KATALYST ADVISORS

Katalyst Kaleidoscope

August 2022: Tax and Regulatory Insights

SUMMARY OF CONTENTS

A. Income tax highlights

1. Pune ITAT: Advances given by company to its shareholder to use his property cannot be treated as deemed dividend[1]

The facts of the case were that assessee, along with the company, purchased a property out of loan availed from 'B' who sanctioned the loan only on the condition that the assessee should be a co-borrower. Assessee allowed his portion of property to be used by the company for business purposes without any payment of rent. Out of the total loan amount sanctioned by 'B', certain amount was allocated to assessee and the company also gave advance of certain amount to assessee towards stamp duty and registration charges.

It is an admitted position that 'B' sanctioned the loan only on the condition that the assessee should be a co-borrower; therefore, when the assessee signed the loan documents as a borrower, the primary responsibility to repay the loan rests upon the assessee. To safeguard against any future liability, the assessee insisted a portion of the property be registered in his name which was being used for the business purpose by the company, and the assessee did not charge rent to the company. Therefore, this shows that substance of the transaction is purchase of property for the purpose of business of the company, and it cannot be called a gratuitous loan or advance given by the company to the assesse; hence, deemed dividend provisions section 2(22)(e) of ITA is not applies in this case.

2. Chennai ITAT: Deemed dividend addition basis common directors' shareholding, unsustainable and current account transactions not covered under section 2(22)(e)[2]

In facts of the case were that Company A and Company B were having common shareholders; Company A given loan to Company B, which the AO treat as deemed dividend in the hands of Company B. The Assessee submitted that the provisions of Section 2(22)(e) of the Act cannot be invoked in case of an amount advanced by one company to another, which is not a shareholder of the company; the shareholding of the common Directors cannot be taken into consideration for the purpose of invoking the provisions of Section 2(22)(e) of the Act relating to deemed dividend.

The Assessee's contention was that even if the monies advanced were to be treated as an inter-corporate deposits, the provisions of deemed dividend should not apply in the light of the fact that interest on inter-corporate deposit is not an interest on the loan or advance under the Interest Tax Act, 1974; therefore, the inter-corporate deposits also cannot be

[1] Jitendra Kapildeo Gupta v. Deputy Commissioner of Income-tax [2022] 140 taxmann.com 276 (Pune - Trib.)
[2] Pallava Resorts Private Limited [TS-591-ITAT-2022(CHENNAI)]

treated as a loan falling within the purview of Section 2(22)(e) of the Act. As such, transactions between the Assessee along with its holding company were in the nature of current account and not in the nature of loans, and hence, do not fall under the scope of the deemed dividend u/s.2(22)(e) of the Act.

The Madras High Court in the case of PCIT Vs. Ennore Cargo Container Terminal Private Limited has held that, even there are if common shareholders in both the companies, deemed dividend can be taxed only in the hands of the registered shareholder of the company and not in the hands of the company which has received the loan. Further, the Delhi High Court in the case of the Commissioner of Income Tax Vs. Ankitech Private Limited reported in [2012] 340 ITR 14 (Del.) wherein the Hon'ble Delhi High Court has held that the provisions of Section 2(22)(e) of the Act are not attracted if the recipient is not a shareholder.

The Tribunal held, that as the Assessee is not a shareholder of the lender company, the amount received from the lender will not be taxable in the hands of the Assessee as a deemed dividend under section 2(22)(e) of the ITA and common shareholding in two companies should not attract the provisions of Section 2(22)(e) of the ITA.

3. Chennai ITAT: Interest spread taxable over tenure of loan, not in year of securitisation; upholds NBFC's revenue recognition policy[3]

The facts of the case were that NBFCs, on securitization of its outstanding debt portfolio, received purchase consideration and the present value of excess interest spread (EIS) after applying discount factor to be received by the investor over the tenure of loan, out of which some amount was offered to tax in current year and balance was to be offered in subsequent years.

The ITAT noted that the assessee had been consistently following the same method to recognise revenue from EIS and consequently, the income from the said transactions has been offered to tax in subsequent years, also that the said method of accounting is prevalent in the industry and also in line with the prudential norms prescribed by RBI and in conformation of AS-9, which provides that, in case the revenue cannot be measured with reasonable certainty, a suitable provision thereof should be made. However, since EIS may not have even accrued to the Assessee in future years, no such provision could be made in this year. In this context, the ITAT upheld the assessee's method of recognizing EIS income.

[3] Cholamandalam Investment & Finance Co. Ltd [TS-590-ITAT-2022(CHENNAI]

4. Delhi HC: No disallowance u/s 40(a)(ia) on short deduction of TDS[4]

The facts of the case were that the assessee paid machinery hire charges to a sub-contractor and on which it deducted tax @ 1% under section 194C(2); however, revenue department held that it is rent and the assessee is required to deduct tax @ 10% under section 194I. Since the assessee purportedly short deducted TDS, expenses were disallowed under section 40(a)(ia).

The conditions laid down u/s. 40(a)(ia) of the Act for making a disallowance is that tax is deductible at source and such tax has not been deducted. Only if both the conditions are satisfied then such payment can be disallowed u/s. 40(a)(ia) of the Act, but where tax is deducted by the assessee, even under a purportedly lesser rate, the provisions of section 40(a)(ia) of the Act cannot be invoked.

B. Corporate Law Highlights

1. NCLAT: Where majority of shareholders approve the scheme of reduction and company has sufficient liquid funds to pay off its liability, then Court cannot interfere with the discretion and commercial wisdom of the stakeholders and the Board of Directors[5]

The capital reduction scheme was rejected by the NCLT, Ahmedabad on the ground that the company having high borrowings and negative net-worth in this situation paying money back to the shareholders is not in the interest of the company and stakeholders.

The NCLAT referred to the judgement of the Delhi High Court in case of Reckitt Benckiser (India) Ltd.[6] wherein it was held that the reduction of the Share Capital is a 'domestic concern' i.e. it is the decision of the majority shareholders should prevail.

The NCLAT held that the reduction of the Share Capital is the 'domestic concern' of the Appellant Company which ought to be permitted, given that there are no objections from the Shareholders and the Creditors, and the company has satisfied the requirements prescribed under Section 66 of the Companies Act, 2013 and the Rules.

[4] Pr. Commissioner of Income Tax-1 v/s Future First Info. Services Pvt. Ltd. (ITA No. 195/2022)
[5] Precious Energy Services Ltd. v/s The Regional Director North-Western Region [Company Application (AT) No. 17 of 2021]
[6] Reckitt Benckiser (India) Ltd. (CP 206 of 2004) (Delhi High Court).

2. Bombay HC: Independent non-executive director not liable for acts of company when not involved in daily business

Independent, non-executive directors cannot be held liable for acts of the company, if they are not involved in the daily affairs of the company, the Bombay High Court recently held in two separate judgements.

A division bench of Justice KR Shriram and Milind Jadhav, on July 8, quashed multiple orders of Joint Director General of Foreign Trade (Joint DGFT) which had imposed penalty on a company and all its directors, ex-directors including a non-executive director.

The High court held "Where there are allegations of vicarious liability, then there has to be sufficient evidence of the active role of each director. There has to be a specific act attributed to a director or the person allegedly in control of management of the company, to the effect that such a person was responsible for the acts committed by or on behalf of the company."

It was held that every person connected with the company could not be held to be vicariously liable for the acts of the company. "Simply because a person is a director of a company does not make him liable under the Negotiable Instruments Act. Only those persons who are incharge and responsible for the conduct of business of the company at the time of commission of the offence will be liable for criminal action".

3. SC: Mere 'designations' not sufficient to make Director liable for cheque dishonour proceedings

In a laudable judgement SC allows appeal filed by non-executive Independent Directors ('Appellants') of a company, impugning the HC order inter alia rejecting the Appellants' application u/s 482 of the CrPC to quash proceedings u/s 141 of the Negotiable Instruments Act (NI Act), holds that "…the laudable object of preventing bouncing of cheques and sustaining the credibility of commercial transactions resulting in the enactment of such sections has to be borne in mind…Every person connected with the company does not fall within the ambit of Section 141 of the NI Act".

The SC Drawing strength from its decision in S.M.S. Pharmaceuticals where it was held that the liability u/s 138/141 of the NI Act arose from being in charge of and responsible for the conduct of the business of a company and not on the basis of merely holding a designation or office in the company, the SC held that "It would be a travesty of justice to drag Directors, who may not even be connected with the issuance of a cheque or dishonour thereof, such as Director (Personnel), Director (Human Resources Development) etc. into criminal proceedings under the NI Act, only because of their designation".

The SC emphasized that Sec. 482 of the CrPC protects the inherent power of the HC to make such orders as may be necessary to give effect to any order under the CrPC or to prevent abuse of the process of any Court or otherwise secure the ends of justice, SC observes that HC failed to appreciate that Appellants were neither MD nor Joint MD nor signatories of the dishonoured cheque and hence, quips that "…the High Court erred in law in not exercising its jurisdiction under Section 482 of the Cr.P.C in the facts and circumstances of this case to grant relief to the Appellants.".

The SC clarifies that when the accused is the Managing Director or a Joint Managing Director of a company, it is not necessary to make an averment in the complaint that he is incharge of, and is responsible to the company for the conduct of its business, because, "…the prefix "Managing" to the word "Director" makes it clear that the Director was in charge of and responsible to the company, for the conduct of the business of the company".

Therefore, Apex Court sets aside the HC order and quashes the pending criminal case u/s 138/141 of the NI Act against the Appellants, while clarifying that the proceedings may continue against the other accused in the criminal case, viz. the accused company, its MD/ Additional MD and/or the signatory of the cheque in question.

4. NCLAT: dismissed an appeal filed by a personal guarantor challenging the NCLT order by contention that he had obtained citizenship of Singapore hence the insolvency proceedings cannot be enforced against him.[7]

The NCLAT in *Sudip Bijoy Dutta versus SBI* dismissed an appeal filed by a personal guarantor challenging the NCLT order admitting SBI's application to initiate insolvency resolution proceedings against the appellant. The contention of the appellant was that he had obtained citizenship of Singapore and the insolvency proceedings cannot be enforced against him.

The NCLT referred to the definition of "person" under the IBC, and held that the provisions are applicable to persons residing in India and outside India, and are applicable to a personal guarantee given by the appellant, even though he acquired Singapore citizenship.

[7]Company Appeal (AT) (Insolvency) No. 807 of 2021 and 740 of 2022

C. SEBI/ FEMA/PMLA

1. SEBI lays down the guidelines for Social Stock Exchange (SSE) by adding chapter X-A in SEBI (ICDR) Regulation, 2018[8].

SEBI after chapter X of SEBI (ICDR) Regulation, 2018 has added chapter X-A, "Social Stock Exchange (SSE)"

"Social Stock Exchange" has been defined as a separate segment of a recognized stock exchange having nationwide trading terminals permitted to register Not for Profit Organizations and / or list the securities issued by Not for Profit Organizations in accordance with provisions of these regulations. Social Stock Exchange shall be accessible only **to institutional investors and non-institutional investors.**

Social enterprises (SEs) eligible to participate in the SSE will be entities—non-profit organisations (NPOs) and for-profit social enterprises—having social intent and impact as their primary goal. Also, such an intent should be demonstrated through its focus on eligible social objectives for the underserved or less privileged populations or regions.

The social enterprises will have to engage in a social activity out of 16 broad activities listed by the regulator. The Social Enterprise shall have at least 67% of its activities, qualifying as eligible activities. Corporate foundations, political or religious organisations or activities, professional or trade associations, infrastructure and housing companies, except affordable housing, will not be eligible to be identified as a social enterprise.

Social Enterprise may raise funds through following means: -

- *Not for Profit Organization may raise funds on a Social Stock Exchange through:*
  - issuance of Zero Coupon Zero Principal Instruments to institutional investors and/or non-institutional investors in accordance with the applicable provisions of this Chapter;
  - donations through Mutual Fund schemes as specified by the Board;
  - any other means as specified by the Board from time to time.
- *Profit Social Enterprise may raise funds through:*
  - issuance of equity shares on the main board, SME platform or innovators growth platform or equity shares issued to an Alternative Investment Fund including a Social Impact Fund;
  - issuance of debt securities;
  - any other means as specified by the Board from time to time.

For more details kindly click on this link: SEBI SSE.

[8] F. No. SEBI/LAD-NRO/GN/2022/90

2. Prevention of Money Laundering Act, 2002: Supreme Court upholds validity of the stringent twin-conditions for bail amongst other provisions[9]

A Constitution Bench of the Supreme Court of India on June 27, 2022, while deciding a batch of over 200 petitions challenging certain provisions of the Prevention of Money Laundering Act, 2002 (**"PMLA"**) relating to the power of arrest, attachment, and search & seizure conferred upon the Enforcement Directorate (**"ED"**), as well as in relation to the reverse burden of proof and the two-conditions for the grant of bail under the PMLA, has upheld the constitutional validity of these provisions. The Supreme Court has given a broad interpretation to the provisions of the PMLA, thereby granting unfettered and wide powers to the ED for the purpose of conducting investigation under the PMLA. The main findings / observations of the SC are as follows:

Re: Twin Conditions for Bail under PMLA

Significantly, in relation to the "twin-conditions" for grant of bail contained in Section 45 of the PMLA, the same being (i) that the Public Prosecutor has been given an opportunity to oppose the application for such release; and (ii) that where the Public Prosecutor opposes the application, the court is required to be satisfied that there are reasonable grounds for believing that the accused is not guilty of such offence and that he is not likely to commit any offence while on bail.

Re: ED Officials are not police officers

Further, the Supreme Court holding that ED officials under PMLA are not police officers as such, rendering these officials outside the purview of several constitutional safeguards offered to the accused.

Re: Submission of the Enforcement Case Information Report ("ECIR") is not mandatory

Further, the Court has held that, in view of special mechanism envisaged by the PMLA, an ECIR cannot be equated with an FIR under the Code of Criminal Procedure, 1973. As per the Supreme Court, the ECIR is an internal document of the ED and therefore, supply of a copy of ECIR in every case to the person concerned is not mandatory, and it is enough if ED at the time of arrest, discloses the grounds of such arrest.

[9] Vijay Madanlal Choudhary & Ors. v Union of India & Ors. [SLP(Criminal) No. 4634 of 2014]

However, the Court has also held that when the arrested person is produced before the Special Court, it is open to the Special Court to look into the relevant records presented by the authorised representative of ED for answering the issue of need for his/her continued detention in connection with the offence of money-laundering.

Re: Scope of the offence of money laundering under Section 3 of the PMLA

Rendering a broad interpretation to Section 3 of PMLA, the Supreme Court has held that the offence of money-laundering has a wider reach and captures every process and activity, direct or indirect, in dealing with the proceeds of crime and is not limited to the happening of the final act of integration of tainted property in the formal economy. The Court was of the view that the expression "and" occurring in Section 3 has to be construed as "or", to give full play to the said provision so as to include "every" process or activity indulged into by anyone.

D. Goods and Service Tax highlights

1. Applicability of GST on payments in the nature of liquidated damages, compensation, penalty etc. arising out of breach of contract or otherwise has been a matter of controversy in the past[10].

This circular seeks to clarify some of those dimensions; it refers to Para 5(e) of Schedule II of the CGST Act which has specifically mentioned that "agreeing to the obligation to refrain from an Act or to tolerate an Act or a situation, or to do an Act" is a supply of services within the meaning of the Act. The circular further goes on to explain the 3 terms in the relevant entry in considerable detail. It also lists out several examples of such cases, including the following:

- Liquidated damages paid for breach of contract.
- Bond amount recovered from an employee leaving the employment before the agreed period.
- Late payment charges collected by any service provider for late payment of bills.

The key aspects brought out by the Circular is that the services contemplated in the relevant entry needs to be a contractual arrangement, and there has to be a necessary and significant nexus between the deemed supply and the consideration. Such contractual arrangement must be an independent arrangement, in the sense that there must be an obligation to perform something under a contract. The circular then mentions that, in case of liquidated damages, it is a payment contemplated u/s 73 of the Contract act and it is not a consideration, but an event in the course of performance of the contract and should not be

[10] Circular No. 178/10/2022-GST

taxable. Similarly, forfeiture of earnest money by a seller in case of breach of agreement to sell would also fall under the same genre. On the other hand, amounts paid for late payment or for pre-payment on loan or cancellation of services by the customer as contemplated by the contract as part of commercial terms agreed by the parties would fall under GST (unless the principal supply itself is exempt). The circular also mentions that penalty imposed for violation of law are also no consideration for supply and is therefore, not taxable.

Katalyst Comments:

This is a detailed and well-reasoned circular (of course, whether entry 5(e) above is justified is another issue, in the sense that it artificially extends the meaning of "supply of services"). Incidentally, the circular can also be helpful in interpreting the taxability or otherwise of items such as liquidated damages, under the Income tax Act.

2. Scope of entry 5(e) of Schedule II[11]- "Agreeing to the obligation to refrain from an act or to tolerate an act or a situation, or to do an act"

The act of (i) refraining from an act; (ii) tolerating an act or situation; or (iii) to do an act can be considered as a 'supply' only if there is a contractual agreement between two parties. In absence of such agreement, there would not be an 'activity for consideration', even though such an activity may lead to the accrual of gains to the person carrying out the activity.

***Katalyst comments**:*

Much needed clarification by the CBIC. Also, it is clarified that the payments such as liquidated damages for breach of contract, penalties under the mining act, forfeiture of salary, penalty for cheque dishonour, etc. are not a consideration for tolerating an act or situation.

[11] Circular No. 178/10/2022-GST dated August 3, 2022

3. GST on sale of developed land[12]

It is clarified that the sale of such developed land is also the sale of land and is covered by Serial. No. 5 of Schedule III to the CGST Act, 2017 ('CGST Act') and accordingly does not attract GST. It is, however, stated that any service provided for the development of land, such as levelling or laying of drainage lines (as may be received by developers) attracts GST at the applicable rate for such services.

Katalyst comments:

Thus, only activity of getting the land 'developed' is covered under the purview of GST. Sale of developed land is covered under the schedule III of the CGST Act and not liable to GST.

4. GST on preferential location charges[13]

The upfront amount (called as premium, salami, etc.) payable in respect of service by way of granting of a long-term lease (of 30 years or more) of industrial plots or plots for the development of infrastructure for financial business subject to specified conditions is exempt from GST as per sr. no. 41 of notification no. 12/2017-CT (R). It has been clarified that locational charges for allowing the choice of location of the plot are an integral part of the principal supply of long-term lease; hence, locational charges being charged upfront are also exempt from GST in terms of Serial. No. 41.

5. GST rate of electric vehicle is 5%[14]

It is clarified that Electronic Operated Vehicle is classifiable under HSN 8703 even if the battery is not fitted to such vehicle at the time of supply; therefore, GST rate of such vehicles is 5% as per sr. no. 242A of Schedule I of Notification No. 1/2017-CT (R) dated June 28, 2017.

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[12] Circular no. 177/09/2022-TRU dated August 3, 2022
[13] Circular no. 177/09/2022-TRU dated August 3, 2022
[14] Circular no. 179/11/2022-TRU dated August 3, 2022