KATALYST ADVISORS

Katalyst Kaleidoscope

March 2024: Tax and Regulatory Insights

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A. Income Tax Highlights

1. SC[1]: Telecom Companies not liable to deduct TDS on Pre-paid SIM Card sales to distributors

The issue before the SC was the interpretation of the relationship between the telecom companies and distributors in relation to sale of discounted pre-paid SIM cards sold by distributors, with the income tax department asserting it as that of principal-agent relationship, thus subjecting the payments to be classified as commission under section 194H of Income Tax Act, 1961 with consequential implications of need for TDS.

However, the SC held that telecom companies (including industry leaders such as Bharti Airtel Limited) are not required to withhold tax at source of income or profits derived by the distributor from discounted pre-paid SIM cards sold by distributors; the crux of the case hinged on the interpretation of Section 194H, which mandates the deduction of tax on commission or brokerage payments. The SC held that this obligation arises when a principal-agent relationship is established, which was not the case between telecom companies and their distributors in this scenario; it is important to note that the SC observed that the sale price is within the control of the distributor.

Accordingly, the SC dismissed the revenue department's argument that distributors should be considered agents of telecom companies, emphasising that the distributors' role does not align with the legal definition of an agent, and the margin earned by distributors represents their gross income or profit, not remuneration paid by the telecom companies; as such lower price offered to distributors should be treated as discount, rather than commission. Thus, the obligation to deduct tax at the source under Section 194H did not apply in this scenario.

Katalyst Comments:

The SC judgement emphasises the importance of establishing a principal-agent relationship for the application of tax deduction obligations and provides clarity on the interpretation in similar commercial arrangements.

2. Mumbai ITAT[2]: Prior period expenditure allowable when crystallised

In the given case, the assessee was engaged in electricity distribution in Maharashtra; the AO disallowed prior period expenditure. The CIT(A) upheld the assessment order.

On appeal before ITAT, it was observed that the assessee has consistently followed the same accounting method, debiting the expenditure when it becomes crystallised; the ITAT referred to a previous ruling in the assessee's case for the assessment year 2012-13, followed the judgment of the jurisdictional High Court in the Mahanagar Gas Ltd[3]. Furthermore, the ITAT noted that the assessee not only claims prior period expenditure in this manner but also

[1] Bharti Airtel Ltd [TS-135-SC-2024], dated 28th February 2024
[2] Maharashtra State Electricity Distribution Co. Ltd [TS-141-ITAT-2024(Mum)], dated 8th March 2024
[3] CIT vs. Mahanagar Gas Ltd., 42 taxmann.com 40 (Bom)

reports prior period income using the same approach, wherein the ITAT emphasised that there cannot be different standards for accepting prior period income and disallowing prior period expenditure and hence directed the AO to adopt a consistent approach, allowing expenditure crystallised during the relevant year. In that instance, the disallowance of prior period expenditure was overruled, aligning with the assessee's accounting method accepted in previous years.

Katalyst Comments:

It is essential to recognise that prior period expenses are of 2 categories: (i) expenses related to a previous period also crystallised during that period, and (ii) expenses related to a previous period but crystallised in the current year; the above case falls under the second category, where the assessee records expenses from a previous period that were crystallised in the current year. It seems that the categorisation of the expense as prior period may have been based on the concept of the 'matching principle' i.e matching income and expense.

3. Mumbai ITAT[4]: Allows short-term capital loss & gain set off despite different tax rates

In the given case, the assessee, who is a US tax resident and a SEBI-registered FPI, offset short-term capital gains (STCG) from the sale or physical settlement of derivatives, which were taxed at a rate of 30%, with short-term capital losses (STCL) from the current year's sale of equity (STT paid), taxable at a rate of 15%. The remaining STCG was then offset against brought forward STCL. However, the Assessing Officer disallowed this setoff citing the difference in tax rates under section 70(2) of the Income Tax Act, 1961, since the sale of derivatives was taxed at 30% while the sale of equity shares with STT paid was taxed at 15%.

On appeal before ITAT, it was observed that Section 70(2) allows STCL from any asset to be set off against STCG from any other asset under a similar computation, irrespective of different rates of tax; it further emphasised that the distinction in tax rates should not preclude such set-offs as long as the computation follows similar procedures. Additionally, the ITAT referred to the Calcutta High Court's decision in Rungamatee Trexim[5], asserting the assessee's right to choose the most beneficial chronology for set-offs. In view thereof, the appeal of the assessee was allowed.

4. Chennai ITAT[6]: Registered and Beneficial Shareholding precondition for Deemed Dividend applicability

In the given case, the assessee company involved in real estate business was part of Promoter and Promoter Group companies, including IG3 Infra Limited ("IG3"), underwent a revenue department search. Allegations included diverting IG3 funds through invoicing without actual work, labelling them as "Capital Work in Progress" instead of "Loans"; the

[4] JS Capital LLC [TS-165-ITAT-2024(Mum)], dated 7th March 2024
[5] CIT v. Rungamatee Trexim (Pvt) Ltd. - ITA No. 812 of 2008 (Kol. HC) (2008)
[6] Mukunda Land Developers Pvt. Ltd [TS-143-ITAT-2024(CHNY)], dated 4th March 2024

revenue concluded that the fund transfers constituted deemed dividends under Section 2(22)(e) of the Income-tax Act 1961. The CIT(A) allowed the appeal of the assessee.

Upon further appeal by the revenue before ITAT, it was observed that neither the assessee nor its shareholders were stakeholders in IG3; moreover, there were no common registered and beneficial shareholders between IG3 and the assessee. Additionally, none of the assessee's shareholders held more than 10% equity shareholding in IG3 at the time of fund transfer; reliance was placed by the ITAT on the SC judgment in C.P. Sarathy Mudaliar[7], which held that the term 'shareholder' used in section 2(22)(e) referred to both a registered and beneficial shareholder.

Accordingly, the ITAT concluded that such loans would not be taxable as deemed dividends in the hands of the assessee company; consequently, the ITAT dismissed the revenue's appeal.

5. Bombay HC[8]: No TDS on business support services as FTS since 'make available' not satisfied

In the given case, the assessee, engaged in the business of operating a chain of retail fuel stations in India, entered into a cost contribution agreement for availing general business support services from its Associated Enterprise (AE) viz Shell International Petroleum Company Limited, a UK resident; it filed an application before AAR seeking determination of the tax liability on the payment to AE, wherein it was held that it would be taxable as FTS, and thus, the assessee would be liable to withhold taxes under Section 195 of Income Tax Act, 1961.

Upon filing a writ petition by the assessee, the HC observed that the cost contribution agreement entered between the assessee and AE did not involve the transfer of technical knowledge or expertise, nor did it relate to the development and transfer of technical plans or designs. Instead, they were found to be managerial in nature; it was also observed that Article 13 of the India-UK DTAA states that, 'even if consultancy services are 'stand-alone', it indicates that the said 'consultancy' necessarily relates to consultancy which 'makes available' technical or any other knowledge, experience, skill, know-how, or processes, and does not relate to consultancy on managerial issues, and reliance was placed on the Madras HC judgment in Skycell Communication[9] to emphasise the importance of understanding the true nature of the services rendered. Additionally, the HC also highlighted the need for clarity on the continuation of agreements and the satisfaction of the "make available" condition.

Accordingly, the Bombay HC set aside the ruling of the AAR, holding that the services provided were not taxable as FTS, and that there is no requirement to withhold the tax.

[7] CIT vs. CP Sarathy Mudaliar (1972) 83 ITR 170 (SC)
[8] Shell India Markets Pvt Ltd [TS-151-HC-2024(BOM)], dated 4th March 2024
[9] Skycell Communications Ltd. v. Deputy Commissioner of Income-Tax (2001) 251 ITR 53

6. Mumbai ITAT[10]: IT Company taxable for Tech Park floor rent as 'house property', not 'business income'

In the given case, the assessee was primarily engaged in IT-enabled business support services and had leased part of a building it owned to another company, the assessee claimed depreciation on the leased portion but did not report any house property income; the assessee classified the rental income as business income and claimed depreciation on the property. The revenue objected and denied the depreciation claim and treating the rental income as taxable under 'income from house property'.

On appeal by the assessee before ITAT, it was observed that the assessee's main objective, as per its MoA, was to provide IT services, not property rental. Additionally, the rental income was categorised as other income in the P&L Account, indicating that property rental was not the primary business activity. The ITAT upon the SC judgment in Chennai Properties[11], and held that rental income falls under the head 'income from house property,' and not business income; ITAT further restricted depreciation under Section 32 based on the proportionate use of the building for business purposes.

7. Mumbai ITAT[12]: Assessment of capital gain tax implications in unregistered Joint Development Agreement (JDA) and General Power of Attorney (GPA)

In the given case, the assessee entered into JDA and GPA with the developer for constructing of a residential complex; the assessee transferred 62% of the land in exchange for 38% of the developed area over time. The revenue treated this arrangement as capital gains under section 2(47)(vi) of the Income Tax Act, 1961, and the CIT(A) upheld this assessment order.

On appeal before the ITAT, it was clarified that section 2(47)(v) read with section 53A of the Transfer of Property Act, 1882 permits partial performance of a property transfer contract, allowing the buyer to enforce their rights even without formal completion of the transfer; however, since both the JDA and GPA were unregistered, they did not fall under section 2(47)(v). Despite the unregistered nature of the agreements, the ITAT concluded that the transaction falls under section 2(47)(vi), which, includes any transaction having the effect of transferring or enabling the enjoyment of any immovable property, relying upon the SC judgement in P. George Jacob v. ITO[13] asserting that the constraining factor of registration of a contract would not be relevant in section 2(47)(vi) which applies to any agreement or arrangement or a transaction in any other manner having the effect of transferring or enabling the enjoyment of any immovable property.

In view of the above, the ITAT held that such a transaction should be construed as capital gains in the year of entering into agreements.

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[10] Directi Internet Solutions Pvt Ltd [[TS-182-ITAT-2024(Mum)], dated 14th March 2024
[11] Chennai Properties & Investment Ltd. v. CIT [2015] 456 taxmann.com (SC)
[12] Directi Internet Solutions Pvt Ltd [[TS-182-ITAT-2024(Mum)], dated 14th March 2024
[13] P. George Jacob v. ITO (in ITA No. 558/Coch/2022, dated 2nd March 2023

8. Mumbai HC[14]: Interest-free advances from interest-bearing funds to subsidiaries are allowable for business purposes

In the given case, the assessee company was engaged in operating amusement parks, infrastructure development management, and finance activities; it extended an interest-free loan to its subsidiary for business purposes. The AO held that interest-bearing funds were diverted through interest-free advances, leading to the disallowance of the entire interest expense claimed by the assessee. However, the CIT(A) dismissed this disallowance, asserting that the investment in the subsidiary was integral to the assessee's business operations.

Upon appeal by the revenue before ITAT, the ITAT upheld the CIT(A)'s decision, and held that the funds provided by the assessee to its subsidiary were indeed for business purposes. Since the assessee had established the subsidiary to undertake infrastructure projects on its behalf, the nexus between the advance of funds and the assessee's business activities was recognized and accepted; consequently, the ITAT held that no disallowance of interest expenses.

9. Mumbai ITAT[15]: Compensation from agency termination agreement treated as 'Business Income' and not 'Capital Gain'

In the given case, the assessee, a pharmaceutical company, entered into an agreement with another company for distribution, manufacturing, and agency services. However, due to non-fulfilment of certain terms in the original agreement, it was terminated, prompting the assessee to take legal action; this legal dispute culminated in an out-of-court settlement where the assessee received compensation for the termination of the agreement, which it treated as capital gains. The AO disagreed with this treatment and categorised the compensation as business income.

The ITAT noted that the assessee was granted a non-transferable, non-assignable license to carry out various activities as an agent; based on this arrangement, the ITAT held that the assessee functioned primarily as an agent and received compensation for the loss of agency business; it further rejected the assessee's argument that the compensation represented the sacrifice of future profits rather than termination of the agency, relying upon the Madras HC judgment in Indo Foreign Traders,[16] asserting that agency termination does not result in business loss or impairment in the profit-making structure of the assessee and is part of its business framework; consequently, the ITAT held that the compensation received constituted business income and not capital gains.

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[14] Essar Infraprojects Ltd, Income Tax Appeal No. 927 of 2018 (Bom). (HC)
[15] Piramal Enterprises Ltd [TS-33-ITAT-2024(Mum)], dated 22nd January 2024
[16] Indo Foreign Traders (P) Ltd. vs. CIT (1987) 166 ITR 308 (Madras HC)

B. Corporate Law Highlights

1. NCLAT[17]: Impact of Extinguished Subrogation on Financial Creditors' Claims Against Personal Guarantors

In the given case, the Personal Guarantor was obliged in the recovery proceedings of Asian Colour Coated Ispat Ltd (Corporate Debtor), where the NCLT had previously approved a Resolution Plan allowing Financial Creditors to seek recourse against Personal Guarantors. The key issue in this context was whether Personal Guarantors could be held accountable under the Resolution Plan, especially given the Corporate Debtor's debt transfer to a Special Purpose Vehicle (SPV); the matter led to an appeal by the Corporate Debtor before the NCLAT.

The Corporate Debtor's argued upon the assignment of debt to an SPV, there should be no provisions for "Excluded Rights" that would allow Financial Creditors to pursue claims against Personal Guarantors. Contrary to this argument, the Respondents (which included the Resolution Professional and Committee of Creditors) asserted that under the Insolvency and Bankruptcy Code (IBC), Personal Guarantors are obligated to fulfill their financial commitments to Financial Creditors, as these obligations formed the basis of the loans and credit facilities extended to the Corporate Debtor.

Further, the NCLAT referred to established legal principles, including the Doctrine of subrogation which allows Personal Guarantors to step into the shoes of Financial Creditors and exercise their rights against the Corporate Debtor; it also highlighted that a Resolution Plan has the authority to modify the rights and obligations of creditors, and Personal Guarantors are bound by the terms of the approved plan. As a result, NCLAT dismissed the appeals filed by the Personal Guarantors as per the provisions outlined in the "Excluded Rights" section of the Resolution Plan.

Katalyst Comments:

The main aim of the IBC is to resolve the debts of companies, not the personal guarantors. However, it allows creditors to pursue personal guarantors, altering their rights as per court-approved plans and impacting the doctrine of subrogation, which differs from the Indian Contract Act; the IBC takes precedence over other laws in governing personal guarantor treatment during insolvency.

2. NCLAT[18]: Law of Succession in Securities

In the given case, the assessee company had refused to transfer the shares of one of the shareholders to his son in the event of the shareholder's death, citing the absence of a succession certificate as the primary document requirement for the transmission of shares, as stipulated in the company's AoA; however, the NCLT ordered the transmission of such shares without the necessary documentation.

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[17] Vikas Aggarwal vs. Asian Colour Coated Ispat Ltd. & Ors. [LSI-194-NCLAT-2024(NDEL)], dated 8th March 2024

[18] [Avanti Metals P. Ltd. v. Alkesh Gupta, C.A. No. 87/2023], dated 17th January 2024

Upon further appeal by the assessee company before the NCLAT, it was observed that shares are considered movable property governed by the AoA, where a Succession Certificate is required for transmission. The legal framework governing the transmission of shares emphasised the importance of proper documentation, such as a Succession Certificate, highlighting its role in providing legal indemnity to the company against third-party claims, relying on Madras HC judgment on Themappa Chettiar which affirmed that legal heirs are entitled not only to receive interest or dividends, but also to negotiate or transfer them.

Additionally, the NCLAT dismissed the argument that a SEBI circular (Form E of the SEBI Circular reads as 'Bond of Indemnity to be furnished jointly by all legal heirs including the claimants') overrides the AoA of the assessee company, clarifying that SEBI's jurisdiction extends only to limited companies and not to unlisted private companies. Consequently, the NCLAT allowed the assessee's appeal, setting aside the NCLT ruling.

C. SEBI / RBI / Other Highlights

1. SEBI:[19] Consultation paper on Nomination in Demat Accounts

This consultation paper proposes revisions to nomination facilities for securities (such as shares, bonds, units of REITs/ InvITs / AIFs and other securities) held in dematerialized form in a demat account and for units of mutual fund schemes held in non-materialized form addressing the objective of providing convenience to investors in the Indian securities market, and institution of uniformity in the facilities and procedures and affording certain choices and flexibilities in nomination facilities; the key points outlined in the consultation are as follows:

- Nominations will remain optional for investors; in case of a single holding, the investor will be required to expressly declare that he does not desire to make a nomination
- Depositories to provide e-nomination facilities
- Nomination may be made, changed or cancelled at any time without any restrictions
- Nomination limit be increased from the current 3 to two or three digits (i.e. 99 or 999).
- Transfer to Nominee(s) shall require KYC completion/updating, due discharge from creditors; no other documentation shall be required and there should be a common form for nominations across the securities market.

2. SEBI:[20] Directors barred from market access for Public-Issue norm violations

In the given case, SEBI has barred the assessee company and its directors from accessing the securities market for one year after finding that they engaged in fund mobilization from the public through Redeemable Preference Shares (RPS), violating various sections of the Companies Act, 1956 and 2013.

[19] SEBI Consultation Paper, dated 2nd February 2024
[20] Sandhya Projects Ltd. [LSI-156- SEBI-2024(MUM)], dated 29th February, 2024

The assessee company raised funds from 221 allottees in FY 2011-12 through RPS, exceeding the limit of 50 persons set by the Companies Act, 1956. SEBI concluded that this constituted a public issue and the assessee company failed to comply with public issue norms; additionally, the assessee company did not maintain a separate bank account for investor funds, failed to list securities, and did not refund collected money, leading to SEBI's directive for refunding with interest and a one-year market access ban.

3. SAT[21]: Appointment of Directors over 75 years vis-à-vis subsequent special resolution

In the given case, the assessee company appointed an additional director categorised as non-executive independent director, who had attained the age of 75 years through a Board resolution. Although, the assessee company already had the required three independent directors, in two cases their terms were ending soon. The Nomination and Remuneration Committee (NRC) recommended the appointment, subject to special resolution approval at the AGM, which was subsequently approved. However, fines were imposed by BSE/NSE alleging non-compliance with Regulation 17(1A) of SEBI LODR citing the need for prior shareholder approval through a special resolution for a person aged 75 years.

On appeal before SAT by the assessee company, it was clarified that Regulation 17(1A) of SEBI LODR requires a special resolution for appointing a non-executive director over 75 years old. The term 'unless' in the regulation does not signify 'prior approval', and passing a special resolution is not a qualifying condition for directorship. Since the company met regulatory requirements by passing a special resolution, its actions were validated, and the fines imposed by BSE and NSE were overturned.

Katalyst Comments:

SAT has allowed a more liberal interpretation of LODR regulations, rather than strict procedural adherence. This order enables listed companies to appoint directors over 75 years of age and to take post facto approval of the shareholders through special resolution.

4. Bombay HC[22]: Tenant's rights in redevelopment cannot supersede landlord's ownership rights

In the given case, the assessee was the owner and landlord of a commercial building located in Mumbai, which housed multiple tenants operating various businesses; the tenants had earlier filed a writ petition seeking permission for structural repairs, arguing that the building could be repaired without immediate evacuation, based on a structural assessment report and also obtained No Objection Certificate (NOC) from the relevant authorities for the repairs. However, the assessee contended that the building was in a dilapidated state (C-1 category) and required immediate evacuation for safety reasons; as a result, the assessee filed a writ petition challenging the NOC granted to the tenants.

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[21] SAT Appeal No. 845 of 2023, 20 Microns Ltd. v. BSE Limited]

[22] Anandrao G. Pawar vs Municipal Corporation of Greater Mumbai and Others Writ Petition (L) No. 20227 of 2023

The Bombay HC analysed the rights associated with property ownership in this context; while acknowledging certain rights of the tenants, the court emphasised that they cannot override the development and safety concerns of the property owner. It was reaffirmed that property owners have the right to develop their properties within the legal framework and enjoy the benefits of ownership; the court rejected the tenant's argument that repair and reconstruction rights take precedence over the owner's development plans, citing relevant legal statutes such as the Maharashtra Rent Control Act and the Mumbai Municipal Corporation Act.

Consequently, the Bombay HC ruled in favour of the assessee, quashing the decision allowing repairs and confirming the owner's right to redevelopment without undue interference from tenants.

D. Goods and Service Tax Highlights

1. Karnataka HC[23]: No service tax applicable to Venture Capital Fund ('trust') for managing funds of investors ('contributors')

In the given case, during an investigation conducted by the Anti-Evasion Unit on the trust, it was held that the trust was deemed liable to pay service tax on the retained portion of monies distributable to contributors, which was considered as service charge or fees for managing the fund. The decision was affirmed by the CESTAT; however, the Karnataka HC has overruled the CESTAT decision, and held that there is no provision of service from the trust to its contributors and further held that, contributors and the trust cannot be treated as separate entities, and under the principle of the doctrine of mutuality, the fund does not perform any action or provide services to itself.

The HC further clarified that the trust functions as a 'pass-through' entity; funds from contributors are consolidated and then invested by the investment manager. The trust/fund serves as a trustee, holding the contributors' money to be invested according to the investment manager's advice. In view thereof, the Karnataka HC held that the trust is not liable for service tax when dealing with monies collected as an investment fund.

Katalyst comments:

Under the GST Law includes trusts under the definition of 'person', and the concept of mutuality is largely nullified by the Explanation to the term 'supply'; this Explanation deems transactions between a person and its members as liable for supply. Based on the judgment, it can be inferred that there is neither a service (supply) nor consideration in the arrangement between contributors and trusts.

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[23] M/s India Advantage Fund III & others vs. Commissioner of Central tax, Bangalore, [TIOL-239-HC-KAR-ST 2024] dated 8th February, 2024

2. Madras HC[24]: GST registration restored contingent upon filing GST returns for the periods preceding the cancellation

In the given case, the taxpayer's GST registration was cancelled due to failure to file returns for certain periods. However, the Madras HC clarified that non-filing of returns for specific periods does not necessitate retrospective cancellation of the taxpayer's registration, especially if the taxpayer was compliant during the periods when returns were filed; the HC further emphasised that registration can only be cancelled if deemed necessary by the appropriate authority, based on objective criteria rather than subjective judgment.

Consequently, the Madras HC ordered the restoration of GST registration, contingent upon filing GST returns for the periods preceding the cancellation.

Katalyst comments:

A welcome decision by the Madras HC decision, as it highlights the need for a fair and objective assessment by the proper officer before cancelling a taxpayer's GST registration, ensuring that cancellations are justified and based on concrete grounds, promoting transparency and fairness in the regulatory process

3. Tamil Nadu AAR[25]: Input Tax Credit denied for Cement, Steel, and Architect Services used in Godown Construction intended for commercial renting

The Tamil Nadu AAR has ruled that Input Tax Credit for goods including cement, steel, PEB Sheet, building materials like bricks and sand, as well as services provided by consultants and architects, is not available (block credit) under Section 17(5)(d) of the CGST Act. The Tamil Nadu AAR further dismissed the applicant's argument that the restriction of Section 17(5)(d) is not applicable to the construction of godowns which, though not directly linked to the core business activities, act as a vital source of income essential for sustaining the business.

Katalyst comments:

In a similar situation, the Orissa HC, in the case of Safari Retreats Pvt. Ltd[26] *rendered a favorable decision; it was held that Input Tax Credit for inputs and input services utilised in the construction of a mall would be available if the assessee is liable to pay GST on rental or leasing income derived from letting out shops within the mall, given that GST has already been paid on all the inputs. However, this case is pending before the Apex court, and a final resolution on the matter is awaited.*

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[24] In the matter of Suswani Foundations Pvt Ltd. [TS-742-AAR(TN)-2023-GST] dated 15th March, 2024
[25] In the matter of Suswani Foundations Pvt Ltd. [TS-742-AAR(TN)-2023-GST], dated 15th March, 2024
[26] Safari Retreats Pvt. Ltd [2019-TIOL-1088-HC-ORISSA-GST]