on sale of shares equity shares acquired prior to 1 April 2017. However, it filed a revised ITR subsequently, wherein the long-term gains from sale of shares in one company were offered to tax under Article 13(B) of the DTAA on a conservative basis since these shares were converted into equity shares on 4 August 2017 i.e., after 1 April 2017. However, before the Income-tax Appellate Tribunal (ITAT**)**, the assessee raised an additional ground that the income from sale of shares in that company was also exempt under Article 13(4).

The assessing officer denied treaty benefits to the assessee on two grounds. Firstly, it held that the assessee was a conduit entity whose sole purpose was to abuse treaty benefits. Secondly, it held that the equity shares in the company were acquired after 1 April 2017 by way of conversion of compulsorily convertible preference shares (CCPS) and therefore, the same would fall outside the purview of exemption under Article 13(4).

While deciding the appeal, the ITAT first relied upon the decision of Hon'ble Supreme Court in the case of *Union of India* v. *Azadi Bachao Andolan* [132 Taxman 373] and the decision of jurisdictional High Court in the case of *Blackstone Capital Partners (Singapore) VI FDI Three Pte Ltd.* v. *ACIT* [146 taxmann.com 569 (Del)] to hold that treaty benefits cannot be denied once TRC has been issued by the competent authority of the other country. Secondly, the ITAT held that CCPSs were compulsorily converted to equity shares without any substantial change in the rights of the Assessee. Therefore, definition of 'shares' when considered in a broader sense will include CCPS as well. Hence, sale of CCPS which were acquired before 1 April 2017 but converted after 1 April 2017 is also covered within the exemption provided under Article 13(4). Therefore, the assessee was eligible for treaty benefit upon sale of investments made in both companies. [*Sarva Capital LLC* v. *ACIT* – Order dated 10 August 2023 in ITA No. 2289/Del/2022, ITAT, Delhi]

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NEW DELHI
5 Link Road, Jangpura Extension, Opp. Jangpura Metro Station, New Delhi 110014
Phone : +91-11-4129 9811

B-6/10, Safdarjung Enclave New Delhi -110 029
Phone : +91-11-4129 9900
E-mail : lsdel@lakshmisri.com

MUMBAI
2nd floor, B&C Wing, Cnergy IT Park, Appa Saheb Marathe Marg,
(Near Century Bazar)Prabhadevi,
Mumbai - 400025
Phone : +91-22-24392500
E-mail : lsbom@lakshmisri.com

CHENNAI
2, Wallace Garden, 2nd Street, Chennai - 600 006
Phone : +91-44-2833 4700
E-mail : lsmds@lakshmisri.com

BENGALURU
4th floor, World Trade Center, Brigade Gateway Campus, 26/1, Dr. Rajkumar Road,
Malleswaram West, Bangalore-560 055.
Phone : +91-80-49331800 Fax:+91-80-49331899
E-mail : lsblr@lakshmisri.com

HYDERABAD
'Hastigiri', 5-9-163, Chapel Road, Opp. Methodist Church, Nampally
Hyderabad - 500 001
Phone : +91-40-2323 4924 E-mail :lshyd@lakshmisri.com

AHMEDABAD
B-334, SAKAR-VII, Nehru Bridge Corner, Ashram Road, Ahmedabad - 380 009
Phone : +91-79-4001 4500
E-mail : lsahd@lakshmisri.com

PUNE
607-609, Nucleus, 1 Church Road, Camp, Pune-411 001.
Phone : +91-20-6680 1900
E-mail : lspune@lakshmisri.com

KOLKATA
2nd Floor, Kanak Building 41, Chowringhee Road, Kolkatta-700071
Phone : +91-33-4005 5570
E-mail : lskolkata@lakshmisri.com

CHANDIGARH
1st Floor, SCO No. 59, Sector 26, Chandigarh -160026
Phone : +91-172-4921700
E-mail :lschd@lakshmisri.com

GURGAON
OS2 & OS3, 5th floor, Corporate Office Tower, Ambience Island, Sector 25-A,
Gurgaon-122001
phone: +91-0124 - 477 1300 Email: lsgurgaon@lakshmisri.com

PRAYAGRAJ (ALLAHABAD)
3/1A/3, (opposite Auto Sales), Colvin Road, (Lohia Marg), Allahabad -211001 (U.P.)
Phone : +91-532-2421037, 2420359
E-mail : lsallahabad@lakshmisri.com

KOCHI
First floor, PDR Bhavan, Palliyil Lane, Foreshore Road, Ernakulam Kochi-682016
Phone : +91-484 4869018; 4867852
E-mail : lskochi@laskhmisri.com

JAIPUR
2nd Floor (Front side), Unique Destination, Tonk Road, Near Laxmi Mandir Cinema
Crossing, Jaipur - 302 015
Phone : +91-141-456 1200
E-mail : lsjaipur@lakshmisri.com

NAGPUR
First Floor, HRM Design Space, 90-A, Next to Ram Mandir, Ramnagar,
Nagpur - 440033
Phone: +91-712-2959038/2959048
E-mail : lsnagpur@lakshmisri.com

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