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Dear Readers,

We are delighted to present the latest issue of Tax Scout, our quarterly update on the recent developments in direct and indirect tax laws for the three months ending September 30, 2024.

In our main story, we have provided a detailed overview of the taxation of employee stock option plans, analysed various intricacies involved, and discussed the recent judgments in this field.

In addition to this story, we have also dealt with other important developments and judicial precedents in the field of taxation for this quarter.

We hope you find the newsletter informative and insightful. Please do send us your comments and feedback at cam.publications@cyrilshroff.com.

Regards,
CYRIL SHROFF

Managing Partner
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India's leading law firm

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Taxation of Employees Stock Options

1. Concept of ESOPs

ESOPs have become extremely popular, with more companies around the world who are offering these as part of their rewards and retention strategy. These stock option plans have particularly gained traction in the start-up ecosystem and the information and technology industry, where equity in the company has become a standard part of the compensation package. These not only help start-ups and companies address their inability to pay cash and preserve scarce resources but also allow employees to receive shares of their employing company and participate in their company's growth.

1.1. Meaning

An ESOP is an employee-benefit programme that gives employees the option to acquire ownership in the company they work for, whereby, as a part of their compensation, they are given an option to buy equity shares of their employer company on a future date, at a predetermined price (or the exercise price), which is often significantly lower than the market value.[1]

These options typically vest over a certain duration, which requires employees to stay with the company for a specific time period – known as the "vesting period". At the end of the vesting period, employees can exercise their options and buy the shares at the lower exercise prices, potentially benefiting from an increase in the company's stock price.

Hence, an ESOP may also be defined as a non-transferable and non-monetisable contractual right or actionable claim available to employees, the benefits of which can be derived at the time of share allotment when they opt to acquire their employer company's shares at a price lower than the market value.[1]

1.2. Purpose and Benefits

ESOPs make for a powerful employee motivation and retention tool. Companies use this that option they give employees to acquire equity shares at lower prices as a strategy to ensure that they develop a sense of ownership and loyalty, feel incentivised to stay longer, improve their engagement to align their interests to the companies', and feel motivated to work towards achieving the company's goals. This, in turn, helps the company increase productivity and display better organisational performance.

ESOPs are also a valuable alternative for start-ups and growing companies with limited cash compensation ability, as these help them maintain liquidity and cash-flow requirements alongside adequately compensating employees' talent. Whereas for the employees, these options represent a potential to accumulate wealth over time. If their employer companies perform well and their stock prices increase, the employees can earn dividends or benefit from the capital gains on selling their shares.

Besides, in India and many other countries ESOPs also tax advantages in that employees can defer tax

[1] Nishithkumar Mukeshkumar Mehta v DCIT, [2024] 165 taxmann.com 386 (Madras).

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liabilities until they exercise their options and corporations can enjoy tax deductions related to stock option grants.

1.3. Types

As companies design a stock option plan with unique features based on their specific needs and financial requirements, the tax implications of each feature of such distinct ESOPs need to be analysed. Some types of ESOPs commonly used by corporations in India include:

i. *Employee Stock Option Scheme* (***ESOS***): Considered a typical, traditional ESOP, an ESOS is the most commonly issued stock option type in India. Like most ESOPs, it provides for a vesting period, which requires employees to remain with the company for a set period before they can exercise the options. The exercise price is set at the stock's fair market value at the time of grant, although it could be set at a different price.[2]

ii. *Employee Stock Purchase Scheme* (***ESPS***) *or Employee Share Purchase Plan* (***ESPP***): An ESPS or ESPP allows employees to purchase shares at a company-offered discounted price, either as part of a public issue or otherwise, or through a private trust, where such trust may acquire shares as part of the scheme. The employees purchase this through their contribution to a fund accumulated through payroll or salary deductions.[3] Listed companies or those in the process of becoming listed within a short time frame follow this structure.

iii. *Restricted Stock Units* (***RSUs***): RSUs are the company's restricted securities that are not fully transferable until certain conditions have been met, i.e., until the removal of such restrictions. The process of grant and allotment of stock plans is similar to that of a traditional ESOP except for the additional requirement of satisfying the restrictions.[4] Mostly listed companies avail these.

iv. *Stock Appreciation Rights* (***SARs***): SARs are a form of equity-linked employee compensation similar to that of an ESOP, where the employees may exercise their rights to receive appreciation or profits for a specified number of shares when the company is performing well in the market and the market value of the shares is higher than the predetermined price. At the time of exercise, the company could opt to either issue the shares or pay the cash equivalent to the employees.[5] The company can only implement this if it has sufficient cash to remunerate its employees or if an investor-promoter decides to provide the requisite amount of liquidity to the company to help implement this structure.

v. *Phantom Stock Options* (***PSOs***): PSOs, or virtual stock options, are SARs that exclusively provide for cash payouts to the employees instead of allotting shares at the time of exercise of their options.[6] The requirement of adequate amount of cash flows would be similar to that of SARs.

1.4. ESOP Mechanisms

Structuring under direct route: A company may implement an ESOP either directly or through a private irrevocable trust. Under the direct route, once the employees exercise their options after the vesting period, the company issues and allocates fresh equity shares to them.

Structuring ESOPs as a trust: A very common practice, implementing ESOPs through a private trust involves the company contributing funds into the trust through a loan, which the trust would use to purchase company shares and allot them to the employees should they decide to exercise their granted options. The trust uses the money it receives from the employees to repay the loan to the company.

If a stock option plan involves secondary acquisition of company shares from the market or a gift of shares from the existing shareholders for the allotment of shares to the employees under the plan, The SEBI (Share Based Employee Benefits and Sweat Equity) Regulations, 2021 (**SEBI Regulations**), mandate that the company establish a trust to implement the same.

The regulations in relation to management of the trust, appointment of trustees, restrictions on the activities of the trust, maintenance of books of accounts of the trust, etc., should comply with the SEBI Regulations.

[2] Regulation 2(j), SEBI (Share Based Employee Benefits and Sweat Equity) Regulations, 2021.
[3] Regulation 2(k), SEBI (Share Based Employee Benefits and Sweat Equity) Regulations, 2021.
[4] FAQ No. 2, SEBI FAQs on SEBI (Share Based Employee Benefits and Sweat Equity) Regulations, 2021 1637066501879.pdf (sebi.gov.in).
[5] Regulation 2(rr), SEBI (Share Based Employee Benefits and Sweat Equity) Regulations, 2021.
[6] FAQ No. 3, SEBI FAQs on SEBI (Share Based Employee Benefits and Sweat Equity) Regulations, 2021 1637066501879.pdf (sebi.gov.in).

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Leveraged ESOPs and financing: Once a company plans and structures its stock option plan(s), it shall have to consider how to fund or finance the plan. It may take loans for this purpose; for instance, if a company sets up a trust for implementing its ESOP plans, the ESOP trust may use loans or borrowed funds to purchase the shares.

2. Overview of ESOP Taxation

Effective tax planning requires both employees and employers to understand the tax implications of the stock options plans. Employers should also understand the tax implications across various ESOP types to take advantage of the tax incentives and ensure necessary compliance.

2.1. Tax Implications for Employees

Taxability as salary

ESOPs are taxable under the head of salary as perquisites under Section 17(2)(vi) of the IT Act. The taxability of such ESOPs arises at the time the employee exercises the options. Explanation (c) to Section 17(2)(vi) of the IT Act provides that the perquisite value be determined as the difference between the FMV of the shares on the date of exercise of options and the exercise price paid by or recovered from the employee.

The fair market valuation is done in accordance with the Rule 3(8)(ii) of the IT Rules, which states that if the equity share is listed on any recognised stock exchange on the date the options are exercised, the valuation should be determined based on the trading prices at the recognised stock exchange with the highest trading volume. If, however, such equity share is not listed on any recognised stock exchange, a merchant banker shall determine the fair market valuation on the day the option is exercised. Here, it is important to note that the valuation shall be on the date of exercise of options and not on the date of allotment of the shares to the employees.

The perquisite valuation in various such scenarios as per Rule 3 of the IT Rules are as follows:

Scenarios	FMV
Where shares are listed on one stock exchange on the date of exercising of ESOP	The average of the share's opening and closing prices on the stock exchange on that date
Where shares are listed on more than one stock exchange on the date of exercising of ESOP	The average of the share's opening and closing prices on the stock exchange that records the highest trading volume in the share
Where, on the date of exercising of ESOP, no trading in shares occurs in the stock exchange (shares are listed on one stock exchange)	The share's closing price of on the stock exchange on the date closest to and immediately preceding the ESOP exercising date
Where on the date of exercising of ESOP, no trading in shares occurs in the stock exchange (shares are listed on more than one stock exchange)	The share's closing price on the stock exchange recording the highest trading volume in the share on the date closest to, and immediately preceding, the option's exercise date
Where shares are not listed on a stock exchange	The share value as determined by a merchant banker on the specified date, i.e., on: - the date of exercising of ESOP; or - any date earlier than the option exercise date, provided the date is not more than 180 days earlier than the exercise date

Moreover, when an employee eligible under an ESOP scheme receives any compensation in relation to the ESOP scheme prior to exercising the options, the compensation shall be chargeable to tax as perquisites. In the ***Sanjay Baweja***[7] case, the Court held that when the company pays compensation to the employees of its subsidiary covered under the ESOP scheme because of a diminution in the value of stock options, it would be a one-time voluntary payment under the ESOP scheme and shall not be chargeable to tax.

[7] Sanjay Baweja v DCIT [2024] 163 taxmann.com 116 (Delhi).

However, the Madras High Court rejected this reasoning in the ***Nishithkumar Mukeshkumar Mehta (supra)*** case when it held that the monetary benefit the employee receives at the pre-exercise stage as compensation for a diminution in the value of stock options would in its entirety qualify as a perquisite and become liable to be taxed under the head of salary because the employee did not make any payment towards ESOPs and continued to retain all ESOPs even after receipt of compensation.

Capital gain tax implications

Pursuant to the allotment of shares to the employees, if an employee decides to sell the shares, there shall be capital gain tax implications depending on the period of holding of the shares on the gains arising from such sale. Here, the period of holding shall be considered from the date of allotment of shares under the scheme and the cost of acquisition shall be the FMV on the option exercise date, i.e., the FMV based on which the value of perquisite is determined.[8]

After Finance Act, 2024, if the shares are listed on a recognised stock exchange and sold after being held for 12 months or more, then gains arising on their sale shall be taxed as long-term capital gains at the rate of 12.5 per cent. If the shares are sold before 12 months, then they shall be taxed as short-term capital gains at the rate of 20 per cent.

In case of unlisted shares, the period of holding shall be 24 months. Hence, if such shares are sold after such period, gains arising on their sale they shall be taxed as long-term capital gains at the rate of 12.5 per cent. If the shares are sold before such period, gains arising from such a sale shall be taxed as short-term capital gains at the applicable rates in the hands of the employees.

2.2. Tax Implications for Employers

Tax deductible at source

As ESOPs are taxable as perquisites under the head of salary, the employer company shall be required to withhold tax under Section 192 of the IT Act on the value of such perquisite as determined earlier. The tax shall be deducted on the basis of rates in force for the financial year in which the shares were allotted or transferred under the stock option scheme.

ESOP expenses as a tax-deductible expense

Apart from the preceding, there shall be no tax liability or any tax obligations in the hands of the company. Although the IT Act does not provide for any explicit tax relaxations in relation to ESOPs, the deductibility of expenses incurred by a company has been established through a myriad of judgments. Section 37 of the IT Act provides that any expense not being in the nature of capital expenditure and incurred wholly and exclusively for the purpose of business or profession shall be available as a deduction.

The key issue for companies issuing ESOPs is whether the cost associated with granting stock options, such as the difference between the exercise price and the market value of shares, can be considered a deductible business expense under this section. Historically, the deductibility of ESOP expenses under Section 37 was a contentious issue in India. The central question was whether the notional loss or difference between the exercise price and the FMV of shares qualifies as a legitimate business expense, given that it represents a non-cash outflow for the company.

One of the landmark cases in this context is ***PVP Ventures Ltd.***,[9] where the Madras High Court held that ESOP-related expenses are allowable as business expenditure under Section 37. The HC noted that the expenses incurred for ESOPs are a part of employee compensation and made wholly and exclusively for business purposes, i.e., to retain and motivate the employees, even though they do not result in a direct outflow of cash. Here, it must be noted that as the objective of an ESOP is not to raise share capital but to retain the workforce and adequately compensate them for their services, the expenses incurred in relation to it shall be revenue in nature.

Further, in the case of ***Biocon Ltd.***,[10] the Court held that ESOP expenses could be claimed as a deduction under Section 37 of the IT Act as recorded in the company's books of accounts basis the accounting standards. Although tax is payable on the allotment of shares, expenses in relation to the same may be incurred prior to the same depending on the terms of the scheme.

As per the accounting principles, the amount of discount granted to the employees on the shares is

[8] Section 49(2AA) of the IT Act.
[9] CIT vs PVP Ventures Ltd. [2012] 23 taxmann.com 286/211 Taxman 554 (Mad.).
[10] Biocon Ltd. v. Dy. CIT (LTU) [2013] 35 taxmann.com 335/[2014] 144 ITD 21.

written off or amortised over the vesting period of the ESOP on a straight-line basis.[11] Here, the deduction under Section 37 of the IT Act shall be available for the written off amounts each year. It has been clarified in the ***Biocon Ltd. (supra)*** case and followed in many subsequent cases that such an expense cannot be held to be a contingent liability.

If at the end of the scheme, some of the options remain unvested or employees do not exercise their options, then the deduction so claimed would have to be reversed and offered for taxation in the subsequent year.

If a holding company implements an ESOP scheme and offers its shares as options to the employees of its subsidiary company and allocates the relevant ESOP expenses to the subsidiary company, such subsidiary shall also be eligible to claim deduction of such ESOP expenses under Section 37 of the IT Act, as it cannot be denied that such expenses have ultimately been incurred to grant the benefit with an intention to retain employees of the subsidiary company. If such arrangement is between a foreign holding company and its Indian subsidiary, the allocation of ESOP expenses must be determined on arm's length basis.[12] Similarly, in case of corporate restructurings such as mergers and demergers, the ESOP expenses may be allocated between the companies depending on terms of the ESOP scheme.

2.3. Tax Implications Where the Employer Is an Eligible Start-Up

Withholding of taxes at the time of allotment of ESOPs under Section 192 of the IT Act was burdensome for newly established start-ups and its employees, which led to reduced cash flow with no immediate apparent benefits. Therefore, the IT Act provides for a beneficial tax treatment in relation to ESOPs for start-ups eligible under Section 80-IAC of the IT Act.[13]

Section 80-IAC of the IT Act defines an eligible start-up as a company or limited-liability partnership incorporated on or after April 1, 2016, but before April 1, 2025, holding a certificate of eligible business from the

Inter-Ministerial Board of Certification and having a total turnover of INR 100 crore or less in the previous year.

Such eligible start-ups and their employees get the benefit of deferment of TDS payable by the employer as well as the tax payable by the employees on the allotment of shares for up to four (4) years.[14] Section 192(1C) of the IT Act provides that such eligible start-ups may deduct or pay taxes on the value of perquisites derived from allotment of shares under an ESOP within 14 days from the happening of the any of the following events, whichever is earlier:

a) Completion of 48 months from the end of the AY in which securities are allotted under ESOPs;

b) Date the employee ceases to be an employee of the organisation; or

c) Date of sale of securities allotted under ESOP by the employee.

Employees belonging to such eligible start-ups shall not be required to pay tax at the time of allotment of shares in the same year of allotment; however, they shall have to disclose the value of perquisite received as shares under the ESOP scheme in the year of such allotment. Accordingly, tax payable on salary shall be

[11] SEBI (ESOS and ESPS) Guidelines, 1999.
[12] Novo Nordisk India (P) Ltd v DCIT [2014] 42 taxmann.com 168/63 SOT 242 (Bang. - Trib.); IBM India (P) Ltd v DCIT [2023] 149 taxmann.com 154 (Bangalore - Trib.).
[13] Income Tax Tutorial on Taxation of Employee Stock Option Plan (ESOP) 50.taxation-of-esops.pdf (taxmann.com).
[14] ibid.

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computed excluding the perquisite value of ESOPs by using the following formula:

3. Taxation at Different Stages

The IT Act provides a clear basis of taxation for benefits extended by the employer to the employee during the ordinary course of business, which is summarised as follows:

i. ***Grant:*** There are no tax implications for either the employees or the employers at the time of grant of an option under any scheme.

ii. ***Vesting:*** There are no tax implications during the vesting period; however, the ESOP expenses amortised during the year as per the company's accounting practices may be claimed as business expenditure by the employer under Section 37 of the IT Act.

iii. ***Exercise:*** Upon exercising the options, the employees shall be liable to pay tax on the value of perquisite under the head of salary and the employers shall be obligated to deduct withholding tax on the value of perquisite.

iv. ***Sale:*** There shall be capital gain tax implications on the sale of shares by the employees.

v. ***Buyback:*** If a company decides to buy back its shares, including shares allotted under an ESOP scheme, pursuant to the Finance Act, 2024, the amount the employee receives for the buyback shall be taxable in the hands of employee shareholders. Such amount shall not only be taxed as deemed dividend under the head of income from other sources as per applicable rates but also be subject to withholding tax at the rate of 10 per cent.

4. Conclusion

ESOPs have become a crucial tool for companies in India to attract, retain, and incentivise employees by offering them a stake in the company's growth. However, the taxation of ESOPs is complex and requires a thorough understanding of the applicable laws, particularly for both employees and employers.

Companies need to be aware of the accounting and tax implications of offering ESOPs, ensuring compliance with the IT Act and relevant judicial precedents in relation to the same. Properly accounting for ESOP expenses and recognising their eligibility for deduction can provide significant tax benefits to businesses, especially in start-ups and competitive industries where retaining talent is critical.

With ESOPs playing a larger role in the modern compensation structure, both companies and employees must plan strategically, seek professional advice, and remain compliant with evolving regulations, especially in scenarios of corporate restructuring or demergers. When managed effectively, ESOPs can create a win-win situation –employees can share in the company's success, while businesses can incentivise performance and retain top talent.

It is also important for employers and employees to keep themselves abreast of the latest provisions of IT Act read with the relevant IT Rules along with the judicial precedents. The situation may become compounded with the prospective of the revised IT Act, which is expected to the presented before the Parliament around the budget for FY 2025-26.

Bifurcation of service fee into business income and fees for technical services

Introduction

The Delhi HC, in the ***International Management Group (UK) Limited***[15] case, held that a service fee derived from a single contract can be bifurcated and taxed as business income to the extent such fee was attributable to the PE of the taxpayer and the remainder as FTS, subject to the satisfaction of the prescribed conditions.

Facts

International Management Group (UK) Ltd. (**Assessee**), a resident of the United Kingdom (**UK**), had entered into a service agreement received with the Board of Control for Cricket in India (**BCCI**) for rendering advisory and managerial services in relation to the establishment, commercialisation, and operation of the cricket league, i.e., Indian Premier League (**IPL**). In the relevant FY, the Assessee received a "service fee" from the BCCI under the said service agreement and was offered a portion of the same to tax in India (**Service Fee**).

The Assessee acknowledged having established a Service PE in India under Article 5(2)(k) of the India–UK DTAA and offered only the Service Fee attributable to such PE to tax in accordance with Article 7 of the DTAA. The Assessee also asserted that the reminder Service Fee, which pertained to services rendered outside India, was not attributable to the PE and consequently not taxable in India, since they did not make available the knowledge and knowhow.

However, the AO held that the balance portion of the Service Fee should qualify as FTS under Article 13 of the India–UK DTAA and should be taxed accordingly. On appeal, the ITAT also held that the reminder portion of the Service Fee was taxable as FTS.

Issue

In the facts and circumstances of the case, whether "Service Fee", to the extent not attributable to the Assessee's PE in India, can be taxed as FTS under the IT Act read with the provisions of India-UK DTAA?

Arguments

The Assessee contended that the Service Fee received from the BCCI was in the nature of a business income and was only taxable to the extent such fee was attributable to the PE. They asserted that the IRA be estopped from treating the balance receipts as FTS, once it has accepted the existence of PE under Article 5(2)(k) of the DTAA and the attribution of receipts thereto, especially considering that the provisions of Article 5(2)(k) are only applicable in respect of services other than those that qualify as FTS. Thus, it was argued that composite receipts the Assessee received, pursuant to an indivisible contract, could not be bifurcated.

The Assessee also contended that even otherwise such Service Fee could not be brought to tax as FTS, as they did not satisfy the

[15] International Management Group (UK) Limited v. CIT [(2024) 164 taxmann.com 225 (Delhi HC)].

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"make available" requirements under Article 13 of the India–UK DTAA.

However, according to the IRA, there was a distinction between the services provided by the Assessee's UK office, i.e., service not attributable to the PE and those rendered by the Indian PE. Thus, merely because a part of the Service Fee, being income attributable to the PE, was offered to tax as business income does not preclude the IRA from evaluating the applicability of other Articles of the DTAA. The IRA also argued that the Assessee used their special knowledge and skill during the course of rendering such services to the BCCI, which they made available to the BCCI in the form of findings, research, processes, etc. Hence, the Service Fee, to the extent not attributable to the PE, qualified as FTS under Article 13 of the DTAA.

Decision

The HC observed that Article 5 of the DTAA does not establish a tax framework or define the nature of income; instead, it specifies the conditions under which a non-resident's activities in India can constitute a PE. Thus, the HC rejected the Assessee's argument that once the income attributed to a service PE constituted under Article 5(2)(k), it is not open for the IRA to tax the remainder income as FTS.

The HC further noted that Article 7(9) of the India–UK DTAA provides that where profits of a taxpayer include incomes specifically dealt with in any other Article, the same would move out of the ambit of Article 7, which is restricted to the taxation of business incomes. The HC concluded that the DTAA's structure recognises that revenues of a taxpayer may include distinct items of income, which would be governed by a specific Article of the DTAA. Thus, the HC held that the IRA was duly empowered to analyse the real nature and character of the Assessee's income, including the balance Service Fee.

The HC also determined that the sharing of research material with the BCCI did not imply that it had gained special knowledge from the Assessee to satisfy the "make available" test under Article 13 of the India–UK DTAA. The HC relied on the decisions in the ***De Beers***,[16] ***US Technology Resources***,[17] and ***Bio Rad***[18] cases and clarified that the "make available" test is satisfied, when a transfer of skill or expertise to the recipient occurs along with the rendering technical or consultancy services, such that the recipient can use that knowledge independently rather than just temporarily using the provider's expertise. In this case, the HC found that the Assessee did not transfer any skills or know-how to the BCCI. The Court also noted that the BCCI relied on the Assessee's ongoing expertise in managing sporting leagues, which reflected that it had no intent to absorb their knowledge. Hence, the HC held that balance Service Fee did not quality as FTS under Article 13 of the India–UK DTAA.

Significant Takeaways

This judgment is particularly significant for cases involving income attributed to a PE. While the remaining income was not taxed as FTS in this instance, the outcome of each case will depend on the facts and applicable DTAA provisions. Thus, it would be pertinent for taxpayer to evaluate the tax implications arising from such structures, having due regard to the factual matrix at hand.

Finally, this decision not only also reasserts the understanding of the "make available" condition but also emphasises the importance the courts give to the tenure of the agreement between the parties in, evaluating the make available conditions. This decision also clarifies that the intentions of the parties, as reflected in the terms of the agreement, also plays a significant role while evaluating the make available conditions. Thus, this decision reiterates the importance of vetting such arrangements/agreements from a tax perspective.

> **"Distinction must be acknowledged between mere utilisation of technical or consultancy service and the transfer, transmission and enablement."**

[16] The Commissioner of Income Tax v. De Beers [(2012) 346 ITR 467 (Karnataka HC)]
[17] US Technology Resources v. The Commissioner of Income Tax [(2018) 407 ITR 327 (Kerela HC)]
[18] The Commissioner of Income Tax (International Taxation)-1, Delhi v. Bio Rad [(2023) 459 ITR 5 (Delhi HC)]

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Consideration received from provision of bandwidth services to Indian telecom operators is neither "process" nor "equipment" royalty

Introduction

In ***Telstra Singapore Pte. Ltd.,***[19] the Delhi HC held that the consideration received for providing bandwidth services to various Indian telecom operators would not be taxable as royalty under Article 12 of the India–Singapore DTAA.

Facts

Telstra Singapore Pte. Limited (**Assessee**), a Singapore-based company was engaged in the business of providing, connectivity services, i.e, bandwidth services. The Assessee entered into various agreements with Indian telecom operators and to provide seamless connectivity to customers of such Indian operators, outside India. Pursuant to this arrangement, the Assessee received consideration from the Indian customers (**Fee**).

While the Assessee had furnished returns of income declaring nil income, the AO alleged that the Fee was liable to be construed as constituting equipment/process royalty, under section 9(1)(vi) of the IT Act read with Article 12(3) of the India–Singapore DTAA.

On appeal, the ITAT reversed the order of the AO and held that the Fee the Assessee received would not be taxable as "royalty". Aggrieved, the IRA preferred an appeal before the Delhi HC.

Issue

Whether the Fee received by the Assessee to provide bandwidth services was in nature of royalty income, taxable under read with Section 9(1)(vi) of the IT Act read with Article 12 of the India–Singapore DTAA?

Arguments

At the outset, the IRA asserted that under both the India–Singapore DTAA and Section 9(1)(vi) of the IT Act, "royalty" has been defined to, among other things, include any kind of consideration for the "use" of, or the "right to use" of any secret formula or process or any industrial, commercial, or scientific equipment. Thus, it argued that the private line services the Assessee provided was for the "exclusive use" of Indian customers, which suggested "use" as well as a "right to use" of the underlying process/equipment. Consequently, the Fee received from the Indian customers for rendering such services should qualify as royalty under the India–Singapore DTAA.

The IRA further relied on the expanded definition of "process", which was incorporated in the IT Act through an amendment. The IRA further argued that Article 3(2) of the India–Singapore DTAA permitted reference to domestic laws of the countries to interpret the terms not defined under the DTAA. Thus, the IRA argued that the expanded definition of "process" under the IT Act, which includes transmission by satellite, cable, optic fibre, or by any other similar technology, should be considered while interpreting the definition of "royalty" under Article 12 of the India–Singapore DTAA. In this regard, the IRA placed reliance on the ***Verizon Communications***[20] case.

On the other hand, the Assessee argued that provision of bandwidth services did not result in any use of equipment / process, since the customers were mere recipients of the service. Therefore, it would not attract equipment/process royalty, as the transaction would not fall within the expression "use or right to use". The Assessee relied on ***Asia Satellite***[21] and other cases,[22] where it was held that threshold for "use" or "right to use" is customers having effective and general control of goods being conferred upon them. On the issue of expanding the definition of "royalty", the Assessee relied on ***New Skies Satellite***[23] and ***Engineering Analysis***[24] and argued that the amendments to the royalty provisions under Section 9 of the IT Act are "transformative and substantive" in nature and such amendments cannot be read into the DTAA.

Decision

The Delhi HC, relied on ***New Skies Satellite (supra)*** and ***Engineering Analysis (supra)***, and observed that the amendments to Section 9 could not be read as having subsumed, eclipsed, or overridden the provisions of the DTAA. While the Delhi HC acknowledged that Article 3(2) of the India–Singapore

[19] Commissioner of Income Tax (International Taxation) v. Telstra Singapore Pte. Ltd., [2024] 165 taxmann.com 85 (Delhi).
[20] Verizon Communications Singapore Lte. Ltd. v. ITO, [2013] 361 ITR 575 (Mad).
[21] Asia Satellite Telecommunications Co. Ltd. v. Director of Income-Tax 2011 SCC OnLine Del 507
[22] See Lakshmi Audio Visual Inc. v. Asst. CCT 124 STC 426 (Karn); Dell International Services India (P.) Ltd. [2008] 172 Taxman 418/305 ITR 37 (AAR).
[23] DIT v. New Skies Satellite BV, [2016] 382 ITR 114 (Del).
[24] Engineering Analysis Centre of Excellence Private Ltd. v. Commissioner of Income Tax, (2022) 3 SCC 321. See also Vodafone Idea Ltd. v. Deputy Director of Income Tax, 2023 SCC OnLine Kar 107.

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DTAA allows reference to domestic legislation, it held that it does not envisage a heedless or wholesale adoption or importation of domestic legislation. The Delhi HC also noted that the amendment to Section 9 of the IT Act was introduced in 2012, while there was no corresponding amendment under the India–Singapore DTAA.

The Delhi HC further reasoned that the power to legislate could not be legally countenanced to depriving a party of the benefits, which two contracting States chose to confer by virtue of a higher covenant drawn in exercise of their political and sovereign authority.

Further, the Delhi HC noted that to fall within the definition of "royalty" under Article 12 of the India–Singapore DTAA, effective control or dominion should have been conferred upon an individual or entity for consideration, i.e., a right given to make use of the patent, trademark process, or equipment. A mere advantage, utilisation, or benefit derived from a service provided cannot possibly be countenanced to fall within the meaning of the expression "use" or "right to use".

On the facts of the case, the Delhi HC observed that the Assessee's customers were not accorded any right over the technology it possessed, and there was no transfer of right in respect of any patent, invention, or process. The agreements between the Assessee and the telecom service providers were essentially representative of a reciprocal arrangement to facilitate their customers to avail of communication services while they moved between territories. Accordingly, the Delhi HC held that neither the concept of "process" nor "equipment" royalty stood attracted, and the Fee is thus not taxable as per Article 12(3) of the India–Singapore DTAA.

Significant Takeaways

The classification of interconnectivity/roaming charges under the head of income from "royalty" has been a matter of controversy frequently. Further, the reconciliation of the definition of "royalty" as given under the DTAA and as amended under Section 9 of the IT Act has also been a matter of litigation, as seen from the plethora of decisions relied on by the parties. While only the characterisation of the Fee received as "royalty" was in dispute in the present case, the IRA has also argued in some cases that the consideration of such nature paid to telecom operators should be chargeable as FTS. However, it is a settled position that income cannot be characterised as FTS in the absence of human intervention. Bandwidth services the Assessee provided typically did not involve human intervention and, therefore, would not be classified as FTS.

The Delhi HC decision in this case is in line with other recent decisions[25] and with the interpretation under the OECD Model Tax Convention on Income and on Capital, 2017 (**MTC**), commentary, which clarifies that payments made by a telecom operator to another network operator under a typical "roaming" agreement would not constitute royalty.[26] This decision, especially considering the HC's intricate analysis of the legal issues, brings much-needed clarity and certainty.

Having said the same, other arrangements involving process/data sharing should be analyzed in light of facts at hand. In some cases, income from provision of certain services, such as telecommunication services through a fibre-optic cable system,[27] can continue to be considered royalty if the equipment is installed in India and if the right transferred to the customers is exclusive in nature. Thus, it is critical to analyse the characterisation of payments before remittance very carefully to avoid any unwanted scrutiny.

"Bandwidth/Roaming charges would not be taxable as royalties under the IT Act read with the applicable DTAA."

[25] DIT v. New Skies Satellite BV, [2016] 382 ITR 114 (Del); Engineering Analysis Centre of Excellence Private Ltd. v. Commissioner of Income Tax, (2022) 3 SCC 321.
[26] Para 9.2, Organisation for Economic Cooperation and Development's Model Tax Convention on Income and on Capital, 2017 ("**OECD MTC**"), Commentary on Article 9.
[27] Dishnet Wireless Ltd., In re, [2013] 353 ITR 646.

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ITAT rules that LLCs will be tax residents under the India–United States DTAA

Introduction

In the ***General Motors Company USA***[28] case, the Delhi ITAT held that LLCs are persons liable to tax under Article 4 of the India–US DTAA and, therefore, would be eligible for DTAA benefits.

Facts

General Motors Company USA (**Assessee**) is an LLC, which has claimed to be a resident of the United States. For FY 2013–14, the Assessee offered to tax payments for FTS at the beneficial rate of 15 per cent under the India–US DTAA. However, during the assessment proceedings, the AO contended that the Assessee was not a tax resident of the United States and, therefore, did not qualify for DTAA benefits, asserting that the applicable tax rate should have been 25 per cent under Section 115A of the IT Act, leading to the reopening of the Assessee's case. The AO held that LLCs did not qualify as "residents" under Article 4 of the DTAA, stating that only individuals or entities liable to tax in their home country were considered as residents for DTAA purposes.

The AO further noted that the term "laws of that State" referred specifically to taxation laws of the State. It stated that it is a fact that LLCs are not liable to tax in the United States, and it is undisputed that the Assessee is an LLC. The AO further determined that LLCs did not fall under the special provisions for partnerships and trusts in Paragraph 1(b) of Article 4 of the DTAA. Consequently, the AO issued a draft assessment order proposing to apply the tax rate of 25 per cent under the IT Act.

The Assessee appealed to the DRP and filed objections, but the DRP concluded that, based on OECD's observations on this issue, the Assessee could not be considered as a tax-resident of the United States. Therefore, the DRP upheld the AO's decision and dismissed all objections from the Assessee. Aggrieved by the judgment, the Assessee filed an appeal before the Delhi ITAT.

Issue

Whether an LLC is a tax resident under the laws of the United States for the purpose of the India–US DTAA?

Arguments

The Assessee argued that it has a TRC from the United States Internal Revenue Service, which qualifies it for residence benefits under the DTAA. Under Article 4 of the DTAA, a resident must (a) qualify as a "person" and (b) be liable to tax in their home country based on factors like domicile or citizenship. The term "person" includes individuals, estates, trusts, partnerships, companies any other body of persons, or other taxable entity as defined in the DTAA. The Assessee is a limited liability company organised under United States law. It is a body corporate under both the Limited Liability Act of Delaware and Indian corporate law. Therefore, it is a person under the DTAA.

Interpreting "liable to tax," the Assessee argued that being "liable to tax" in a Contracting State does not require actual tax payment; rather, it encompasses situations where the State has the right to tax, regardless of whether that right is exercised. Although the treaty does not define "liable to tax," Article 4 of the OECD commentary (2017) suggests that a person can be considered liable to comprehensive taxation even if no tax is imposed. Additionally, Professor Philip Baker's commentary clarifies that a person does not need to be actively paying tax to be considered "liable," as those with deductible losses or specific exemptions would still meet this criterion.

The Assessee relied on ***Azadi Bachao Andolan***,[29] which states that "liability to taxation" is a legal condition, while "payment of tax" is a fiscal fact. The SC in this case emphasised that, for the application of Article 4 of a tax treaty, the focus should be on the legal status of tax liability rather than the actual payment of taxes. The Assessee relied on the same to argue that LLCs are residents of the United States under the DTAA. Merely paying tax through the owner and not directly did not mean they are not liable to tax.

The Assessee relied on the Mumbai Tribunal's decision in ***Linklaters LLP***,[30] involving a UK-based limited liability partnership recognised as a fiscally transparent entity. The Tribunal noted that while the methods of taxation may differ between jurisdictions, the crucial factor is whether the income for which treaty protection is sought is taxed in the partner country. It concluded that treaty benefits should not be denied if the partnership's income is taxed in the residence country, even if it is not taxed at the entity level.

[28] General Motors Company USA v ACIT [TS-659-ITAT-2024(DEL)]
[29] UOI vs. Azadi Bachao Andolan [(2013) 263 ITR 706 (SC)]
[30] Linklaters LLP vs. ITO [(2010) 40 SOT 51 (Mum)]

The IRA, on the other hand, reiterated the ruling of the AO and the DRP. It argued that only those liable to tax in their country qualify as residents for DTAA purposes. It is a fact that LLCs are not liable to tax in the United States, and it is undisputed that the Assessee is an LLC. LLCs are fiscally transparent entities according to the United States tax law, i.e., their income is not subject to tax in their own hands in the United States and such corporations, therefore, do not qualify as residents of the United States in terms of Article 4 of the India–US DTAA. Additionally, LLCs do not fall under the special provisions for partnerships and trusts outlined in Paragraph 1(b) of Article 4. Further, the OECD's MTC commentary on Article 4 clarifies that if a country treats a partnership as fiscally transparent and taxes the partners on their share of income, the partnership itself is not considered "liable to tax" and cannot be regarded as a resident of that country. The IRA relied on this recent OECD guidance, which addresses the core issue.

Decision

The ITAT relied on the United States Department of the Treasury's Publication 3402, according to which, LLCs are recognised by the US state tax law and can be classified for federal tax purposes as partnerships or disregarded entities. For income tax purposes, an LLC with two or more members is treated as a partnership, while a single-member LLC is disregarded as separate from its owner. However, the LLC can elect to be treated as a corporation for US federal income tax purposes. The ability of the LLC to elect its tax classification under US federal income tax law also supports the contention that LLCs are liable to tax. Further, where an LLC is disregarded as separate from its tax owner for US federal income tax purposes, the tax owner of the LLC pays tax on the tax owner's share of the taxable income attributed from the LLC. This further supports the legal situation of a LLC being liable to tax, i.e., the LLC is essentially "liable to tax," but the income is attributed to its tax owner and such tax is imposed and paid by its respective tax owner.

Therefore, the ITAT held that on consideration of US federal tax law, LLCs are liable to tax. Further, the TRC issued to the LLC recognises it as a body corporate and that is a tax resident of the United States. Based on the aforementioned facts, the ITAT ruled that the Assessee is a resident under Article 4 of the DTAA, a person by virtue of being a body corporate, and liable to tax by virtue of the US federal tax laws.

The ITAT also held that the intent of the DTAA should take precedence, particularly regarding the concept of a fiscally transparent entity as it relates to the phrase "liable to tax." Article 4, paragraph 1(b), recognises partnerships as US residents for treaty purposes, as long as their income is taxed in the United States, either at the partnership level or at the level of its partners or beneficiaries. This is supported by the Mumbai Tribunal's decision in ***Linklaters LLP (supra)***.

Furthermore, the treaty limits a partnership's eligibility for benefits by excluding any income that is not "subject to tax" in

the United States. The AAR ruling reinforces this point in ***General Electric Pension Trust***,[31] which emphasises that an exclusion can only apply to something that was included initially. Thus, a fiscally transparent partnership is considered "liable to tax" under the treaty, and this provision clarifies the eligibility of such partnerships by excluding income that is not ultimately taxed in the United States. The ITAT applied this concept to LLCs and ruled in favour of the Assessee.

The ITAT held that the IRA had erred in not extending the treaty benefits to the Assessee. The Assessee is a tax resident under the DTAA and, therefore, FTS is liable to be taxed at the beneficial rate of 15 per cent.

Significant Takeaways

This case is monumental in its ruling that LLCs are liable to tax despite being fiscally transparent entities. In the ***Linklaters LLP (supra)*** case, the Mumbai ITAT held that partnership firms despite being fiscally transparent entities would be liable to tax under Article 4. This was before the incorporation of Article 4(1)(b) in the India–UK DTAA. Article 4(1)(b) provides that *"in the case of income derived or paid by a partnership, estate, or trust, this term applies only to the extent that the income derived by such partnership, estate, or trust is subject to tax in that State as the income of a resident, either in its hands or in the hands of its partners or beneficiaries"*. Therefore, this article explicitly incorporates fiscally transparent partnerships as residents under the DTAA. The same provision exists in the India–US DTAA. As contended by the IRA "companies" or "body corporates" are not covered under this article. However, the instant ruling has included LLCs under the scope of this provision as well.

However, this is an ITAT ruling, and the dispute may reach the HC or the SC. It will be interesting to see the views of higher judiciary regarding fiscally transparent entities as to whether they would be considered liable to tax even under DTAAs that do not have a provision similar to Article 4(1)(b). Additionally, India has chosen not to incorporate Article 3 of the MLI, which explicitly grants DTAA benefits to fiscally transparent entities. Therefore, this decision is merely the starting point for judicial precedence on whether LLCs would be considered liable to tax under the DTAA framework. Analysis of language under various DTAAs as well as a higher court judgment will help further clarify this issue.

"LLCs that are taxable entities are eligible for DTAA benefits."

[31] General Electric Pension Trust vs DIT [(2006) 150 Taxman 545 (AAR)]

Delhi HC holds there must be an ineffaceable connect in the reasoning initially disclosed for proposing initiation of reassessment and the final order passed to initiate such reassessment

Introduction

In the ***Genpact Luxembourg S.A.R.L.*** case,[32] the Delhi HC held that there must be an ineffaceable connect between reasons initially disclosed for proposing initiation of reassessment and the final order passed to initiate such reassessment, in the absence of which the reassessment cannot be done. The Delhi HC also commented on whether interest income from NCDs can be characterised as dividend income.

Facts

Genpact Luxembourg SARL (**Assessee**), a Luxembourg-incorporated company registered as a Foreign Portfolio Investor (**FPI**) under the Securities and Exchange Board of India (Foreign Portfolio Investors) Regulations, 2014, subscribed to NCDs issued by Genpact India Private Limited (**GIPL**). In its return of income for AY 2018–19, the Assessee declared the interest income received from these NCDs, offering the income to tax at the rate of 5 per cent under Section 194LD of the IT Act. The assessment orders for prior AYs, i.e., 2015–16 and 2016–17 also accepted this treatment. The Assessee received an intimation for the relevant year, but subsequently, reassessment was initiated via a notice under Section 148A(b) of the IT Act. The AO contended that the interest income from the NCDs issued by GIPL had not been appropriately offered to tax due to alleged mischaracterisation. Following this, an order was issued under Section 148(d), where the principal allegation of the AO shifted to buttress their case of proposed reassessment on an order under Section 263 of the IT Act the CIT had passed in the ***Headstrong Consulting Singapore Pte. Ltd.*** (**Headstrong**) (now known as Genpact Consulting (Singapore) Pte. Ltd.) case, asserting that the funds disbursed as interest payments should instead be classified as dividends, thereby attracting DDT.

This led the Assessee to file a writ petition challenging the validity of the reopening notice.

Issue

i. Should there be an ineffaceable connect between the reasons provided under Section 148A(b) of the IT Act for proposing to initiate reassessment proceedings and a subsequent order passed under Section 148A(d) of the IT Act to initiate reassessment proceedings under Section 148 of the IT Act?

ii. Whether interest income from NCDs can be recharacterised as dividend income in the hands of the Assessee?

Arguments

In the notice proposing the initiation of reassessment proceedings, the IRA claimed that the income had escaped

[32] Genpact Luxembourg S.A.R.L. v. Assistant Commissioner of Income-tax [(2024) 165 taxmann.com 417 (Delhi)]

assessment and mischaracterisation had led to it not being offered to tax. However, in the order passed under Section 148A(d) of the IT Act, the IRA changed its stance based on the revision proceedings on Headstrong under Section 263 of the IT Act that despite being categorised as interest payments, the amount paid should be treated as dividends and hence, subject to DDT. Subsequent to this, the Assessee argued that there was significant discrepancy between the initial reasons provided in the notice for initiation of reassessment proceedings and the final order passed to initiate reassessment proceedings, suggesting that the rationale for reassessment had changed in a way that undermined the validity of the IRA's initial position.

The IRA countered that the transaction, although allegedly structured as an interest pay out on NCDs, in fact, constituted remittances arising from the reserves and surplus of GIPL post-merger under the garb of principal and interest payments. It also contended that these interest payments be reclassified as dividends. This recharacterisation implies that what were reported as principal payments were, in fact, dividend distributions, which should have been subject to DDT that was not paid on these remittances.

Decision

The Delhi HC emphasised the need for an ineffaceable connect between the reasons initially disclosed for proposing reassessment and the final order to initiate such reassessment. Relying on its own judgment in the ***ATS Infrastructure Ltd.***[33] case, it noted that the validity of proceedings under Section 148 of the IT Act must be assessed based on the original reasons for suspecting income escapement. This opinion cannot change or rely on new reasoning; it must be grounded in tenable and sufficient reasons to justify invoking reassessment under Section 148 of the IT Act. Further, the Courts held that having regard to the entire scheme and purpose of the Act, the AO is confined only to the recorded reasons for the initiation of the reassessment and the reasoning given at a later stage cannot be relied on.[34]

Therefore, the Delhi HC remarked that the validity of the notice to reopen the assessment under Section 148 of the IT Act must be based on the reasons disclosed to the Assessee, as these reasons form the foundation for the AO's action. Importantly, these reasons cannot be altered or supplemented later.

The Delhi HC thus allowed the writ and held the initiation of reassessment proceedings as invalid.

In addition, the Delhi HC emphasised that the proceedings in question be quashed. The HC noted that the Assessee was merely the recipient of the interest income and not the entity that had declared or paid the alleged dividend. Therefore, even if the payment were considered to be in the nature of dividend, the tax liability for such DDT under Section 115-O of the IT Act should be the sole responsibility of the company that declared or distributed it, which in this case would have been on GIPL.

33 ATS Infrastructure Ltd. v. Asstt. CIT [2024 SCC Online Delhi 5048]
34 S. Sreeramachandra Murthy v. Deputy CIT [(2000) 111 Taxman 338/243 ITR 427 (Andhra Pradesh)], Equitable Investment Co. P. Ltd. V. ITO, [(1988) 174 ITR 714 (Calcutta)]

Significant Takeaways

This judgment follows the Delhi HC's own recent ruling in ***ATS Infrastructure Ltd. (supra)***. It emphasises that the reasons for initiating reassessment cannot be altered in subsequent proceedings or in the final order, a principle well-supported by numerous judicial precedents. These precedents have commented on the scope and limitations of Sections 147 and 148 of the IT Act, offering a comprehensive framework within which the AO must exercise reassessment power. In ***Rajesh Jhaveri***,[35] the SC held that under Section 147, the AO only had the power to reassess not review and this reassessment must be based on the fulfilment of certain preconditions. If change of opinion were allowed, it would amount to review, not merely reassessment. In ***Catchy Prop-Build Pvt. Ltd.,***[36] the Delhi HC opined that if the foundational allegation was missing in the notice issued under Section 148A(b) of the Act, the same could not be incorporated by issuing a supplementary notice. Therefore, the powers of the AO were not boundless under Section 148 of the IT Act. As supported by these cases, the reasons initially recorded for proposing reassessment must be the same as the reasons recorded when the notice for reassessment was issued. Further, the AO could not incorporate allegations in subsequent notices. These cases are important for the Assessee across tax disputes as they set the boundaries of the AO's power of reassessment.

Regarding the observation on liability to pay DDT, since the writ was allowed holding the initiation of reassessment proceedings to be invalid, the Delhi HC refrained from commenting on the recharacterisation of the transaction, clarifying that the obligation would have rested with GIPL rather than the Assessee.

> **“ Reassessment order cannot divert from reasons given in notice initiating reassessment proceedings. ”**

[35] ACIT vs Rajesh Jhaveri Stock Brokers Pvt. Ltd. [2008 (14) SCC 208]
[36] Catchy Prop-Build Private Limited vs ACIT [2022/DHC/004344]

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SC dismisses SLP vis-à-vis invocation of Section 14A for interest expense on loan utilised for acquiring shares

Introduction

The SC dismissed the SLP in the case of ***Mahesh K Mehta***[37] and concurred with the Bombay HC in its finding that interest paid on loans could not be deducted as an expense as the loans were utilised in acquiring shares that led to earning dividend income that is not taxable.

Facts

Mr. Mahesh K Mehta (**Assessee**) is a chartered accountant by profession who later became a stockbroker. The Assessee utilised borrowed funds to invest primarily in shares of two private companies he owned. For AY 1998–99, he allocated INR 36.9 lakhs (approx.) towards interest paid on these borrowings and claimed a deduction under Section 36(1)(iii) of the IT Act.

The AO disallowed the deduction of this interest amount under Section 14A of the IT Act. This disallowance was made on the grounds that the investments were used to earn dividend income, which is exempt from tax under Section 10(33) of the IT Act *(which was later omitted and then reintroduced as Section 10(34) of the IT Act)*. Under Section 14A(1) of the IT Act, expenses related to income that is exempt from tax should not be deducted while computing the total income.

The CIT(A) concurred with this and held that whether the dividend income is received or not, the expenditure claimed for such income cannot be allowed in view of provisions under Sections 14A and 10(33) of the IT Act. The CIT(A) distinguished these shares from stock in trade as they were shares of a private company that could not be traded in the market for business profit. Being aggrieved by the decision of the CIT(A), the Assessee approached the ITAT, which upheld the CIT(A)'s judgment. The Assessee then approached the Bombay HC.

The Bombay HC did not grant any relief but relied on the SC's decision in the ***Maxopp Investments Ltd.***[38] case, which had held that as per Section 14A(1) of the IT Act, deduction is not to be allowed of an expenditure incurred by the Assessee *"in relation to income which does not form part of the total income"* under the IT Act.

The Bombay HC held that this section should not be tested based on the dominant purpose but on the principle of apportionment. The dominant purpose behind the expenditure is immaterial for the consideration of this section. If expenditure were incurred on earning the dividend income, the expenditure attributable to the dividend income must be disallowed and cannot be treated as business expenditure.

The Bombay HC ruled that since dividend income from the two companies is tax exempt, the interest expense on borrowed funds used to invest in these shares is subject to Section 14A of the Act and is not deductible. This is because the dividends from these shares are not part of the taxable income.

Being aggrieved by the HC order, the Assessee approached the SC.

[37] Mahesh K. Mehta v Commissioner of Income Tax [(2024) 160 taxmann.com 468 (Bombay)]
[38] Maxopp Investments Ltd. v Commissioner of Income Tax, New Delhi [(2018) 91 taxmann.com 154 (SC)]

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Issue

Whether interest amount on loans used to earn dividend income can be deductible as an expense?

Arguments

The Assessee argued that interest deductions should be allowed if the investment is for business purposes and commercial expediency. He explained that he started as an individual stockbroker and used borrowed funds to expand into a corporate entity, investing in two companies he controlled. The loans taken in his name were duly utilised in acquiring equity shares in two closely held companies fully under his control, reflecting a clear commercial purpose.

The IRA relied on the SC ruling in ***Maxopp Investments Ltd. (supra)***, wherein the SC examined whether expenditures, including interest on borrowed funds used to invest in shares of operating companies for acquiring or retaining a controlling interest, are subject to Section 14A of the Income Tax Act. The crux of the case was whether such expenditures should be considered as related to dividend income, which is exempt from tax.

The Assessee, however, argued that the primary intention behind purchasing the shares was not to earn dividend income but to gain control over the company. Thus, it was contended that the expenditures were not related to dividend income and, hence, did not form part of the total taxable income.

The SC observed that the dominant purpose of the investment was not a relevant consideration for interpreting Section 14A. Regardless of the primary intention behind the investment, since dividend income is exempt from tax, any expenditure incurred for earning such dividend income must be disallowed if such expenditure exceeds the amounts referred to under Section 14A and cannot be treated as a business expense.

The IRA relied on this case as the facts were identical to the present situation. It argued that despite the purpose of the investment, it should not be deductible since the expenditure was incurred in earning dividend income.

Decision

The SC dismissed the SLP against this decision of the HC, upholding the preceding reason for defending.

Significant Takeaways

In its judgment in the case of ***Godrej & Boyce Manufacturing Co. Ltd.***,[39] the SC addressed the application of Section 14A of the IT Act to dividend income. It was established that DDT, as mandated by Section 115-O, is paid by the distributing companies, rendering the dividend income exempt from tax in the hands of the recipients under Section 10(34) of the IT Act. Due to this exemption, the SC held that Section 14A of the IT Act, which disallows expenses related to exempt income, remains applicable. The SC held that Section 14A could still be invoked to

[39] Godrej & Boyce Manufacturing Co. Ltd. v. DCIT [(2017) 81 taxmann.com 111 (SC)]

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disallow expenses related to earning such exempt income, reinforcing the principle that expenses connected to tax-free income should not be deductible. This is affirmed by the instant judgment.

However, the instant decision does not apply to shares held as stock in trade. The CIT(A) had noted that the shares in question were from a private company and not part of the Assessee's stock-in-trade. The Delhi HC in ***Punjab Sind Bank***[40] distinguished between dividend income from shares held as stock-in-trade versus shares held as investments. It held that expenses related to dividend income from shares held as stock-in-trade are deductible from total income as the shares form part of the taxpayer's business or professional income. The SC in ***Maxopp Investments Ltd. (supra)*** clarified that, while the dominant purpose of acquiring shares does not impact the applicability of Section 14A, shares held as stock-in-trade are treated differently. Therefore, Section 14A's disallowance provisions do not extend to shares classified as stock-in-trade.

It is also important to note that the instant case shall be applicable only for dividends distributed from June 1, 1997, to March 31, 2002, and then from April 1, 2003 to March 31, 2020. With the abolition of DDT post-March 31, 2020, dividend income is now taxable under Section 56 as "income from other sources" at the applicable income tax slab rate. Consequently, Section 14A of the IT Act should not be attracted to the expenses incurred in acquiring shares.

To conclude, this judgment is relevant for shareholders who have earned dividend income in the FYs in which DDT is applicable. However, under the present tax regime, dividend income is taxable under Section 56 as part of the total income of the taxpayer. Therefore, the shareholder must take note of the legal position applicable in the relevant financial year.

The Finance Act 2022 introduced an amendment to Section 14A of the IT Act vide an Explanation to provide that expenditure incurred in relation to an exempted income that has neither accrued nor arisen during the current year shall also be considered for disallowance under this section. In a recent September ruling in the case of ***Williamson Financial Services Limited***,[41] the Gauhati HC held that this amendment would only apply prospectively and would not be applicable to FYs prior to 2022.

"Section 14A disallowance mandatory for expenses incurred in relation to earning exempt income."

[40] CIT v Punjab Sind Bank [(2022) 145 taxmann.com 31 (Delhi)]
[41] Williamson Financial Services Limited v. Commissioner of Income Tax [(2024) 166 taxmann.com 607 (Gauhati)]

Delhi HC rules on the issue of notional income and ESOP taxation

Introduction

In the case of ***Ravi Kumar Sinha***,[42] the Delhi HC held that the market value of non-transferable ESOPs would be the face value at which they were acquired and that notional income would not be taxed as perquisite under Section 17(2)(iiia) of the IT Act.

Facts

Ravi Kumar Sinha (**Assessee**), the managing director of a company, was allotted 11,50,500 shares at the rate of INR 15 each under an Employees Stock Purchase Scheme (**ESPS**). Of that stock, 25 per cent was subject to a lock-in-period of 12 months, while the balance 75 per cent was locked in for 18 months. The share certificates stated that the shares were non-transferable during the lock-in period. During the previous FY, the Assessee paid INR 10.5 per share against the issue price of INR 15. The employer company engaged Ernst and Young and obtained a Valuation Report of the shares in question, which ascribed a value of INR 22.50 for each share.

While filing the income tax return for the FY, the Assessee took the position that since the shares were not marketable in view of the lock-in stipulation, the fair market value of the shares could not exceed their face value and hence, no taxability should arise as a perquisite.

During the assessment proceedings, the AO held that although the Assessee had been allotted shares at a concessional rate of INR 15 per share, the market price as quoted in the stock exchange at the relevant time was INR 49.45 per share. The AO concluded that the difference between the two figures, i.e. INR 34.45 per share, was liable to be taxed as perquisite in terms of Section 17(2)(iiia) of the IT Act, which led to an addition of INR 3,96,34,725 in the hands of the Assessee.

Aggrieved by the AO's order, the Assessee filed an appeal before the CIT(A) who held that as the shares were locked-in and could not be transferred, it would not be appropriate to consider the price appearing in the stock exchange the purpose of determining the fair market value. However, considering the valuation of INR 22.50 determined by the Valuer, the CIT(A) directed the AO to recompute the income considering INR 22.50 as the fair market value.

Aggrieved by the CIT(A) order, both the Assessee and the IRA filed an appeal before the ITAT, which upheld the CIT(A) order.

Against the order of ITAT, the Assessee and the IRA filed appeals in the Delhi HC.

Issue

What should be the taxability as perquisite in the hands of the Assessee?

Arguments

The Assessee submitted that since there was a lock-in stipulation and the shares were not marketable, the FMV of the shares could not exceed the face value of the shares and the FMV should be INR 15. According to the Assessee, the concept of FMV is determined based on the sale of the asset in the open market. The FMV is defined in Section 2(22B) of the IT Act as the price at which the capital asset would typically be sold in the open market on the relevant date. Therefore, it does not contemplate a tax being imposed on a notional income. Contending the Valuation Report, the Assessee submitted that this was obtained out of caution and was not determinative of the value of the shares. The Assessee relied on judicial precedent to support his contentions.

The IRA argued that the AO's assessment order should be considered and the publicly traded market value of the shares should determine the value of the perquisite. According to the IRA, the correct the FMV was the market price as quoted at the relevant time. It did not consider the Valuation Report or the face value of the shares to be determinative of the FMV.

Decision

The Delhi HC relied on the the Karnataka HC judgment in the ***Infosys Technologies Ltd.***[45] case, which the SC had later affirmed.[46] In this judgment, the SC had held that where shares

[42] Ravi Kumar Sinha v. The Commissioner of Income Tax [TS-590-HC-2024 (DEL)]

[43] Section 17(2) (iiia) states that the value of any specified security allotted or transferred, directly or indirectly, by any person free of cost or at concessional rate, to an individual who is or has been in employment of that person will be taxed as a perquisite. This was introduced vide the Finance Act 1999. This section was subsequently removed and then replaced by section 17(2)(vi) vide the Finance Act 2009. Section 17(2)(vi) of the IT Act presently states that, a perquisite is "the value of any specified security or sweat equity shares allotted or transferred, directly or indirectly, by the employer, or former employer, free of cost or at concessional rate to the assessee"

[44] Commissioner of Income Tax, Bangalore v. Infosys Technologies Ltd. (2008) 2 SCC 272, Commissioner of Income-Tax, Bangalore v. B.C. Srinivasa Setty [(1981) 5 Taxman 1/128 ITR 294 (SC)]

[45] Commissioner of Income Tax v. Infosys Technologies Ltd. [(2007)159 Taxman 440 (Kar.)]

[46] Commissioner of Income Tax, Bangalore v. Infosys Technologies Ltd. (2008) 2 SCC 272

have a lock-in period and are subject to transfer restrictions, the benefit that arises on the day such shares are acquired is only a notional benefit of unascertainable value. Unless a benefit is in the nature of income or specifically included by the legislature as part of income, the same is not taxable. In this case, the SC explained significance of the lock-in period, suggesting that during the said period, the share would neither have any realisable value nor would it be possible for the employee to foresee or project a price those shares may realise in the future. It was thus pertinently observed that a potential benefit could not be considered as the income of the employee and, hence, could not be chargeable under the head of salary.

Subsequently, the SC noted that in ***BPL Ltd.,***[47] it was concerned with promoter quota shares subject to a lock-in restriction as well. Even this case held that the shares in question had no market value, as they could not be traded in the Stock Exchange. Further, the SC noted that the method of calculating the FMV provides the value "if shares are sold in an open market." However, the SC held that this expression does not presume a sale or transfer. The phrase "if sold in the open market" means that the property's value should reflect the price a willing buyer would pay, taking into account all its rights, obligations, and any restrictions. This approach ensures that the valuation remains realistic and does not artificially inflate the property's worth by ignoring its limitations or constraints.

The SC also noted that the idea that notional income cannot be taxed is a well-established principle it had enunciated in ***Excel Industries Ltd.***[48] In this case, the SC had held that real accrual of income and not a hypothetical accrual of income ought to be taken into consideration.

Therefore, after consideration of these judicial precedents, the SC held that in light of the restriction with respect to marketability and tradability of the stock in question, the FMV could not have been recognised to exceed the face value of the shares, i.e., INR 11.5. The Valuation Report, as noted earlier, was at best a medium the employer adopted to broadly ascertain its obligations for the purposes of withholding tax. The same could not have consequently been taken into consideration for the purposes of the FMV. Further, it is a well-established principle of Indian tax law that notional income is not taxable.

Significant Takeaways

The taxation of ESOPs has seen several legislative changes over the years. Initially introduced through the Finance Act of 1999 as Section 17(2)(iiia) of the IT Act, it was later replaced by provisions under the Fringe Benefit Tax in 2005. Subsequently, ESOP taxation was reintroduced under Section 17(2)(vi) in the Finance Act 2009, which remains the current provision. The timing of taxation has also evolved, shifting from the exercise of the

[47] Deputy Commissioner of Gift Tax v. BPL Ltd. (2022) 448 ITR 739 (SC)
[48] Commissioner of Income Tax v. Excel Industries Ltd. (2014) 13 SCC 459 (SC)

option, to vesting, and to the point of sale. Presently, the provisions are broadly similar to those established under the Finance Act of 1999, with only minor variations. A significant aspect of ESOP taxation addressed in recent judgments is the determination of FMVs for shares that are subject to a lock-in period. This judgment, which follows established precedents, is crucial in clarifying the tax implications and valuation of locked-in shares, thereby impacting the overall treatment of ESOPs for tax purposes.

With respect to capital gains/other income, the determination of the FMV for quoted versus unquoted shares follows Rule 11UA of the IT Rules but lacks guidance for quoted shares with restrictions. The SC case of ***BPL Ltd. (supra)*** clarified that shares listed on an exchange can be classified as "unquoted" if they face trading restrictions due to legal constraints. The SC stressed that the FMV should be evaluated based on the trading status relevant to the individual shareholder, not just the general class of shares. This distinction is crucial, as seen in ***BPL Ltd. (supra)***, where FMV discrepancies of over INR 15 crore arose between market value and net asset value. Accurate share classification before valuation is essential to mitigate tax risks and incorporate protections in transaction documents for potential tax liabilities.

Further, the IT Rules mandate that a certified Merchant Banker conduct the valuation reports in case of an ESOP-related perquisite. Hence, the judgment in the present case highlights that reports from accountancy firms used for the company's benefit cannot have the same standing.

These judgments serve as an important reference for tax advisors and corporate entities regarding the structuring of ESOPs and understanding the tax consequences of shares allotted under such plans. In conclusion, it is crucial to classify accurately the nature of shares before valuation to avoid potential tax issues and prevent the tax department from invoking anti-avoidance measures. Additionally, incorporating appropriate safeguards in transaction documents can help manage any extra tax liabilities that may arise from incorrect share valuations during transfers.

"ESOP related notional income not taxable as perquisite."

Bombay HC allows petition to dismiss criminal prosecution regarding delay in payment of TDS

Introduction

In the case of ***Hemant Mahipatray Shah***,[49] the Bombay HC allowed the petition to dismiss the criminal prosecution initiated against the taxpayer and its directors under Section 276B of the IT Act read with Section 278B of the IT Act regarding delay in the payment of the TDS.

Facts

Hubtown Ltd (**Company**) is incorporated under the Companies Act, 1956. During FY 2013–14, the IRA issued notices to the Company and its Directors (including Hemant Mahipatray Shah (**Assessee**)) alleging delay in depositing TDS amounting to INR 13 crore (approx.), violating the provisions of Section 200 of the IT Act, which is punishable under Sections 276B and 278B of the IT Act. Therefore, the CIT(TDS) issued an order under Section 279(1) of the IT Act to prosecute the Directors under Section 276B read with 278B of the IT Act. Although challenged by filing criminal revision applications, these were rejected by the Magistrate, leading to the present issue arising before the Bombay HC.

Admittedly, the TDS the Company had deducted was deposited with interest by the time the matter was heard by the Bombay HC.

Issue

Under what circumstances is Section 276B of the IT Act, which deals with imprisonment on failure to pay the TDS, applicable?

What conditions must be met to prosecute a director for an offence under Section 278B of the IT Act?

Arguments

The Company argued that the Directors could not be held vicariously liable as they were not "in-charge" and "responsible" for conducting the business of the Company. These were essential ingredients of Section 278B of the IT Act and an automatic presumption could not be made assuming the Directors to be the principal officers. Further, no notice had been issued under Section 2(35) of the IT Act and no order passed under Section 201 of the IT Act treating the Directors as "Principal Officers" of the Company by which they could be deemed to be the assesses in default.

The IRA argued that under Section 204 of the IT Act, the Directors shall be included in the meaning of the term "person responsible for paying." According to the IRA, this would *ipso facto* mean that the Directors are the principal officers. The IRA relied on the judgment in ***Madhumilan Syntex Ltd.***,[50] which held that failure to pay the TDS included delay in depositing the TDS and that the directors could be held liable for the same.

Decision

The Bombay HC ruled that Section 276B of the IT Act pertains to failure to pay TDS and not delay in depositing the TDS. In the present case, even though there was a delay, the TDS has been paid in full with interest and, hence, Section 276B of the IT Act would not be attracted. The HC relied on the CBDT Circulars dated May 28, 1980, and April 24, 2008. The said CBDT instructions provide that prosecution under Section 276B of the IT Act shall normally not be proposed when the amount involved and/or the period of default is not substantial and the amount in default has also been deposited in the meantime to the credit of the Government. In the case of ***M/s. Dev Prabha Construction Private Limited***,[51] the Jharkhand HC case relied on the CBDT instructions and ruled that since the amount was already deposited with interest, there was no reason for the criminal proceedings to continue. In ***Bee Gee Motors & Tractors***,[52] the HC held that the discretion of the authorities could not go against the CBDT instructions, nor could it mean that an identical set of facts would lead to prosecution in one case and exemption in another.

Further, in ***Sree Metaliks Ltd. Vs. Union of India***,[53] the taxpayer had failed to deposit the amount during the statutory period. Despite specifically depositing the TDS amount with interest, prosecution was sanctioned under Section 279 (1) of the IT Act. The taxpayer had explained that the delay was due to factors such as market sluggishness, insolvency proceedings, and the COVID-19 pandemic. Therefore, it was held that the IRA ought to have taken into consideration the taxpayer's explanation, particularly because the taxpayer had suffered insolvency and bankruptcy proceedings and restrictions imposed during COVID-19 pandemic. Further, in this case, the Orissa HC opined that the

[49] Hemant Mahipatray Shah and another v Anand Upadhyay and another [TS-612-HC-2024 (BOM)]
[50] Madhumilan Syntex Ltd. v. UOI [(2007) 160 Taxman 71 (SC)]
[51] M/s. Dev Prabha Construction Private Limited Vs. The State of Jharkhand and another [Cr. M.P. NO.2941 of 2018]
[52] Bee Gee Motors & Tractors Vs. Income Tax Officer [(1996) 218 ITR 155 (Punj. & Har.), 157-158]
[53] Sree Metaliks Ltd. Vs. Union of India [(2024) 162 Taxmann.com 161 (Orissa)]

authorities do not have indefinite time to prosecute the taxpayer. The CBDT Circular of 2008 prescribes that the prosecution be launched within sixty (60) days of the deduction of the default. Although the Circular also prefixes the requirement with the words "preferably," it signifies that if not in sixty (60) days, the period cannot extend indefinitely for an unreasonable period.

Therefore, based on the aforementioned judicial precedents and a combined reading of the Circulars, the Bombay HC adjudged that prosecution should not be launched where tax has already been deposited, especially if it was launched after a considerable period of time.

The Bombay HC also observed that the AO had not issued any notice to treat the Directors as "Principal Officers" of the Assessee.

The Bombay HC also ruled that no averment was made in the complaint regarding "consent," "connivance," or "negligence" as required under Section 278B (2) of the IT Act.

Therefore, the Bombay HC ruled that Directors cannot prime facie be held responsible without following the procedure required by the provision. The IRA had categorically referred to Section 204 of the IT Act, which states there must be a principal officer, and to Section 278B, which requires that essential ingredients be fulfilled.

The Bombay HC finally held that there was no failure to pay under Section 276B and the Directors were not responsible for the same under Section 278B of the IT Act. Accordingly, the writ petition filed by the Assessee was allowed and the initiation of prosecution proceedings was held to be invalid.

Significant takeaway

The Bombay HC's ruling addresses critical aspects of Sections 276B and 278B of the IT Act. Section 276B regarding failure to pay TDS has been the subject of contentious litigation. In cases involving delays in tax payment, it has been established that merely depositing TDS to the Central Government's account, even if done late, does not preclude prosecution for default under Section 276B of the IT Act. The SC in ***Madhumilan Syntex Ltd. (supra)*** emphasised that a late deposit does not absolve the default, and the Delhi HC in ***Rishikesh Balkishandas***[54] reinforced that timely deposit before complaint filing does not negate the offence. However, if the delay is minor, the amount involved is not substantial, and the defaulted amount has been paid, the prosecution under Section 276B may be at the Department's discretion, as noted in ***Vijaysingh***.[55] Additionally, prosecution proceedings initiated after a three-year delay, especially when the delay was due to an accountant's oversight, would be contrary to CBDT instructions and subject to being quashed, as observed in ***Sonali Autos (P.) Ltd.***[56]

While earlier decisions enforced stricter standards for prosecution under Section 276B, recent judgments reflect a more lenient approach, favouring the Assessee, especially post the 2008 CBDT circular.

Regarding Section 278B the judicial stance has been quite consistent and uniform and the Bombay HC's ruling is in line with well-established judicial precedents. Under Section 2(35) of the IT Act, a director of a company is not automatically considered a "principal officer," and if the AO intends to prosecute a director along with the company for an offence under Section 276B, they must issue a specific notice under Section 2(35)(b) indicating their intention to treat the director as a "principal officer." Without such a notice, prosecution against the director will fail, as illustrated in ***Delhi Iron Works (P.) Ltd.***[57] Additionally, directors cannot be prosecuted en masse for violations of the IT Act; specific allegations must be made against each director, meeting the requirements of the relevant provision, as reaffirmed in ***Confident Projects India (P.) Ltd.***[58] Therefore, the Bombay HC is relying on already settled principles in its Section 278B ruling.

This case is pivotal for taxpayers as it clarifies key aspects of criminal prosecution under the IT Act, particularly concerning the responsibility of company directors. It is crucial for both taxpayers and authorities to heed this judgment to navigate and uphold compliance effectively.

> **"Prosecution can be made only on failure to deposit TDS, not on delay."**

[54] Rishikesh Balkishandas v. I.D. Manchanda [(1987) 167 ITR 49/34 Taxman 305 (Delhi)]
[55] Vijaysingh v. UOI and Dev Multicom (P.) Ltd. v. State of Jharkhand [(2006) 150 Taxman 117 (MP)]
[56] Sonali Autos (P.) Ltd. v. State of Bihar [(2017) 84 taxmann.com 286 (Pat.)]
[57] ITO v. Delhi Iron Works (P.) Ltd [(2011) 9 taxmann.com 277/198 Taxman 174 (Delhi)]
[58] Confident Projects India (P.) Ltd. v. Income-tax Department [(2021) 124 taxmann.com 36/279 Taxman 46 (Kar.)]

SC's ruling on whether "royalty" is a tax

Introduction

On July 25, 2024, a nine-judge bench of the SC, led by Chief Justice D.Y. Chandrachud, delivered a significant verdict in the case of ***Mineral Area Development Authority.***[59] In an 8:1 majority judgment, the Court held that royalty prescribed by the Mines and Minerals (Development and Regulation) Act, 1957 (**MMDR Act**), is not a tax. It ruled that the obligation to pay royalty, although prescribed under MMDR Act, arises from the contractual terms of the mining lease. Consequently, the State Legislatures retain their power to impose taxes on mineral rights and mineral-bearing land, unaffected by the imposition of royalty under law.

Facts

On December 28, 1957, the Union Government enacted the MMDR Act to establish Union jurisdiction over the control of mines and minerals. Section 9 of the MMDR Act provided that the holders of mining leases were obligated to pay royalties for minerals *"removed or consumed"* from the leased area. The allocation of legislative authority between the Union and the States regarding the taxation of mineral rights, particularly in relation to Entry 50 of List II in the Seventh Schedule of the Constitution has been a point of contention. The said entry pertains to taxes on mineral rights, which are subject to any limitations imposed by the Parliament concerning mineral development. The SC's earlier decision in ***India Cement***[60] held that royalty constitutes a tax, thereby limiting the State Legislatures' authority to levy taxes on mineral rights due to the subject matter being governed by the MMDR Act. However, in 2004, the SC in ***Kesoram***,[61] clarified that the decision in the India Cement Case was based on a misunderstanding, reaffirming that royalty is not a tax.

Following the ruling in *Kesoram*, several State Legislatures, including Rajasthan, Uttar Pradesh, and Bihar, exercised their legislative powers to impose levies on mineral-bearing lands. These levies, however, faced constitutional challenges in the respective HCs, based on the earlier India Cement Case. The issue eventually reached the SC, where a three-judge bench referred the matter to the nine-judge bench for a determination on the validity of the India Cement Case ruling.

Issue

i. What is the true nature of royalty as defined under Section 9 in conjunction with Section 15(1) of the MMDR Act?

ii. If royalty is regarded as a consideration paid by the lessee to the lessor as part of the conditions of a mining lease, can this payment be classified as a tax?

[59] Mineral Area Development Authority & Ors. v. M/s Steel Authority of India & Ors, 2024 SCC OnLine SC 1796 (SC).
[60] India Cement Ltd. v. State of Tamil Nadu, AIR 1990 SC 85 (SC).
[61] State of West Bengal v. Kesoram Industries Ltd., AIR 2005 SC 1646 (SC).

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Arguments

The Appellants argued that royalty represents the consideration for relinquishing the right to exploit a mine and extract minerals, which may be owned by the Government or a private entity. Under Section 9 of the MMDR Act, the price that the lessee is obligated to pay to the lessor for the grant of rights under a mining lease is statutorily established. Considering royalty paid by the lessee pursuant to Section 9 of MMDR Act does not satisfy the criteria of a "tax" or an "impost" as defined under Article 366(28) of the Constitution, royalty cannot be classified as a tax on either minerals or mineral rights. They also contended that the MMDR Act primarily addresses the regulation of mines and mineral development. It does not aim to legislate comprehensively on all aspects of mines and minerals, but rather only within the specified parameters. Levies such as royalty and dead rent under the MMDR Act are not considered taxes; instead, they are payments for the right to use the land and its resources.

As the proprietor of minerals, the State is entitled to receive royalty for the relinquishment of its mineral rights and may impose taxes on the same minerals in its sovereign capacity. Further, they submitted that, typically, the landowner or mining lessor contracts the lessee to pay royalty as compensation for the depletion of mineral value from the land. Section 9 of the MMDR Act imposes a statutory cap on the royalty that may be charged contractually by the lessor. Furthermore, Section 9(3) of the MMDR Act, which restricts the Central Government's authority to increase royalty rates, does not limit the taxing power of State legislatures under Entry 50 of List II. It was also argued that the Constitution recognises that the States' legislative power to tax mineral rights could hinder mineral development. Therefore, it empowers the Parliament to impose limitations or restrictions concerning mineral development under Entry 50 of List II on the taxing authority of State legislatures.

On the other hand, the counsel for the Respondent submitted that the grant of permission to engage in any mineral-related activity is contingent upon specific terms and conditions set forth in the MMDR Act. The consideration for such permission is royalty, which fundamentally represents the demand for relinquishing the privilege to extract the mineral. Also, the MMDR Act constitutes a comprehensive framework governing all aspects of mine regulation and mineral development. All mineral rights are conferred according to the provisions of this central legislation, irrespective of whether the minerals are owned by the State Government. Additionally, whether royalty is labeled as a tax is irrelevant. Any levy associated with mineral development, insofar as it pertains to mineral rights, imposes a limitation on the taxing authority of State legislatures under Entry 50 of List II.

Further, royalty shares similarities with a tax on mineral rights in that both represent exactions by the sovereign exercised through statutory powers. The term "taxes on mineral rights" is narrowly defined and should be interpreted accordingly. Constitutionally, "tax on mineral rights" refers to an exaction that provides States with a share of the minerals produced. The royalty required under Section 9 of the MMDR Act aligns with this definition. Lastly, both royalty and dead rent are mandatory levies under the MMDR Act, rather than outcomes of negotiations resulting in a contractual agreement. Thus, royalty satisfies the criteria for a tax as outlined in Article 366(28) of the Constitution.

Decision

The Apex Court observed that the Parliament had enacted the MMDR Act under its legislative authority granted by Article 246 in conjunction with Entry 54 of List I. The purpose was to regulate mining and the development of minerals under the jurisdiction of the Union. The Court stated that this declaration reflected the Parliament's intention to centralise the regulation of mines and mineral development as specified in the statute. It noted that prior to the enactment of the MMDR Act, the terms of the lease governed the rates of royalty, and upon the establishment of a mining lease between a lessor and lessee, the royalty rates would remain fixed for the duration of the lease.

Section 9 of the MMDR Act empowers the Central Government to periodically review and adjust the rates of royalty for all minerals, considering various factors, including the uniformity of mineral prices. The Court clarified the State's active role in organising and utilising mineral resources. However, to ensure a consistent regime of royalty across India, State Governments were not authorised to set royalty rates. This approach aims to support domestic industry and maintain competitive commodity prices in the global market. The Apex Court outlined that "royalty" is the compensation for the rights and privileges granted to the lessee. The key characteristics of royalty were as follows:

i. A payment made to the mineral owner, whether a government or private entity;

ii. Arises from a statutory agreement (the mining lease between the lessor and lessee) and represents compensation for the privilege of extracting or consuming the minerals;

iii. Is usually determined based on the quantity of minerals extracted.

The Apex Court emphasised that the term "tax" as defined under Article 265 encompasses all forms of compulsory exactions. The authority to impose such exactions is a characteristic of sovereignty. A liability arising from a contractual agreement cannot be classified as an impost or tax. Payments made under a contract to the State Government for obtaining exclusive privileges and rights concerning a specific activity cannot be considered an "impost" or "tax" as defined by Article 366(28) of the Constitution. After observing the discrepancies between the decisions in ***India Cement*** and ***Kesoram***, the Court expressed the view that royalty does not satisfy the essential criteria of a tax. Instead, it is a payment made by a mining lessee to the lessor for the enjoyment of mineral rights, compensating for the loss of value of minerals incurred by the mineral owner and is a contractual right offered to the lessor. The lessee's failure to pay royalty constitutes a breach of the contractual terms, entitling the lessor to terminate the lease and initiate recovery proceedings against the lessee. Therefore, payments made under a contract to the State Government for acquiring exclusive privileges cannot be classified as imposts. Consequently, the Court concluded that the ruling in India Cement, which classified royalty as a tax, to be incorrect.

Significant Takeaways

While the judgment has settled the long battle regarding classification of royalty, it has opened avenues for mineral-rich States to enhance their revenue through the imposition of additional cesses and taxes on mining activities. Post the present ruling, mining companies may have to strategise in case States chose to impose additional taxes. This competitive landscape could result in uneven economic development across mineral-extracting regions, as States strive to attract mining operations. This decision will profoundly influence the financial and operational dynamics of the mining industry, balancing state revenue interests with regulatory and contractual obligations.

This decision will have significant ramifications for pending cases concerning erstwhile service tax and GST demands related to royalty payments. The issue of Service Tax or GST on mining royalties, currently under consideration in the case of ***Udaipur Chamber of Commerce and Industry,***[62] may now be argued based on the premise that royalty constitutes a consideration rather than a tax. The majority judgment has interpreted the MMDR Act to clarify that royalties paid are considerations under a mining lease and not imposts or taxes.

Furthermore, it is important to note that subsequent to the judgment, the counsel for the Assessees have requested that the ruling be applied prospectively. However, the Apex Court did not allow this application and permitted a retrospective application of the ruling. This allows the States to recover tax dues for the prior period in accordance with this judgment. However, the Court specified that the imposition of tax by the States should not apply to transactions conducted prior to April 1, 2005.

It is anticipated that the retrospective application of this ruling would impose a substantial burden on the mining companies and could affect a number of public and private sector undertakings and industries. It could lead to a significant increase in the prices of most products, adversely affecting the broader economy.

> **"Royalty is not a tax but a statutory consideration payable by the lessee to the lessor for the exercise of mineral rights."**

[62] Udaipur Chamber of Commerce and Industry v. Union of India, SLP(c) No. 37326/2017 (SC).

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Search engine optimisation services do not qualify as OIDAR services

Introduction

Search engine optimisation (**SEO**) is a strategic process designed to enhance the visibility of a taxpayer's client's website within search engines such as Google and Microsoft Bing. This increased visibility could lead to greater organic traffic, allowing businesses to attract more potential customers and improve their overall online presence. The issue in ***Wildnet Technologies***,[63] was whether the SEO services offered by the Appellant fall under the category of Online Information and Database Access or Retrieval (**OIDAR**) services.

Facts

The Appellant is a software development company engaged in offering taxable services, including SEO service, Google ads/pay per click service, and applications & web development/designing service. During the pre-negative list regime, these services were classified under the category of business support services, and the Appellant duly paid service tax on services rendered in India. No service tax was paid on services provided outside India, as they were treated as export of service.

The Respondent initiated an investigation based on the data received from the Income Tax Department for the FYs 2015–16 and 2016–17. They observed discrepancies between the value of services declared in the Appellant's service tax returns vis-à-vis income tax returns.

The Respondent was of the view that SEO services did not qualify as export services as they qualified as OIDAR services. The same was confirmed by a demand for service tax amounting to INR 2.847 crore for the period from April 1, 2015, to November 30, 2016, along with interest and an equivalent penalty. Aggrieved by the same, the Appellant approached CESTAT by filing an appeal.

Issue

Whether the SEO services provided by the Appellant during the relevant period should be classified under the category of OIDAR?

Arguments

The Appellant submitted that the Place of Provision of Services (**POPS**) Rules, 2012, provides that the location of provision of service is the location of recipient except for specified services like service in relation to immovable property, actual performance, event, banking, OIDAR, intermediary, etc., Rule 2(1) of the POPS Rule defined OIDAR services as providing data or information, retrievable or otherwise, to any person, in electronic form through a computer network.

Hence, only when services are for providing access to or retrieving information from a database do they qualify as OIDAR. In the case of SEO services, the Appellant makes technical adjustments to the client's website to increase its visibility and attract more customers. This process does not involve providing access to or retrieving information from a database, and, therefore, SEO services do not fall under the definition of OIDAR. In this regard, it further relied on Paragraph 5.9.5 of the Education Guide issued by CBIC dated June 19, 2012, which provided the following:

"'Online information and database access or retrieval services' are services in relation to online information and database access or retrieval or both, in electronic form through computer network, in any manner. Thus, these services are essentially delivered over the internet or an electronic network, which relies on the internet or similar network for their provision. The other important feature of these services is that they are completely automated, and require minimal human intervention."

The Appellant further contended that it has no direct interaction with any website viewers. Its role is limited to setting up campaigns on platforms like Google, which the Appellant's clients hire for their own purposes. Hence, it did not qualify as OIDAR.

The Respondent reiterated the findings of the impugned order, maintaining that since the services provided by the Appellant qualify as OIDAR services as they were rendered online, the Appellant's claim of the services being exportable was legally unsustainable in the case of OIDAR services. The place of provision of OIDAR services is deemed to be the location of the service provider.

[63] M/s Wildnet Technologies Pvt. Ltd. v. Principal Commissioner of CGST, Noida, [TS-321-CESTAT-2024-ST].

Decision

The CESTAT analyzed Rule 2(1) of the POPS Rule and observed that it covers access or retrieval service. It also analyzed and the definitions of "data" and "information" under the Information Technology Act, 2000, to conclude that content is processed in a computer and is stored in memory called data, and information is data, message, images, etc. SEO is a technological modification made to the client's website to improve its ranking for potential customers. The Appellant's role is confined to optimising the client's website, and the service does not fall within the scope of OIDAR since it does not involve providing data or information for retrieval. It held that the process of SEO does not involve providing access to or retrieval of information or a database.

Furthermore, the CESTAT noted that the Appellant merely provides digital content on platforms like Google, which then creates a database, and Google's viewers access or retrieve that data. The Appellant has no direct relationship with any viewers or users retrieving the data. OIDAR services, by contrast, are accessible by anyone globally. In this case, the Appellant provides services only to a specific client, who then uses the service for its own viewers worldwide. The nature of the service provided is, therefore, more akin to "Business Support Service" rather than OIDAR.

Accordingly, the Court ruled that the services in question are not classified as OIDAR. Thus, as it is not a specified service, the place of provision for the Appellant's services is outside India, hence, qualifying as an export.

Significant Takeaways

The ruling underscores a critical distinction in service classification under tax law, particularly regarding the categorisation of digital services. This decision highlights that SEO constitutes a business support service focused on technological modifications to enhance website visibility rather than an OIDAR service. Therefore, the ruling delineates the boundaries between different categories of services, emphasising that not all digital services automatically qualify as OIDAR. This distinction is crucial for service providers in the digital domain, ensuring clarity in tax liabilities.

The definition of OIDAR has been amended and the definition as per GST legislation is wide enough to include any service rendered on online. Hence, while the decision may not apply directly, in our view, the essence of OIDAR service is that there must be direct relationship with any viewers or users retrieving the data. It cannot be any service rendered online as it will make the provisions pertaining to e-commerce operator redundant. There is also a possibility that online platform assisting buyers and sellers to connect may qualify as OIDAR as disputed by department in a crypto-exchange platform. Hence, it is essential that clarifications be issued to avoid further litigation in the future.

> **"Software development activities for further operation do not qualify as OIDAR."**

Extension to pass order for FY 2017–18 and 2018–19 *ultra vires* of Section 168 of CGST Act

Introduction

The Central Government issued Notification bearing No. 56/2023-Central Tax, dated December 28, 2023, for the extension of the relevant date for issue of order under Section 73(10) of the CGST Act for the FYs 2017–18 and 2018–19, exercising the powers granted to the Central Government under Section 168A of the Act. The Gauhati HC, in the case of ***Barkataki Print and Media Services,***[64] held that such notification is *ultra vires* and the SCNs issued under such extended period are void.

Facts

Section 168A grants the government power to extend certain deadlines under GST legislation due to circumstances such as *force majeure*, but only with the approval from the GST Council. The Petitioners herein challenged via writ petition their respective Order-in-Original passed under Section 73(9) of the CGST Act as well as SGST Act on the ground that the Notification No. 9/2023-CT dated March 31, 2023, and Notification No. 56/2023-CT dated December 28, 2023, by which the period for passing of the order under Section 73(10) of the Central Act was extended in exercise of the powers under Section 168A of the CGST Act was *ultra vires*. In addition to that, the Petitioners have assailed the imposition under on the ground that there is no Notification issued under Section 168A of the State Act extending the period for passing order under Section 73(10) of the State Act.

Issue

Whether both notifications, extending time limits under Section 168A of the CGST Act, were *ultra vires*, as they lacked the GST Council's recommendation and did not arise from a *force majeure* event, as required by law?

Arguments

The learned counsels appearing on behalf of the Petitioners argued that there is no recommendation from the GST Council prior to issuance of the Notification No. 56/2023-CT dated December 28, 2023, the said notification is *ultra vires* the provisions of Section 168A of the Central Act. They also submitted that in spite of having no recommendations, the Central Government, for reasons other than *bona fide*, had resorted to falsehood by mentioning in the Notification No. 56/2023-CT that there was a recommendation. Further, a perusal of Section 168A of the both the Central Act and the State Act shows that the recommendation of the GST Council is a condition precedent, there cannot be a subsequent ratification by the GST Council.

Additionally, it was submitted that on the basis of the Notification No. 56/2023-CT, the Department had passed various impugned orders under Section 73(9) of the Central Act as well as the State Act and, as such, the said orders were without jurisdiction having been passed beyond the period prescribed in Section 73(10).

Finally, it was also argued that the condition of *force majeure* is unsatisfied as the COVID-19 pandemic had not affected the working of the administration in the year 2022 and an extension was already granted earlier. Thus, unless the State Government or the Central Government have proven by way of an affidavit or otherwise providing material particulars that they were not able to perform on account of *force majeure*, the condition precedent that it is only when there exists *force majeure* is not fulfilled. Hence, Notification No. 9/2023-CT dated March 31, 2023, was not required to be interfered with.

The Respondents submitted that regarding the fulfilment of *force majeure*, during this period, the COVID-19 pandemic had a ripple effect in matters as there were various delays on account of completing certain assessments, audits, etc. Thus, under such circumstances, the *force majeure* as defined in the Explanations to Section 168A existed.

Respondents also submitted that it was inconceivable why the Notification No. 56/2023-CT had been put to challenge in as much as none of the Petitioners were affected by the said Notification as the impugned Orders-in-Original were passed during the period covered by the Notification No. 56/2023-CT.

The Respondents also relied in the case of ***Mohit Minerals***[65], which held that all recommendations made by the GST Council were not binding and were persuasive in nature. Hence, no notification under Section 168A of the Central Act may be issued. The Petitioner rebutted the same by arguing that when Section 168A of both the Central Act and the State Act categorically mentions "on the recommendations of the Council," the power to extend can only be on the recommendation of the Council. It was submitted that the judgment does not lay a proposition that without recommendations, the Union Government or the State Government can exercise the power under Central Act or the State Act.

[64] Barkataki Print And Media Services v. Union of India and Ors., WP(C)/3585/2024 (Gauhati HC)
[65] Union of India and Another vs. Mohit Minerals Pvt. Ltd., (2022) 10 SCC 700 (SC).

Decision

The court analysed the powers granted under Articles 246A, 279A, and 254 of the Constitution, and noted that the intention behind inserting the Articles 246A and 279A and overriding Article 254 was to promote fiscal and cooperative federalism. Under such circumstances, the GST Council's recommendations if required as per the provisions of the Central Act or the State Act have to be construed to be *sine qua non* for the Union or the State Government to exercise power. Further, it held that the Central Government knew that there was no recommendation from the GST Council, and this aspect was clearly admitted.

However, in the Notification No. 56/2023-CT, the Central Government mentioned "on the recommendations of the Council," which shows that the exercise of power by the Central Government is a colourable exercise of power. The HC also observed that the Explanation to Section 168A deals with various types of natural calamities, war, and epidemics as within the ambit of *force majeure*. The recommendations to be made by the GST Council must also be based on the existence of *force majeure* conditions. In the 49th Meeting of the GST Council, it was clearly recorded that there shall be no further extension beyond the three months in the interest of the taxpayers.

The Notification No. 56/2023-CT was issued without the recommendation and that natural corollary thereof is that the GST Council had no occasion to consider the existence of *force majeure* in as much as the same was never placed before the GST Council before the issuance of the same. Therefore, the Notification No. 56/2023-CT if construed from that angle also would be a notification issued without the *force majeure* condition being not considered in accordance with law. The HC also provided interim protection to the petitioners, stating that no coercive action should be taken based on the assessment order dated April 26, 2024.

Significant Takeaways

This judgment is the reaffirmation of the principles of fiscal federalism and the requirement of cooperative decision-making between the Central and State governments in matters related to GST. The court emphasised that the Central Government's exercise of its powers under Section 168A of the Central GST Act, 2017, is contingent on receiving recommendations from the GST Council, particularly when invoking an extension of deadlines due to a *"force majeure"* event. Further, while the ruling provides relief to the taxpayers, the tax department is likely to litigate the matter before the Apex Court. Further, it needs to be seen whether the lawmakers initiate action by issuing notifications with retrospective effect for such extensions once the GST Council makes recommendations in subsequent meetings.

Notification 56/2023-CT and Notification no. 9/2023-CT are both challenged in multiple writs before various HCs. In this decision, the Gauhati HC diverged from the positions taken by the Kerala HC and the Allahabad HC regarding the validity of the COVID-19 extension for tax assessment, which it deemed *ultra vires*. The Gauhati HC adopted a stringent procedural stance, asserting that a recommendation from the GST Council was essential before invoking powers under Section 168A of the CGST Act. The Court ruled that the issuance of Notification No. 56/2023-CT occurred without such a recommendation, indicating that the GST Council did not have the opportunity to assess *force majeure* conditions. Consequently, the Court declared the notifications *ultra vires* and annulled orders made under the extended timelines.

Conversely, the Allahabad HC validated the Notifications, recognising the COVID-19 pandemic as a *force majeure* event. It underscored the legislative character of the authority under Section 168A and highlighted the substantial deliberation by the GST Council and the government, asserting that legislative judgments should remain beyond judicial scrutiny unless there is evident arbitrariness or illegality. Similarly, even the Kerala HC supported the notifications, emphasising the executive's discretion to extend deadlines based on recommendations from the GST Council. The Court acknowledged COVID-19 as a *force majeure* event and validated the extensions as being within the scope of powers granted by Section 168A.

Now, it is expected that the matter will be go to the SC, which shall decide the issue finally.

> **"Recommendations made by the GST council on its own would not result in a legislation."**

If the law mandates issuance of a SCN before imposing a penalty, the penalty is discretionary

Introduction

The Apex Court in the decision of ***Toyota Industries Engine India Pvt. Ltd.,***[66] held that if the provision requires issuance of SCN prior to imposing a penalty, the decision to impose a penalty cannot be automatic. It is a discretionary action based on the facts and circumstances of each case, and the authority must consider these factors before determining whether or not to impose the penalty.

Facts

The Respondent is engaged in the manufacture and supply of auto parts, including aluminum castings, which were supplied to its sister concern, Toyota Kirloskar Auto Parts Pvt. Ltd. The Appellant initially believed that the aluminum castings were classifiable as "non-ferrous castings" under Entry 66 of the Third Schedule of the Karnataka Value Added Tax (**KVAT**) Act, attracting a tax rate of 4 per cent. However, the Revenue contended that these castings should be classified under scheduled goods and taxed at 12.5 per cent.

To avoid prolonged litigation and considering that the sales to Toyota Kirloskar Auto Parts Pvt. Ltd. were revenue-neutral due to its status as an Export-Oriented Unit eligible for input tax refunds, the Appellant paid the entire differential tax along with interest. Despite this, the Assistant Commissioner of Commercial Taxes imposed a penalty under Section 72(2) of the KVAT Act by an order dated March 12, 2007. This penalty order was challenged before the Joint Commissioner of Commercial Taxes, then further appealed to the Karnataka HC, and eventually led to the present SLP in the SC.

Issue

Whether the power to impose a penalty under Section 72(2) of the KVAT Act is "mandatory" or "discretionary" in nature?

Arguments

The Respondent argued that there is potential ambiguity in the classification of "aluminum castings" as "non-ferrous castings," and, as per them, it attracted lower rate of duty. However, to avoid prolonged litigation and availability of credit to the sister affiliate, it discharged a higher tax. It contended that penalty imposition under Section 72(2) of the Act was neither automatic nor mandatory. It relied on the SC's decision in ***Electro Optics***.[67] The Respondent also argued that since the transaction was revenue-neutral, mala fide intention could not be present.

The Appellant argued that the imposition of a penalty under Section 72(2) of KVAT Act was automatic, with the show-cause opportunity provided only in relation to the determination of the penalty rate. Additionally, given the circumstances, the Additional Commissioner of Commercial Taxes properly exercised jurisdiction and rightfully reinstated the order.

Decision

The Karnataka HC held that under Section 72(2) of the KVAT Act, before a penalty would be levied, the dealer must be given an opportunity to present a written show-cause against the imposition of the penalty. A penalty can be imposed only after considering the dealer's explanation. Thus, the imposition of penalty under Section 72(2) is not automatic; it involves a discretionary power granted to the assessing authority, allowing them to decide whether to impose a penalty or not. The rate of the penalty is fixed by statute, meaning the discretion lies solely with the decision to impose the penalty, not with the rate. The SC upheld the same. Further, it was observed that in several judgments, the SC had affirmed that while a statute may allow for the imposition of penalties, the authority possesses judicial discretion to determine whether a penalty should be imposed in cases of failure to fulfil a statutory obligation. This discretion must be exercised judiciously after considering all relevant circumstances. Even where a minimum penalty is prescribed, the authority may choose not to impose a penalty in cases where the breach arose from a *bona fide* belief that the offender was not required to act as per the statutory mandate. Therefore, the imposition of a penalty under Section 72(2) of the KVAT Act is neither automatic nor mandatory.

Significant Takeaways

This judgment underscores the discretionary nature of penalty imposition under Section 72(2) of the KVAT Act, highlighting that such penalties are not automatic but contingent upon a careful consideration of individual circumstances. The Court's ruling

[66] The Additional Commissioner of Commercial Taxes (Zone)-II vs. Toyota Industries Engine India Pvt. Ltd., [TS-307-SC-2024-VAT] (SC).
[67] Electro Optics (P) Ltd. v. State of Tamil Nadu [(2016) 89 VST 156 (SC)] (SC).

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clarifies that tax authorities must issue a SCN and provide the Assessee with an opportunity for a personal hearing before imposing a penalty. This establishes a crucial procedural safeguard for taxpayers, ensuring that penalties are levied only when warranted by the facts of the case.

Further, the Court's recognition of a *bona fide* belief as a relevant factor in penalty assessment emphasises that genuine misunderstandings or misinterpretations of tax obligations can mitigate the imposition of penalties. This decision may provide some respite to the taxpayers who act in good faith, knowing that if they can demonstrate a legitimate basis for their actions, they may be afforded leniency by the tax authorities.

“ It is only after consideration of the cause shown by the dealer, the penalty can be imposed. ”

Levy of interest, fine, and penalty on IGST payment due to violation of pre-import condition under the Advance Authorisation Scheme is not sustainable

Introduction

The Government issued Notification No. 18/2015-Cus dated April 1, 2015, under Section 25(1) of the Customs Act for granting exemptions from duties to imported goods. This Notification was later amended by Notification No. 79/2017-Cus on October 13, 2017, introducing exemptions from customs duties, additional duties, safeguard duties, transitional product-specific safeguard duties, and anti-dumping duties, provided a valid Advance Authorisation was obtained from the Regional DGFT Authority under Paragraph 4.03 of the FTP. The amended notification mandated that the goods imported under the scheme be physically incorporated into export products and not be diverted for domestic consumption. It is entirely unclear why this pre-import condition was initially implemented, particularly considering that all duties had previously been exempted under the Advance Authorisation Scheme.

Upon recognising the incongruity of this provision, the Government subsequently issued Notification No. 01/2019-Cus on January 10, 2019, which removed the pre-import condition. The department interprets the pre-import condition to mean that an exporter must first import the goods, utilise them in manufacturing, and then export the finished products. This understanding was intended to ensure compliance and prevent the misuse of exemptions. However, the introduction of the pre-import condition has resulted in numerous disputes and litigations, underscoring its complex and often-contentious nature.

Facts

The Appellant in ***M/s. Chiripal Poly Films Ltd.,***[68] is engaged in the import and export of goods such as Bi-Axially Oriented Polypropylene Film, Aluminum Metalised Bi-Axially Oriented Polypropylene Film, Polyester Metalised Film, and Polyester Chips, among others. Inputs like plastic granules, additives, etc., were imported by availing the exemption under Notification No. 18/2015-Cus dated April 1, 2015, issued under Section 25(1) of the Customs Act.

Later, Notification No. 79/2017-Customs, dated October 13, 2017 introduced "Pre-Import" condition for availing benefits of IGST on the import of goods under the Advance Authorisation Scheme. SCNs were issued to the Appellant, demanding payment of duties, interest, and penalties for allegedly violating these conditions. Furthermore, the Appellant did not pay IGST on imports during the period from October 13, 2017, to January 09, 2019, but made a voluntary payment of IGST after June 07, 2023. However, the said demands were confirmed by orders-in-original dated April 18, 2024, passed by the Principal Commissioner of Customs, Ahmedabad.

Issues

1. Whether interest, fines, and penalties for non-payment of duty under Sections 3(7) or 3(12) of the CT Act can be imposed on the taxpayer?
2. Whether the extended period of limitation can be invoked in cases of alleged violations of the "pre-import condition"?

Arguments

The Appellant contended that they had fully used all the imported materials classified as raw materials under the Advance Authorisation for the manufacture of final products, which they subsequently exported following the standard procedures, including the filing of shipping bills and export invoices. Therefore, there was no violation of the core condition of the Advance Authorisation Scheme, which mandates that goods imported under the scheme be used for the production of finished goods intended for export, with the imported materials physically incorporated into the exported products.

They argued that the facts of the case were revenue-neutral, both at the time of import during the relevant period and at the time of IGST payment in 2025. The Appellant was eligible to pay the tax and claim its credit or refund, as applicable. In this case, the Appellant was granted credit for the entire amount of tax paid upon the reassessment of the Bills of Entry, and this credit was fully utilised within a month or two from the date of its allowance. Thus, the allegation of an intent to evade tax could not reasonably be attributed to the Appellant.

Further, it is a well-established legal principle that penalties and fines are distinct levies, and they cannot be imposed in the absence of a clear and specific charging provision within the statute. With respect to the IGST levied under Section 3(7) of the CT Act, no specific provisions exist within the CT Act for imposing interest, penalties, or redemption fines. While the provisions of the Customs Act, are applicable to duties and taxes levied under

[68] M/s. Chiripal Poly Films Ltd. v. Commissioner of Customs-Customs Ahmedabad, 2024 (9) TMI 940 (CESTAT, Ahmedabad).

Section 3 of the CT Act their application is limited by sub-section (12) of Section 3 of the CT Act. As there is no charging provision under Section 3(7) or any other section of the CT Act for imposing interest, penalties, or fines, there is no legal basis for such levies.

Finally, they contended that the invocation of the extended period of limitation for issuing the SCN was unjustified, as the necessary conditions for invoking the extended period did not exist in this case.

Decision

CESTAT, Ahmedabad, observed that there is no specific provision for the recovery or imposition of interest, fines, or penalties under Section 3(7) or Section 3(12) of the CT Act, in contrast to similar provisions found in Section 8B(9) and Section 9A(8) of the same Act. In the absence of such specific provisions, interest, fines, and penalties could not be imposed.

Further, it concluded that when the situation was revenue-neutral, the demands for interest, confiscation of goods, and the imposition of redemption fines and penalties becomes unsustainable. The facts were revenue-neutral as the Department had allowed credit for the entire amount of IGST and the interest paid by the Appellant.

Regarding the time-barred nature of the demand, the Court observed that the case was based on the final assessment of the relevant Bills of Entry by proper customs officers, with the Appellant duly having provided all necessary documents and information. There was no suppression of facts by the Appellant. Given that the case centres around the alleged violation of the pre-import condition under the Advance Authorisation Scheme, a condition that customs authorities were aware of following its insertion through a Notification on July 13, 2017, the department had the opportunity to take action within the standard limitation period. Hence, it concluded that since there was no suppression of facts and the SCNs were issued beyond the two-year limit from the date of import, the entire demand was time-barred.

Significant Takeaways

The issue at hand pertains to the violation of the pre-import condition as stipulated in Notification No. 79/2017 Customs, which was under investigation by the Customs Department. This investigation has gained further momentum following the recent judgment by of *Cosmo Films*.[69] The Gujarat HC deemed the pre-import condition to be *ultra vires* the Constitution; however, the SC subsequently overturned this ruling in the *Cosmo Films* case.

The term "pre-import" is not defined in the Notification. This omission requires importers under investigation to conduct a thorough review of relevant documents to demonstrate their compliance with pre-import conditions. Therefore, the Government should be careful to define important terms while bringing in such Notifications.

The Court's decision in *M/s. Chiripal Poly Films Ltd.*, emphasises the relevance of the revenue-neutral principle in tax disputes. Since the Department allowed the credit for the entire amount of IGST and interest paid, the ruling indicates that demands for additional payments become unsustainable when they do not result in actual revenue gains for the government. The Court dismissed the demand of penalty, redemption fine, and interest due to the absence of legal provision. In this regard, the decision has followed previous rulings, like the case of ***Birla Cement Works***,[70] wherein the SC ruled that interest on delayed tax payments might only be imposed if the statute imposing the tax contains a specific provision allowing for such charges. While this may assist taxpayers for a past period, it is essential to note that the FA, 2024 has made significant changes in this space.

The ruling emphasises the need for clear legislative provisions and underscores the significance of judicial discipline in the interpretation and application of tax laws. It could serve as a significant precedent in future cases involving similar disputes.

"There is no substantive provision for confiscation or imposing redemption fine in CT Act."

[69] Union of India & Ors. v. Cosmo Films Ltd., 5 Centax 286 (S.C.) (SC).
[70] Birla Cement Works & JK Synthetics Ltd. v. Commercial Taxes Officer and State of Rajasthan (1994 (5) TMI 233 - SC).

CBDT notifies Vivad se Vishwas Rules 2024

- The Direct Tax Vivad se Vishwas Scheme, 2024 (**VSV Scheme, 2024**) has been introduced in the Finance (No. 2) Bill, 2024. The scheme aims to reduce pending income tax litigation by offering a dispute resolution mechanism, allowing eligible taxpayers to settle their outstanding tax disputes by paying a specified portion of the tax dues. Notably, the provisions of the VSV Scheme, 2024, are largely consistent with those of the 2020 Vivad se Vishwas Scheme.
- On September 19, 2024, the CBDT issued Notification No. 103/2024,[71] specifying October 1, 2024, as the effective date for the implementation of VSV Scheme, 2024. Accordingly, taxpayers may file declarations under VSV Scheme, 2024 from October 1, 2024, until the sunset date (which is yet to be notified).
- On September 20, 2024, the CBDT issued a Notification No. 104/2024[72] detailing the "Direct Tax Vivad se Vishwas Rules, 2024 (**VSV Rules 2024**)" pertaining to the VSV Scheme 2024.
- VSV Rules 2024, among other things, prescribe the following: (i) the method for computing carry-forward losses, unabsorbed depreciation, MAT credit, and Alternative Minimum Tax credit when the settled dispute involves such losses or credits; (ii) the calculation of disputed tax for issues resolved in the taxpayer's favour; (iii) the forms for filing a declaration, waiving the right to appeal, and notifying payment; and (iv) the forms for the certificate and order to be issued by the Designated Authority.
- Under the VSV Rules, the term "dispute" refers to appeals, writs, or SLPs filed by the taxpayer or tax authority before the Appellate Forum; objections filed with the DRP under Section 144C of the IT Act where no directions have been issued by the DRP; instances where the DRP has issued directions but the assessment under Section 144C(13) has not been completed by the tax officer; and applications filed under Section 264 of the IT Act.
- A matter is considered covered in favour of the "declarant" in instances where an appeal, writ, or special leave petition has been filed by the tax authority, or when the declarant has filed an appeal or objections before the appellate authorities or DRP, and already received a favourable decision from either the ITAT or the HC which has not been overturned by a higher court.
- For disputes involving issues already covered in favour of the declarant, the disputed tax is computed based on the current status of appeals or judgments that have not been reversed.
- In cases involving a reduction in loss or unabsorbed depreciation, the declarant has two options: (i) include the tax payable on the reduced amount in the disputed tax, and carry forward the loss or depreciation by disregarding the reduction, or (ii) carry forward the reduced amount after paying the applicable tax and interest. For issues covered in favour of the declarant, only 50 per cent of the reduction amount will be considered. Notably, the written-down value of a block of assets will not increase if the declarant opts to carry forward the reduced unabsorbed depreciation.

[71] Notification No. 103 /2024, F.No.370142/17/2024-TPL
[72] Notification No. 104/2024, F. No. 370142/16/2024-TPL

- When a dispute involves a reduction in MAT credit to be carried forward, the declarant has similar options: either include the reduced credit in the disputed tax and carry forward the MAT credit disregarding the reduction or carry forward the reduced MAT credit after tax payment. If the reduction is related to issues covered in favour of the declarant, only 50 per cent of the reduction amount will be considered.

SC dismisses low-effect tax cases pursuant to the CBDT Circular

- The CBDT, through Circular No. 9/2024 dated September 17, 2024 (**Circular**),[73] has increased the monetary limits for filing appeals before the ITAT, HC, SC. The revised limits are INR 60 lakhs for the ITAT, INR 2 crore for the HC, and INR 5 crore for the SC. This change supersedes the limits set in Circular No. 5/2024.[74]
- The CBDT emphasised that the decision to file an appeal should be based on the merits of the case rather than solely on the tax effect exceeding the prescribed limits, with an emphasis on reducing unnecessary litigation and enhancing transparency. These revised limits also apply to SLPs and pending appeals, which should be withdrawn in accordance with the new thresholds. This update aims to streamline the appeal process and maintain public trust in the income tax system.
- On September 24, by way of Order in the case of **GBL Power Ltd.,**[75] the SC bench of CJI D.Y. Chandrachud, Justice J.B. Pardiwala, and Justice Manoj Misra disposed of hundreds of tax cases where the tax limit was less than INR 5 crore, following the issuance of this circular. In total, 573 income tax cases were resolved, significantly reducing the backlog of tax-related litigation.

73 Circular No. 09/2024 F. No. 279/Misc./M-74/2024-ITJ
74 Circular No. 5/2024 F. No. 279/Misc.14212007-ITJ (Pt.)
75 The Commissioner of Income Tax v M/s GBL Power Ltd [TS-723-SC-2024]

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REGULATORY INDIRECT TAX UPDATES

- The recent GST Notifications mark a significant step towards achieving a more efficient and transparent tax system. They reflect the Government's commitment to reform and the ongoing efforts to create a conducive business climate. The industry, in turn, can look forward to engaging constructively with policymakers to shape a GST regime that is equitable, straightforward, and conducive to growth. Businesses, especially those engaged in cross-border transactions and complex supply chains, stand to benefit significantly from these Notifications. The reduced litigation risk and clearer compliance requirements will likely lead to cost savings and operational efficiencies.

Exemption from filing annual return

- *Vide* Notification No. 14/2024 – Central Tax dated July 10, 2024, CBIC has exempted registered persons whose aggregate turnover does not exceed INR 2 crore during FY 2023-24 from the obligation to file an annual return for that financial year. This exemption applies specifically to those entities whose financial activity falls within the specified turnover threshold.
- This clarification alleviates the regulatory burden associated with annual return filing for the stated period for such entities.

Change in rate of TCS to be collected by every electronic commerce operator for intra-State taxable supplies

- *Vide* Notification No. 15/2024- Central Tax. dated July 10, 2024, the government amended Notification No. 52/2018-Central Tax, dated the 20th September, 2018 wherein, the Central Government notified that every electronic commerce operator, not being an agent, shall collect an amount calculated at a rate of 0.5% of the net value of intra-State taxable supplies made through it by other suppliers where the consideration with respect to such supplies is to be collected by the said operator. Corresponding changes have also been made in the SGST and IGST legislations. Therefore now, the rate has been changed to 0.5%, instead of the earlier 1%.
- This change in rate has reduced the tax burden on electronic commerce operators by 50%. A lower rate of TCS could mean that the electronic commerce operators would pass on this benefit to the consumers, thereby reducing the prices.

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GLOSSARY

ABBREVIATION	MEANING
AAR	Hon'ble Authority for Advance Rulings
AO	Learned Assessing Officer
AY	Assessment Year
CBDT	Central Board of Direct Taxes
CBIC	Central Board of Indirect Taxes
CENVAT	Central Value Added Tax
CESTAT	Hon'ble Customs, Excise and Service Tax Appellate Tribunal
CGST	Central Goods and Service Tax
CGST Act	Central Goods and Service Tax Act, 2017
CGST Rules	Central Goods and Service Tax Rules, 2017
Customs Act	Customs Act, 1962
CT Act	Customs Tariff Act, 1975
CIT	Learned Commissioner of Income Tax
CIT(A)	Learned Commissioner of Income Tax (Appeal)
CVD	Countervailing Duty
DGFT	Directorate General of Foreign Trade
DRP	Dispute Resolution Panel
DDT	Dividend Distribution Tax
DTAA	Double Taxation Avoidance Agreement
EPCG	Export Promotion Capital Goods
ESOP	Employee Stock Option Plan
FA	Finance Act
FMV	Fair Market Value
FTP	Foreign Trade Policy
FTS	Fees for technical services
FY	Financial Year
GST	Goods and Services Tax
HC	Hon'ble High Court
HUF	Hindu Undivided Family
IBC	Insolvency and Bankruptcy Code, 2016
IGST	Integrated Goods and Services Tax
IGST Act	Integrated Goods and Services Tax Act, 2017
INR	Indian Rupees

GLOSSARY

ABBREVIATION	MEANING
IRA	Indian Revenue Authorities
IT Act	Income-tax Act, 1961
ITAT	Hon'ble Income Tax Appellate Tribunal
ITC	Input Tax Credit
ITO	Income Tax Officer
IT Rules	Income-tax Rules, 1962
Ltd.	Limited
LLC	Limited Liability Company
MAT	Minimum Alternate Tax
NCLT	National Company Law Tribunal
NCLAT	National Company Law Appellate Tribunal
NCD	Non-convertible Debenture
OECD	Organisation for Economic Co-operation and Development
PAN	Permanent Account Number
PCIT	Learned Principal Commissioner of Income Tax
PE	Permanent Establishment
Pvt.	Private
RBI	Reserve Bank of India
SAD	Special Additional Duty
SC	Hon'ble Supreme Court
SCN	Show-cause Notice
SEBI	Security Exchange Board of India
SEZ	Special Economic Zone
SGST	State Goods and Services Tax
SGST Act	State Goods and Services Tax Act, 2017
SLP	Special Leave Petition
TDS	Tax Deducted at Source
US	United States
UTGST	Union Territory Goods and Services Tax
UTGST Act	Union Territory Goods and Services Tax Act, 2017
VAT	Value Added Tax
VAT Tribunal	Hon'ble VAT Tribunal

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