Direct Tax Vista

Your weekly Direct Tax recap

Edn. 21 – 30th August 2022

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1. Deduction of writing off of an advance is available only incase write off is "on sound and reasonable basis"

It is rare that the Apex Court turns down a judgement of both, the ITAT and The High Court on the same lines. However, sometimes the Apex Court also gets into the facts incase the matter of law is hidden in the facts of the case. Writing off an advance is allowed only when the ingredients of both Section 36(1)(vii) and Section 36(2) of the Act are satisfied. Where the loan/advance made is bereft of any material as to the terms of the loan/ advance, the conditions of repayment or interest; Where the accounts of the assessee nowhere showed that the advance was made by it in the ordinary course of business or there was no material to substantiate this submission that the amount was given for the purpose of purchasing certain goods/ services - the Deduction of writing off of an advance is not "on sound and reasonable basis" and hence would not be allowed. The same was held by The Apex Court in the case of PR. COMMISSIONER OF INCOME TAX Vs KHYATI REALTORS PVT LTD [2022-VIL-20-SC-DT].

An alternate argument generally taken, was also made by The Counsel in this case, i.e. if a claim for deduction under a particular Section in PGBP is not allowed, the possibility of its exclusion under Section 37 cannot be ruled out. The Hon'ble Court ruled that as a proposition of law, that enunciation is unexceptional, since the heads of expenditure that can be claimed as deduction are not exhaustive. In a given case, if the expenditure relates to business, and the claim for its treatment under other provisions are unsuccessful, application of Section 37 is per se not excluded. In our view is that this matter on application of Section 37 may have been dealt with in greater detail by The Hon'ble Apex Court as there are counter arguments to the judgement of The Apex Court in this respect on which assessees may rely in future cases.

2. Merely because an expense results in enduring benefit would not make it capital in nature

It is a common law that incase an expenditure results in a 'enduring benefit', it would be treated as capital expenditure and the deduction would not be allowed. However, the test of enduring benefit cannot be applied blindly and mechanically, without regard to particular facts and circumstances. Incase the intent and purpose of expenditure is incurred for smooth running of business, then, even if there is an enduring benefit, such expenditure has to be considered as revenue in nature. The principle was laid down by The Hon'ble Supreme Court in Empire Jute Co. Ltd. Vs. CIT (1980) 124 ITR 1 (SC) and the ration of this judgement may be applied by assessees in their cases.

Therefore, incase a permission is mandatory to seek from a Government agency before making any changes in a product or before introducing new / upgraded version of existing product before its commercial use, it would be considered as a business expenditure and be allowed as revenue expenditure. The same was held in the case of THE ASSTT. C.I.T Vs MERCEDES-BENZ INDIA PVT LTD [2022-VIL-1072-ITAT-PNE].

3. Penalty cannot be imposed without mentioning the specific charge / guilt

Very rarely does an assessee get a favourable judgement even without appearance. However, taxation litigation throws up surprises and so it did in the case of SEZ INDORE LIMITED Vs ACIT [2022-VIL-1073-ITAT-IND]. In this case while the penalty proceeding was initiated by the DCIT for furnishing of inaccurate particulars of income by the assessee, yet while imposing penalty the DCIT clearly came to a conclusion that there was concealment and furnishing of inaccurate particulars of income by the assessee. The Court did not align to this and held that It is incumbent upon the assessing authority to come to a positive finding as to whether there was concealment of income by the assessee or whether any inaccurate particulars of such income had been furnished. Otherwise the penalty order passed by the authorities below is liable to be quashed. Penalty can be imposed without specifying guilt as to whether there was concealment of income by the assessee or furnishing of inaccurate particulars of such income by the assessee. There should be no

confusion in the mind of the AO as to why a penalty needs to be levied. This decision was pronounced even in the absence of the assessee, yet it was in its favour.

One aspect to learn from this judgement is that one must never loose hope in litigation and the match is not complete until the last ball is bowled.

4. 'Interest' paid by assessee to the Dept. is a 'debt' in the hands of the department. Hence Interest on this debt needs to be paid and it cannot be coloured as 'interest on interest'

It is generally seen that two standards are followed by the department, one while collecting and the other while refunding an amount collected. A payment was collected by Revenue towards interest under Section 234D and Section 220(2) of the Act. The said collection was found to be incorrect and the AO directed refund to the assessee. Now the question was whether an interest on the refund of 'interest' was payable to the assessee. It was held in the case of PRINCIPAL COMMISSIONER OF INCOME TAX Vs PUNJAB & SIND BANK [2022-VIL-195-DEL-DT], that the nature of the amount collected was that of demand and hence it was a 'debt' in the hands of the department.

The amount which was been directed by AO to be refunded to the assessee under Section 234D and Section 220(2) of the Act was not 'interest' in the hands of the assessee i.e. the recipient. The refund amount did not bear the character of 'interest' either in the hands of the assessee i.e. the payee or in the hands of the Revenue i.e. the payer. For Revenue to term 'payment of this debt' as 'interest' was fallacious. The said payment sought by the assessee from the department was therefore interest on the debt owed to it by the Revenue and not 'interest on interest'.

5. Substantive law, no retrospective application

Late Mr. Jaitley explained in Parliament as to why the Government opted for amending the Original Act instead of enacting a fresh legislation. He stated that "Anybody will know that a law can be made retrospective, but under Article 20 of the Constitution of India, penal laws cannot be made retrospective. The simple answer to the question why we did not bring a new law is that a new law would have meant giving immunity to everybody from the penal provisions during the period

1988 to 2016 and giving a 28-year immunity would not have been in larger public interest, particularly if large amounts of unaccounted black money have been used to transact those transactions."

The Supreme Court in the case of UNION OF INDIA & ANR. Vs M/s GANPATI DEALCOM PVT. LTD. [2022-VIL-18-SC-DT] held against the same ground that Benami Transactions (Prohibition) Amendment Act, 2016 does not have retrospective application and the authorities cannot initiate or continue criminal prosecution or confiscation proceedings for transactions entered into prior to the coming into force of the legislation. The Apex court ruled that section 3(2) and section 5 of the Benami Transactions (Prohibition) Act, 1988 are vague and arbitrary.

The Apex Court did not agree with the erstwhile Finance Minister and held that Article 20(1) mandates that no law mandating a punitive provision can be enacted/re-enacted retrospectively. It thus firewalled the benami properties transacted between 1988 and 2016. It declared the provision of the law dealing with a three-year jail term and a penalty as "unconstitutional". The Court ruled that such implied intrusion into the rights to property cannot be permitted to operate retroactively because that would be unduly "harsh and arbitrary".

6. Big Changes made by RBI in Overseas Investment Rules and Regulations

The Government vide Notification no. G.S.R 646(E), dated 22-08-2022 has notified the Foreign Exchange Management (Overseas Investment) Rules, 2022. The new norms aim to simplify the existing framework for overseas investment by a person resident in India to cover wider economic activity and significantly reduce the need for seeking specific approvals. The Foreign Exchange Management (Overseas Investment) Rules, 2022 will subsume extant regulations pertaining to Overseas Investments and Acquisition and Transfer of Immovable Property outside India Regulations, 2015. These rules specify the Restriction on acquisition or transfer of immovable property outside India.

There are five schedules Schedule I specifies Manner of making Overseas Direct Investment by Indian entity, Schedule II specifies Manner of making Overseas Portfolio Investment by an Indian entity, Schedule III specifies Manner of making

Overseas Investment by resident individual, Schedule IV specifies Overseas Investment by person resident in India other than Indian entity and resident Individual, Schedule V specifies Overseas Investment in IFSC by person resident in India. The mode of payment, deferred payment of consideration, reporting, realisation, and other requirements for any investment outside India by a person resident in India shall be as per the regulations made in this behalf by the Reserve Bank under the Act. The various pointers as per the Rules are as follows –

1. Non-applicability of overseas direct investment norms to specified investments/transfers: These rules shall not apply to:

(a) any investment made outside India by a financial institution in an IFSC;

(b) acquisition or transfer of any investment outside India made:

- out of Resident Foreign Currency Account; or
- out of foreign currency resources held outside India by a person who is employed in India for a specific duration irrespective of length thereof or for a specific job or assignment, duration of which does not exceed three years; or
- by a person when he was resident outside India or inherited from a person resident outside India

2. Restrictions and Prohibitions on activities under 'Overseas Investment norms'

Any investment made outside India by a person resident in India shall be made in a foreign entity engaged in a bona fide business activity, directly or through a step-down subsidiary or the special-purpose vehicle, subject to the limits and the conditions laid down in these rules and the said regulations

3. **Prohibited Entities that are engaged in specified activities**

A person resident in India are prohibited from making any investment in a foreign entity engaged in:

(a) Real estate activity

(b) Gambling in any form

(c) Dealing in financial products linked to the Indian rupee without specific approval of the Reserve Bank.

These activities are still restricted.

4. ODI in Starts-ups –

Indian entities can't use borrowed funds to make an ODI in the start-ups. The new Rules and regulations specify that any 'Overseas Direct Investment' in start-ups recognized under the laws of the host country or host jurisdiction as the case may be, shall be made by an Indian entity only from the internal accruals whether from the Indian entity or group or associate companies in India and in case of resident individuals, from own funds of such an individual.

This restriction is to limit the risks associated with the investments in start ups.

5. **No financial commitment is allowed in a foreign entity if it resulting in having two layers of subsidiaries**

No person resident in India shall make a financial commitment in a foreign entity that has invested or invests into India, at the time of making such financial commitment or at any time thereafter, either directly or indirectly, resulting in a structure with more than two layers of subsidiaries

6. **Valuation norms proposed for overseas direct investments**

The new norms permit restructuring of the balance sheet by a foreign entity. Under new norms, a person resident in India who has made ODI in a foreign entity can permit restructuring of the balance sheet by a foreign entity, which has been incurring losses for the previous two years as per its last audited balance sheets.

However, restructuring can be permitted by a foreign entity only after ensuring compliance with reporting, documentation requirements, and diminution in the total value of the outstanding dues towards a person resident in India on account of investment in equity and debt. The diminution

in value is required to be duly certified on an arm's length basis by a registered valuer:

(a) where the amount of original investment is more than USD 10 million or **(b)** where the amount of such diminution exceeds 20% of the total value of the outstanding dues towards the Indian entity or investor,

The certificate to be submitted to the AD Bank should not be more than 6 months old.

7. NPA account holder must obtain NOC from lender bank before making financial commitments

Under new norms, a person resident India who has account appearing as NPA or is classified as willful defaulter by any bank or under investigation by CBI/ED/SFIO shall obtain NOC from lender bank before making any financial commitment or undertaking disinvestment. In case if lender bank or regulatory body or investigative agency concerned fails to furnish the certificate within 60 days from the date of receipt of such application, it may be presumed that there was no objection to the proposed transaction.

This is a relaxation with a rider.

8. **Pricing for issue/transfer of equity of foreign entity shall be at Arm's length**

The norms provide that issue or transfer of equity capital of a foreign entity from a person resident outside India or a person resident in India to a person resident in India who is eligible to make such investment or from a person resident in India to a person resident outside India shall be subject to a price arrived on an arm's length basis. The norms obligate AD Bank to ensure compliance with Arms' length pricing before facilitating such transactions.

The impact on transfer pricing should also be seen.

9. Government lists out debt and non-debt instruments

As per Section 6(6) of the Act, the term 'debt instruments' for the purpose of capital account means such instruments as listed out as under:

(a) Debt instruments:
- Government bonds;
- corporate bonds;
- all tranches of securitization structure that are not equity tranche;
- borrowings by firms through loans; and
- depository receipts whose underlying securities are debt securities;

(b) Non-Debt instruments:
- all investments in equity in incorporated entities (public, private, listed and unlisted);
- capital participation in LLPs;
- all instruments of investment as recognised in the FDI policy;
- investment in units of AIF and REITs and InVITs;
- investment in units of mutual funds and Exchange-Traded Fund which invest more than 50 % in equity;
- the junior-most layer (i.e. equity tranche) of securitization structure;
- acquisition, sale or dealing directly in immovable property;
- contribution to trusts; and
- depository receipts issued against equity instruments;

10. Continuity of certain investments for a smooth transition to new norms

In order to have a smooth transition from the old regime to the new overseas investment norms, any investment or financial commitment outside India made in accordance with the Act or the rules or regulations made thereunder and held as on the date of publication of these rules in the Official Gazette shall be deemed to have been made under these rules and the Foreign Exchange Management (Overseas Investment) Regulations, 2022.

The impact of these transitional provisions needs to be seen more in detail going forward.

11. **Treatment of Rights issue and bonus issue for investors who hold equity in a foreign entity**

Similarly, any person resident in India who has acquired and continues to hold equity capital of any foreign entity may invest in equity such entity as right issue and he may be granted bonus shares in compliance with the terms and conditions laid out in new norms.

12. Transfer or liquidation of overseas Investment

A person resident in India may transfer equity capital by way of sale to a person resident in India, who is eligible to make such investment under these rules, or to a person resident outside India. In case the transfer is on account of merger, amalgamation, or demerger or on account of buyback of foreign securities, such transfer or liquidation in case of liquidation of the foreign entity shall have the approval of the competent authority as per the applicable laws in India or the laws of the host country or host jurisdiction, as the case may be.

13. **Conditions for Disinvestment**

If disinvestment by a person resident in India relates to ODI then, the transferor shall not have dues outstanding for the receipt from the foreign entity as an investor in equity capital or debt. In case of any disinvestment, the transferor must have stayed invested for at least one year from the date of making ODI. However, the above conditions shall not be applicable in case of a merger, demerger or amalgamation between two or more foreign entities that are wholly-owned, directly or indirectly, by the Indian entity or where there is no change or dilution in aggregate equity holding of the Indian entity in the merged or demerged or amalgamated entity.

14. **Introduction of the new definitions**

a. Overseas Investment: “Overseas Investment” or “OI” means financial commitment and Overseas Portfolio Investment by a person resident in India;

b. Overseas Direct Investment: “Overseas Direct Investment” or “ODI” means investment by way of acquisition of unlisted equity capital of a foreign entity, or subscription as a part of the memorandum of association of a foreign

entity, or investment in 10%, or more of the paid-up equity capital of a listed foreign entity or investment with control where investment is less than 10% of the paid-up equity capital of a listed foreign entity;

c. Overseas Portfolio Investment: "Overseas Portfolio Investment" or "OPI" means investment, other than ODI, in foreign securities, but not in any unlisted debt instruments or any security issued by a person resident in India who is not in an IFSC.

There are many other definitions as per the new rules and regulations.

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