Direct Tax Vista

Your weekly Direct Tax recap

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1. Suspicion can trigger seizure where seizure order is after application of mind... Karnataka High Court upholds Sec 37A of FEMA

Tracking down and bringing back the wealth which ultimately belongs to country is the abiding commitment to country. To hold the provisions related to this broad purpose as manifest with arbitrariness, it has to be demonstrated as such against the presumption which is otherwise. As the matter of black money again heats up in the country with amendment to PMLA Act, this issue was dealt with in great detail by The Hon'ble Karnataka High Court when deciding upon the vires of Section 37A and which may be a precedent in other such cases, especially where Tracking down and bringing back the wealth of Country is concerned. The Court has dealt with the history of Section 37A which needs to be understood by professionals while dealing with such cases which it seems would now be dealt with more frequently.

The finance minister in his Budget 2015 speech while highlighting key features of the new Black Money law mentioned that Concealment of income and assets and evasion of tax in relation to foreign assets will be prosecutable with punishment of rigorous imprisonment, a non-compoundable offence, no recourse to the Settlement Commission and a penalty at 300% of tax. Simultaneously he mentioned that FEMA 1999 is amended to the effect that if any foreign exchange, foreign security or any immovable property situated outside India is held in contravention of the provisions of this Act, then action may be taken for seizure and eventual confiscation of assets of equivalent value situated in India; Accordingly, Clause 168 of Finance Bill 2015 inserted Sec. 37A to the Foreign Exchange Management Act 1999, which was thereafter enacted. This was done post a Special Investigation Team (SIT) was appointed to unearth black money stashed abroad, and to analyse classified information received from countries. Section 37A was introduced after having

passed through elaborate scrutiny and hence The Hon'ble Karnataka High Court in the a most discussed case of XIAOMI TECHNOLOGY INDIA PRIVATE LIMITED Vs UNION OF INDIA [2023-VIL-52-KAR-DT], has refused to hold it arbitrary. The company had questioned the constitutional validity of Section 37A while challenging the ED's April 2022 action of seizing ₹5,551.27 crore lying in company's bank accounts. The ED had seized the amount on the allegation that the company had sent foreign currency equivalent to ₹5,551.27 crore to three foreign–based entities, which include one Xiaomi group entity, in the guise of royalties in violation of FEMA.

Again the question was whether a mere Suspicion may trigger seizure or there has to be a 'reason to believe'. The Court answered this by holding that Seizure by itself is not final. There are several procedures after such seizure. Meanwhile, the court gave liberty to the company to file an appeal before the Appellate Tribunal under Section 37A(5) challenging the seizure order passed by the competent authority.

2. PE for Project/EPC companies based on control over fixed place of business

Project/EPC companies get projects in different Countries. They send their employees and the capital goods from the home countries. The project is completed in the other Country and the employees come back. These employees continue to be employees of the Project company and may for sometime be seconded. Now the question asked is that whether incase the employees stay in the other Country for more than 183 days, then does it lead to a PE in the other Country. In this case, a question is also to be asked that what is the principal test to ascertain PE – whether it is merely stay period of employees or a fixed place of business at the disposal of the assessee. This question was answered in the case of MTR CORPORATION LTD Vs DCIT, CIRCLE-2(2)(1), INTERNATIONAL TAXATION [2023-VIL-745-ITAT-DEL] where it was held that the burden is entirely on the Revenue to establish that the assessee has effective control over the premise in the Country where Project work will be carried out – and consequently a PE there. The same was also held by the Hon'ble Supreme Court in case of ADIT Vs. M/s. E-Fund IT Solutions Inc. [2018] 13 SCC 294 as well as in case of Formula One World Championship Ltd. Vs. CIT, [2017] 15 SCC 602.

For all EPC Companies executing projects overseas or in India, this is an important judgement and may provide further food for thought.

3. Compromise Settlements and Technical Write offs policy for wilful defaults

The RBI has pushed the peddle on growth of credit and liquidity in the market. With a focus on expediting closure of settlement proposals under a certain regulatory framework, cleansing of bank and corporate books and to boost credit and business growth, it has allowed banks to go for compromise settlement of fraud accounts and wilful defaults. Vide Circular No. RBI/2023-24/40 DOR.STR.REC.20/21.04.048/2023-24, Dated 08.06.2023, RBI has introduced a framework for compromise settlements. Regulated entities must establish board-approved policies for such settlements. Compromise settlements involve fully settling borrower claims in cash, potentially requiring Regulated Entities (REs) to sacrifice some amount due with a corresponding waiver of claims against the borrower. In non-farm credit cases, REs will maintain a cooling period of at least 12 months before they take fresh exposures to such borrowers. They can prescribe higher cooling, based on board-approved policies.

The Circular also allowed Technical write-off wherein NPA will be written off for accounting purposes without waiving claims against the borrower or hindering future recovery.

4. RBI allows Fintechs to enter into Default Loss Guarantee (DLG) arrangements with a cap

In August 2022, RBI issued digital lending guidelines, which placed restrictions on the practice of DLGs and noted that the same was under examination. Now, The RBI vide RBI/2023-24/41, DOR.CRE.REC.21/21.07.001/2023-24 dated 8th June implemented the Default Loss Guarantee (DLG) arrangements as a result of which Fintech lending firms can now offer loans to borrowers with lower credit scores and limited credit histories thus broadening the customer pool and serving the underserved segments of the market. The guidelines are applicable to regulated entities (REs) such as commercial banks (including small finance banks), primary

(urban) co-operative banks, state co-operative banks, central co-operative banks, and non-banking financial companies (including housing finance companies). Fintech lending firms may enter into DLG arrangements with regulated entities with which they have entered into outsourcing arrangements.

However, the total amount of DLG cover on any outstanding portfolio specified upfront is capped at 5% of the amount of such loan portfolio. This also includes arrangements involving implicit guarantee linked to performance of the RE's loan portfolio specified upfront. This small cap may be a dampner in bolstering the digital lending space.

5. MSMEs Credit flow further eased.. TReDS gets a push

In a move which may improve cash flow of MSMEs, the RBI expanded the trade receivables discounting system (TReDS) by permitting insurance companies to function as participants. This may also result in an increase in NBFC registrations on TREDs platforms. This step would also further push up TReDS volumes which have already doubled in the last couple of years. Financers are generally not inclined to bid for payables of low-rated buyers. To overcome this, an insurance facility is being permitted for TReDS transactions, which would aid financiers to hedge default risks. Premium for insurance shall not be levied on the MSME seller.

Further, All entities that can undertake factoring business under the Factoring Regulation Act would be allowed to participate as financiers in TReDS

6. Disallowance of expenditure for Freebies to doctors provided by pharma companies – retrospective; but facts need to be weighed with MCI regulations

Explanation 1 to Sec 37(1) of the Income Tax Act declares 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. Explanation 3 to section 37(1) has been inserted with effect from 1/4/22 to clarify that the expression "expenditure incurred by an assessee for any purpose which is an offence or which is prohibited by law" under Explanation 1, shall

include and shall be deemed to have always included the expenditure incurred by an assessee for any purpose which is an offence under, or which is prohibited by, any law for the time being in force, in India or outside India;

In the decision of the Hon'ble Apex Court in the case of M/s.Apex Laboratories Pvt. Ltd. v. DCIT [2022] 135 taxmann.com 286 (SC), it was held that since acceptance of freebies by medical practitioners was punishable as per Circular issued by Medical Council of India under MCI regulations, 2002, gifting of such freebies by - pharmaceutical company to medical practitioners would also be prohibited by law and thus, expenditure incurred in distribution of such freebies would not be allowed as a deduction in terms of Explanation 1 to section 37(1).

Hence, freebies provided to doctors by Pharma Companies, which are disallowed by MCI regulations would be considered to have always been disallowed. However, the MCI regulations need scrutinized and the allowable expenditures need to be so treated. This was held in the case of MEDLEY PHARMACEUTICALS LTD Vs DCIT, C-44, MUMBAI [2023-VIL-741-ITAT-MUM] and the ratio would be applicable for pharma companies who incur such expenses.

7. Where the CoA is not ascertainable, then the computation machinery fails

The landmark decision of the Hon'ble Supreme Court in the case of Cit –vs.- B.C. Srinivasa Setty (1981) 128 ITR 294 (SC) is followed in most cases where Cost of Acquisition (CoA) is not ascertainable. Where the CoA is not ascertainable, then the computation of Capital Gain fails. The same was found fit in the case of M/s SREI INFRASTRUCTURE FINANCE LIMITED Vs ASSISTANT COMMISSIONER OF INCOME TAX, CIRCLE-11(2), KOLKATA [2023-VIL-743-ITAT-KOL]. Here the assessee entered into an agreement with other consortium member for transfer of voting rights in shares of a Company. AO taxed said amount as short-term capital gains. CIT(A) deleted addition made by AO by holding that, since cost of acquisition of said rights could not be determined, computation machinery will fail.

8. When TDS deducted on advance, then credit should also be admissible

Mobilization advance is a capital receipt being in the nature of a loan and there is no legal obligation to deduct tax at source. However, the question is that incase TDS is deducted, can the Credit be availed in the year of deduction or is it available only in the year of offering the subsequent income to tax. In this context it is important to note the provisions of section 199(1) wherein it has been stated that any deductions made paid to the Government shall be treated as a payment of tax on behalf of the person from whose income the deduction was made. Therefore, as per Sec 199(1), once the TDS was deducted, a credit of the same to be given to the assessees, irrespective of the year to which it relates, was held in the case of BRIJ GOPAL CONSTRUCTION COMPANY P. LTD Vs ACIT, SPECIAL RANGE-2, DELHI [2023-VIL-732-ITAT-DEL]. However, it is important that consistent accounting policy is followed.

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