Direct Tax Vista

Your weekly Direct Tax recap

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1. Is Class Legislation possible in Taxation?

The Rule of Law cannot prevent a certain class of persons from being subject to special laws. The State has the power to make laws operating differently on different classes of people, in a way that the principle of equality of civil rights and equal protection of law is followed. This is known as the 'Doctrine of Reasonable Classification'. Article 14 permits Reasonable Classification and not Class Legislation.

However, as held in the case of V. Venugopala Ravi Varma Rajah vs. Union of India, (1969) 74 ITR 49, incase of taxation statutes, the power to classify may be exercised so as to adjust the system of taxation in all proper and reasonable ways; the legislature may select person, properties, transactions and objects, and apply different methods and even rates for tax if the legislature does so reasonably. If the classification is rational the legislature is free to choose objects of taxation, impose different rates, exempt classes of property from taxation, subject different classes of property to tax in different ways and adopt different modes of assessment. A taxing statute may contravene Article 14 of the Constitution if it seeks to impose on the same class of property, persons, transactions or occupations similarly situate incidence of taxation, which leads to obvious inequality.

A taxing statute is not, therefore, generally exposed to attack on the ground of discrimination merely because different rates of taxation are prescribed for different categories of persons, transactions, occupations or objects. Sec 10 (26AAA) also sought to achieve this ‘reasonable classification’ by providing to exempt income of an individual Sikkimese from any source in the State of Sikkim; or by way of dividend or interest on securities incase :

1. An individual, whose name is recorded in the register maintained under the Sikkim Subjects Regulation, 1961 read with the Sikkim Subject Rules, 1961 (hereinafter referred to as the "Register of Sikkim Subjects"), immediately before the 26th day of April, 1975; or
2. The person is not a Sikkimese woman who, on or after the 1st day of April, 2008, marries an individual who is not a Sikkimese.

When such classification was contested in the case of ASSOCIATION OF OLD SETTLERS OF SIKKIM AND ORS Vs UNION OF INDIA AND ANR [2023-VIL-02-SC-DT], it was held by The Hon'ble Apex Court that the purpose of Section 10(26AAA) is to grant exemption to the residents of Sikkim from payment of income tax under the Income Tax Act. Therefore, all such Indians/citizens, who have settled in Sikkim prior to the merger of Sikkim with India on 26.04.1975 should be treated at par and they form the same group/class. Also, a Sikkimese woman who marries a non-Sikkimese after 01.04.2008 should also be treated at par with other Sikkimese women.

Therefore, The Apex Court laid down that taxation Law can also only classify into groups on satisfaction of twin criteria as follows -

1. On identifiable and intelligible criteria, which sets apart one group from the other.
2. Such a classification of a separate and identifiable group should bear a reasonable nexus with the object and purpose sought to be achieved by that law.

This judgement would be useful in tax matters where dissimilarity prevails in taxing classes of people.

2. Satisfaction of "Make Available" Clause in "Cross Charge" of Managerial Expenses

Again and again the AOs dispute on Taxation of "Fees for Technical Services" and again and again the Courts keep on quashing demands on "Make Available" Clause. Now let us understand the 'make available' test on cross charge of managerial

expenses from India-USA DTAA. In order to qualify as Fees For Technical Services (FTS), the services rendered ought to satisfy the ‘make available’ test. In order to bring managerial services within the ambit of FTS under the India-USA DTAA, the services would have to satisfy the ‘make available’ test and such services should enable the person acquiring the services to apply the technology contained therein. Article 13 of the DTAA indicates that 'fees for technical services' would mean payments of any kind to any person in consideration for the rendering of any technical or consultancy services which, inter alia, "makes available" technical knowledge, experience, skill, know-how or processes, or consist of the development and transfer of a technical plan or technical design. This "make available" condition shall not be considered to be satisfied incase no technical knowledge, experience, skill, know-how, processes, have been made available by the assessee to the service recipient companies operating in India. It also does not consist of the development and transfer of any technical plan or technical design.

Plethora of cases which can be referred to are -
DIT v. Guy Carpenter & Co. Ltd. [2012] 20 taxmann.com 807/207 Taxman 121/346 ITR 504 (Delhi); CIT v. De Beers India Minerals (P.) Ltd. [2012] 21 taxmann.com 214/208 Taxman 406/346 ITR 467 (Kar.); Raymond Ltd. v. Dy. CIT [2003] 86 ITD 791 (Mum.) ; CESC Ltd. v. Dy. CIT [2003] 87 ITD 653 (Kol.); Mckinsey & Co. Inc. v. Asstt. DIT [2006] 99 ITD 549 (Mum.); Anapharm Inc., In re [2008] 174 Taxman 124 (AAR); ISRO Satellite Centre, In re [2008] 175 Taxman 97/307 ITR 59 (AAR); Dell International Services India (P.) Ltd., In re [2008] 172 Taxman 418 (AAR); Cushman & Wakefield (S) Pte. Ltd., In re [2008] 172 Taxman 179 (AAR); Intertek Testing Services India (P.) Ltd., In re [2008] 175 Taxman 375/307 ITR 418 (AAR); Dy. DIT (International Taxation) v. Scientific Atlanta Inc. [2009] 33 SOT 220 (Mum.); Engineering Analysis Centre of Excellence (P.) Ltd. v. CIT [2021] 125 taxmann.com 42/281 Taxman 19/432 ITR 471 (SC); DIT v. Mitsubishi Corpn. [2021] 130 taxmann.com 276 (SC)

It was again held in the case of M/s BIO RAD LABORATORIES INC. Vs THE A.C.I.T CIRCLE 1(1)(2) INTERNATIONAL TAXATION, NEW DELHI [2023-VIL-66-ITAT-DEL] that the receipts of the assessee on account of provision of information technology

and other administrative services to its affiliate in India are not in the nature of Fees for Technical Services under the India USA Double Taxation Avoidance Agreement

3. Expenses on Construction of Roads are Revenue in Nature

We have earlier dwelt with the debate on Revenue Expenditure Vs Capital Expenditure in detail. This time we will dwell on a specific expenditure which is generally needed to be incurred by almost all factories, warehouses, depots, etc. Does construction of roads come within the ambit of Revenue expenditure or will it be classified as capital expenditure.

The Hon'ble Supreme Court in the case of L.H. Sugar Factory & Oil Mills (P.) Ltd vs. CIT reported in 125 ITR 293 held that if the advantage from an expenditure consists merely in facilitating the assessee's business operations or enabling management and conduct of the assessee's business to be carried on more efficiently or more profitably while leaving the fixed capital untouched, the expenditure would be on revenue account, even though the advantage may endure for in indefinite future. It needs to be considered whether there is an advantage in the capital field; whether tangible or intangible asset was acquired by the assessee; Whether there is any addition to or expansion of the profit-making apparatus of the assessee;

On the same grounds it was held in the case of RUDRAKSH DETERGENT& CHEMICALS PVT. LTD. Vs THE ACIT, GANDHIDHAM CIRCLE [2023-VIL-70-ITAT-RKT] that while there is no ambiguity that assessee shall gain benefit out of road expenses incurred by it, but benefit is in nature of smooth and efficient running of business. Benefit to assessee though enduring in nature is not on capital transaction rather it directly relates to revenue transaction of assessee. In absence of any fixed assets coming into existence out of such expenditure, road making expenses cannot be treated as capital in nature but revenue in nature

4. How to prepare for Share Capital / Premium disputes

Incase of share capital / premiums addition, there is an obligation on the part of the assessee to prove three ingredients of the person from where the money is actually received as basic parameters –

1. Identity of the person
2. Genuineness of the person
3. Creditworthiness of the person

The Apex Court in the case of PCIT vs NRA Iron & Steel Pvt. Ltd. [2019] 103 taxmann.com 48 (SC) has held that "practice of conversion of unaccounted money through the cloak of share capital/premium must be subjected to careful scrutiny. This would be particularly so in the case of private placement of shares, where a higher onus is required to be placed on the assessee since the information is within the personal know of the assessee. The assessee is under legal obligation to prove receipt of share capital/ premium to the satisfaction of the A.O. failure of which would justify addition.

Hence the Assessing/Appellate Authority must consider the following points in such cases as held in ITO 13(3) (1) Vs M/s TRUSTED TRADING PVT LTD [2023-VIL-62-ITAT-MUM] –

1. They must examine the shareholders of the assessee company, or the directors of the assessee company
2. They should enquire regarding the investing Company, its directors, shareholders, etc
3. They should enquire regarding the activities of the assessee, reason for share premium
4. How the assessee came to connect with the investors
5. On what basis have the investors agreed to invest
6. Whether all investors have same/nearby addresses

The assesses should thus be ready for these questions while preparing for assessment.

5. Allowability of ESOPs expenditure and preparation for its assessment

ESOPs are used by various companies as a measure to retain employees. The difference of value on a reporting date and the cost to the employee is debited to the P&L account and claimed as a deduction by companies. The industry practice on

the basis of valuing the ESOP and the periodicity of debiting the P&L account varies across taxpayers. In the matter of deductibility of ESOP expenditure, the bone of contention of the revenue are that -

1. In terms of Circular No. 9 of 2007, the expenditure ought not to be allowed given that actual expenditure towards acquisition of shares, and not mere allotment of shares by the employer can be considered as a permissible deduction.
2. ESPOs are Capital Expenditure

As regards allowability of expenditure for ESOPS, Four conditions need to be satisfied for any expense to be deductible u/s 37(1) of the Act:

1. Expenditure should not be of the nature described in sections 30 to 36;
2. Expenditure should not be in the nature of capital expenditure;
3. Expenditure should not be in the nature of personal expenses of the assessee;
4. Expenditure should be laid out or expended wholly and exclusively for the purposes of the business or profession.

ESOP satisfies all the four conditions as was held in various cases like the following–

The Hon'ble High Court of Delhi in ITA 107/2015 in the case of CIT vs Lemon Tree Hotels Ltd. vide order dated 18.08.2015

Delhi High Court – Pr. CIT v. New Delhi Television Ltd. – [2018] 99 taxmann.com 401 (Delhi)

Madras High Court – CIT v. M/s PVP Ventures Limited – [2012] 23 taxmann.com 286 (Mad.)

Bangalore Special Bench – M/s Biocon Ltd. v. DCIT [2013] 35 taxmann.com 335 (Bangalore – Trib.) (SB)

Another question is on the deduction of ESOPs allotted On the shares of the Ultimate Holding Company where the employees of the company are eligible to participate in share-based compensation schemes of the Ultimate Holding Company. The ITAT

Bangalore in M/s. Hewlett Packard (India) Software Operation Pvt. Ltd. Versus Deputy Commissioner of Income-tax determined that the expenditure of ESOP cross-charge by the Ultimate Holding Company is an actual expense incurred and remitted rather than a hypothetical expenses.

However, given the legal backdrop, it is suggested that the following documents be prepared for an assessment of ESOP –

1. Agreements with each individual Employee
2. A Logic Note and resolution defining/explaining the criteria for allotment of shares under the scheme

A further question is the amount of allowable expenditure. In the matter, the following example can be followed as per the decision in the case of CURADEV PHARMA PVT. LTD. Vs ITO, WARD 6 (4), NEW DELHI [2023-VIL-52-ITAT-DEL] **-**

1. Market value of shares Rs.505
2. Charged to the employees - Rs. 100 (face value being Rs.10 and security premium Rs.90).
3. The difference was been considered as an expense and the relevant perquisite has been accounted for in the hands of employees and the same have been taxed in their hands and due TDS has been deducted by the appellant.
4. The Assessing Officer however has taken the value as per book value by considering the value around Rs.335/- and the Assessing Officer has commented that the valuation taken at Rs. 505/- is very high.
5. The appellant has followed the DCF method as prescribed by Income Tax Law which was allowed as per

While ESOP expenses may still be disputed on one point or the other, it is seen that the legal grounds are set now and if an assessee prepares accordingly, the assessments can be suitably handled.

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