UPDATES

Direct Taxation – Legal Milestones Financial Year 2020-21 and a Look Ahead

14 April 2021

This update covers:

The direct taxation regime witnessed some significant developments in 2020 in terms of structural tax reforms and noteworthy tax rulings. The major reforms that were introduced include faceless appeals, abolition of dividend distribution tax and introduction of taxation of dividend income in the hands of shareholders and the expansion of equalisation levy provisions to include digital transactions in the e-commerce space. Additionally, to incentivise investments, tax exemption was granted to certain incomes of sovereign wealth funds and global pension funds. A new tax regime has also been introduced for Category-III Alternative Investment Funds (AIFs) located in International Financial Services Centres (IFSC).

To provide interim relief from the impact of the COVID-19 pandemic, tax authorities have introduced certain interim measures, for instance, relaxation in tax residency norms for the financial year 2019-20 for expatriates stranded in India due to lockdown restrictions and reduction in the tax withholding rates. *Please click here for a more detailed analysis.*

For the financial year 2020-21, the tax authorities have requested individuals facing double taxation because of being stranded in India due to the COVID-19 pandemic to file prescribed forms by 31 March 2021. After examining possible situations of double taxation based on such filings, the authorities may consider granting general or specific relief. *Please click here for a more detailed analysis.*

The financial year 2020-21 witnessed key changes to the direct tax regime such as the overhaul of the dividend distribution tax and expansion in the scope of the equalisation levy provisions. Budget 2021 largely focused on simplification of legal provisions and procedures. This update summarises some of the major developments in the past year along with our expectations for the year ahead.

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The Budget 2021 seeks to enhance transparency and administrative ease by focusing on simplification of legal provisions and procedures, thereby reducing litigation. However, a few proposals may lead to tax uncertainty and ambiguity. The Finance Act, 2021 has received presidential assent on 28 March 2021.

1 Major Developments in the Financial Year 2020-21

1.1 Abolition of dividend distribution tax

Prior to 1 April 2020, in addition to the income-tax chargeable in respect of the total income of domestic companies and mutual funds, any amount declared, distributed or paid by way of dividends was subject to dividend distribution tax (DDT) at an effective rate of 20.56%. Such dividend was then exempt in the hands of shareholders (or unitholders).

The Finance Act, 2020 abolished DDT and instead, the classical system of taxation of dividends was re-introduced. Under these provisions, dividend income is subject to tax in the hands of the shareholders (or unitholders) at the applicable tax rate. The domestic company declaring dividend is required to withhold tax at the rate of 10% (plus applicable surcharge and cess) on dividends paid or payable to resident shareholders, and 20% (plus applicable surcharge and cess) on dividends paid or payable to non-resident shareholders.

Unlike the erstwhile DDT regime, where the availability of treaty relief in respect of dividend income was a contentious issue, under the newly introduced classical regime, non-resident shareholders are clearly eligible to avail of the concessional rates of tax applicable to dividend income as provided in the treaty (if any) between India and their country of tax residence.

1.2 Expanded scope of equalisation levy provisions

Through the Finance Act, 2020, the government has brought in amendments expanding the scope of 'equalisation levy' to cover non-resident 'e-commerce operators' supplying goods or services in India. The Finance Act, 2016 had originally introduced the concept of equalisation levy, at a rate of 6% on the consideration payable to non-residents for provision of digital advertising space and other services relating to online advertisement. With effect from 1 April 2020, the Indian government has enlarged the scope of equalisation levy to cover non-resident e-commerce operators.

Specifically, as per the Finance Act, 2020, an equalisation levy of 2% is payable on the amount of consideration receivable by an '*e-commerce operator*' from '*e-commerce supply or services*' made or provided or facilitated by it to:

a. a person resident in India; or

b. a non-resident in specified circumstances, i.e.,

   i. sale of advertisement, which targets a customer who is resident in India or a customer who accesses the advertisement through an internet protocol (IP) address located in India; and

   ii. sale of data collected from a person who is resident in India or from a person who uses an IP address located in India; or

c. a person who buys such goods/services using an Indian IP address.

'*E-commerce operator*' has been defined as a non-resident who owns, operates or manages digital or electronic facility or platform for online sale of goods or online provision of services or both. Further, '*e-commerce supply or services*' in this context means:

1 online sale of goods owned by the e-commerce operator; or

2 online provision of services provided by the e-commerce operator; or

3 online sale of goods or provision of services or both, facilitated by the e-commerce operator; or

4 any combination of activities listed above.

The equalisation levy is required to be paid to the Indian government on a quarterly basis. Further, for certain prescribed situations, a non-resident e-commerce operator is excluded from the ambit of equalisation levy provisions. It has also been clarified that amounts subject to equalisation levy would not be subject to income tax.

1.3 Tax exemption for sovereign wealth funds and pension funds

To incentivise investments in the infrastructure sector, the government has introduced tax exemptions for specified persons (fulfilling prescribed conditions) investing in this sector. On a broad level, the exemption would be available to (i) sovereign wealth funds, (ii) wholly owned subsidiaries of the Abu Dhabi Investment Authority, and (iii) foreign pension funds in respect of interest, dividends, and long-term capital gains income from investments made in specified infrastructure sectors. The law prescribes that eligible investments are those made on or after 1 April 2020 and up to 31 March 2024 and that have been held for at least three years.

1.4 Pre-deposit of 20% of disputed demand for grant of stay by Income Tax Appellate Tribunal

Certain circulars issued by the tax department stipulated a pre-condition of 20% deposit of the disputed demand for grant of stay at the first appellate level. However, such circulars were not binding on the Income Tax Appellate Tribunal (ITAT).

Through the Finance Act, 2020, the government introduced amendments curtailing the ability of the ITAT to grant stay without a pre-deposit of tax by the taxpayer. Accordingly, under the new provisions, a stay may only be granted by the ITAT subject to the taxpayer pre-depositing at least 20% of the amount of the demand or furnishing security of equal amount.

1.5 New tax regime for Category III AIF located in IFSC

The characterisation and taxability of income of Category-III Alternative Investment Funds (Cat–III AIFs) has historically been a controversial issue. The government has brought in amendments through the Taxation and Other Laws (Relaxation and Amendment of Certain Provisions) Act, 2020 (Taxation Act), which brings some clarity with respect to taxation of income of Cat-III AIFs located in IFSC. Key amendments under the new regime are:

a. Introduction of exemptions

Prior to the amendments, tax exemption was available in respect of income of Cat-III AIFs located in IFSC from transfer of specified securities listed on a stock exchange located in IFSC. The amendments seek to also provide tax exemption in respect of:

i. Income received by a Cat-III AIF located in IFSC as a result of transfer of securities (other than shares of an Indian company);

ii. Income (interest/dividend) from securities issued by a non-resident and where such income otherwise does not accrue or arise in India;

iii. Income from securitisation trust under the head profits and gains from business and profession to the extent such income is attributable to units held by non-residents;

iv. Income received by unit holders from Cat-III AIF located in IFSC or on account of transfer of units of Cat-III AIFs located in IFSC.

These changes not only seek to bring Cat-III AIFs located in IFSC at par with Foreign Portfolio Investors (FPIs), but also provide certain additional incentives for investing through IFSC. For instance, while capital gains income earned by FPIs on transfer of debt securities issued by Indian companies is subject to tax in India, such income would be tax exempt in case of Cat-III AIFs located in IFSC.

b. Tax rates for Cat-III AIFs located in IFSC at par with FPIs

The income tax laws provide a special regime for the taxation of income of FPIs. The Taxation Act has amended the provisions to provide flat rates of tax for taxable income of Cat-III AIFs located in IFSC (as well to the extent of income that is attributable to units held by non-resident investors). As a result, the tax rates applicable to Cat-III AIFs located in IFSC are now at par with those applicable to FPIs (except for dividend and interest income tax rates, which are more favorable for Cat-III AIFs located in IFSC, being 10%, as compared to 20% applicable to FPIs).

1.6 Direct tax jurisprudence

a. Payment for resale / use of computer software not in the nature of 'royalty'

The taxation of income from the sale of computer software has been a litigious issue in India. The Indian tax authorities have generally taken a position that payments made by (resident as well as non-resident) distributors and end users of software should be characterised as 'royalty', irrespective of the nature of rights acquired by such distributors and end users in the software. On the other hand, taxpayers have contended that such payments cannot be characterised as royalty (particularly under treaty provisions), considering the limited rights granted to the distributors and end users in the software (i.e. a limited right to use / re-sell the software, without grant of rights of the copyright owner).

In a landmark decision concerning a batch of 103 appeals (with the lead case of Engineering Analysis Centre of Excellence Private Limited), a three-judge bench of the Supreme Court has ruled that payments made to non-residents for purchase of software cannot be taxed as royalty. The ruling has put to rest a two-decades long dispute between taxpayers and the tax authorities. In the ruling, the Supreme Court analysed key terms of agreements entered into by parties for the purchase / use of software in conjunction with the relevant provisions of the Indian copyright and tax laws to hold that a limited right to use software, without grant of rights of the copyright owner, does not qualify as grant of copyright. Hence, such payments would not partake the characterisation of royalty.

This ruling provides certainty to several taxpayers and will apply to a wide range of software related transactions.

b. Tax rates on dividends specified in the treaty override the provisions of DDT

As previously discussed, until the enactment of the Finance Act, 2020, domestic companies were required to pay DDT on declaration of dividends, while such dividend was tax exempt in the hands of the shareholders. Due to the tax exemption available to the shareholders, the availability of treaty relief (i.e. restricting DDT to the lower rate of tax provided in the relevant tax treaty) to non-resident shareholders was a contentious issue.

On 13 October 2020, the Delhi bench of the ITAT in the case of *Giesecke & Devrient Pvt Ltd v. ACIT* held that the beneficial tax rate under the treaty will override the provisions of DDT. In its ruling, the ITAT observed that DDT was introduced as a matter of administrative convenience and was, for all intent and purposes, a charge on dividends in the hands of shareholders. In terms of economic cost, the burden of DDT was discharged by the shareholders.

Further, the Tribunal noted that DDT was introduced in 1997 while the relevant tax treaty (India – Germany, in this case) was notified in 1996. Accordingly, since DDT was introduced after the treaty came into force, the tax rates specified in the tax treaty must prevail over the DDT.

While the ruling is based on the principles of equity and economic substance, it has given rise to certain fundamental questions from a technical-legal perspective that will have to be answered by the higher courts in the course of appellate proceedings.

c. Karnataka High Court upholds Special Bench ruling in Biocon allowing ESOP discount as a deductible expenditure

Employee Stock Option Plans (ESOPs) are frequently utilised by companies as an employee retention tool. Generally, in a conventional ESOP scheme, the company undertakes to issue shares to its employees at a future date, at a price usually lower than the current market price. The employees acquire the right to exercise the options on completion of the vesting period.

In the present case, the taxpayer (i.e. Biocon) claimed a tax deduction of *pro-rata* ESOP discount debited to its profit and loss account as employee compensation expense. The tax authority disallowed the deduction, based on the reasoning that the ESOP discount was a contingent expense since there was no certainty that the options would vest. The first appellate authority upheld the tax authority's order. Aggrieved, the taxpayer appealed before the ITAT. The division bench of the ITAT referred the case to the Special Bench in view of conflicting decisions on this issue between different benches of the ITAT. The Special Bench ruled in favour of the taxpayer and held that discount provided under an ESOP scheme represents certain consideration for services rendered by employees and therefore would be a deductible expenditure.

On further appeal filed by the tax authority, the Karnataka High Court upheld the Special Bench ruling and held that by undertaking an obligation to issue shares at a discounted price at a future date, the taxpayer had incurred an obligation towards remunerating the employees for their services, which is nothing but expenditure. Hence, for tax purposes, the taxpayer was entitled to claim a tax deduction of the ESOP discount.

In the absence of specific provisions in the statute, the ruling has provided a measure of certainty to taxpayers in respect of tax deductibility of ESOP discount.

d. Karnataka High Court's ruling reiterates no withholding obligation in secondment arrangements

In a typical secondment arrangement with a foreign entity, the Indian entity reimburses the foreign entity for the costs incurred by the foreign entity in respect of the individuals seconded to the Indian entity. The characterisation of such reimbursements has been a controversial issue, with tax authorities treating such reimbursements as fees for technical services (FTS) received by the foreign entity from the Indian entity and therefore liable for withholding tax, instead of treating them as pure cost reimbursements that are not exigible to withholding tax.

In *DIT v. Abbey Business Services India Pvt Ltd,* the Karnataka High Court has reaffirmed the view that reimbursement by a taxpayer to the foreign entity of expenses incurred by the seconded employees cannot be recharacterised as FTS and therefore are not subject to any withholding tax obligations in India.

In this case, the UK entity had entered into a secondment arrangement with the Indian entity (taxpayer) in order to facilitate an outsourcing agreement. The Indian entity made certain payments to the UK entity, part of which were reimbursement for expenses for hotel and travel, on which the Indian entity did not withhold tax on the grounds that such expenses could not be treated as FTS. The revenue contended that since the seconded employees were highly skilled, the entire payment was in the nature of FTS.

The High Court analysed the substance of the arrangement and held that since the seconded employees were working under the control, direction, and supervision of the Indian entity, they must for all practical purposes, be treated as employees of the Indian entity. Accordingly, the payments to the UK entity were in the nature of pure cost reimbursements, on which there is no obligation to withhold tax.

e. International arbitral tribunal rules in favour of Vodafone

The international arbitral tribunal constituted in the case of *Vodafone International Holdings BV v. The Republic of India* under the 1995 Bilateral Investment Promotion and Protection Agreement between the Republic of India and the Kingdom of Netherlands (India – Netherlands BIT) has ruled in favour of Vodafone.

The arbitral tribunal was constituted in respect of retrospective taxes (along with penalties and interest) imposed by India in relation to Vodafone's indirect acquisition of Hutchinson's mobile business in India. Vodafone had acquired an offshore entity that held certain Indian assets, including the mobile business and other assets of Hutchison in India ('indirect transfer'). The Indian tax authorities raised a tax demand on Vodafone, alleging that it should have deducted tax at source before making a payment to Hutchison. Vodafone challenged the demand before the Bombay High Court, which ruled in favour of the tax authorities. Subsequently, Vodafone challenged the High Court judgement in the Supreme Court, which ruled in favour of Vodafone.

Following the ruling of the Supreme Court, legislative amendments were made to the Indian tax laws, allowing the tax authorities to retrospectively tax such indirect transfers. As a result of the amendments, the onus to pay the taxes fell back on Vodafone. Vodafone tried to resolve the dispute amicably with the tax authorities and the Indian government. Following the failure of these negotiations, Vodafone Group initiated proceedings under the India-Netherlands BIT.

In September 2020, the international arbitral tribunal passed an award in favour of Vodafone, for India's violation of the fair and equitable treatment standard under the India – Netherlands BIT. The tribunal has directed India to cease the conduct in question and reimburse legal costs of approximately INR 850 million to Vodafone. India has challenged the arbitral award before a Singapore Court.

2 Looking Ahead

The year 2021 is expected to bring in some important developments on the international taxation front. The arbitration proceedings in the Vodafone dispute (discussed above) have been decided against the government, and the government has appealed the decision. On a similar fact pattern, the dispute with respect to the retrospective tax demand imposed on *Cairn* has been adjudicated in favour of *Cairn* by an international arbitral tribunal constituted under India – UK BIPA. The arbitral tribunal has ordered India to compensate *Cairn* for 'total harm suffered' due to breach of treaty obligations. The government has also appealed this decision. It will be interesting to see jurisprudence develop in this area.

Other developments to watch out for include the jurisprudence relating to dividend taxation post the ruling in *Giesecke & Devrient* and the decision of the Delhi High Court in the writ petition filed by Tiger Global challenging the order passed by the Authority of Advance Rulings (AAR) that the sale of shares of a Singapore company by Tiger Global's Mauritius entities to offload Tiger Global's stake in Flipkart was *prima facie* designed to avoid tax.

Further, on the legislative front, Budget 2021 largely focuses on simplification of legal provisions and procedures. For instance, it provides for the introduction of a faceless Income Tax Appellate Tribunal and the constitution of a Dispute Resolution Committee to resolve tax disputes of small and medium taxpayers. Further, the Budget 2021 provides for a slew of tax incentives for the housing sector, units in International Financial Services Centre and sovereign wealth funds and pension funds, which should go a long way in boosting investment in these sectors.

From a transaction tax perspective, implementation of the key proposals in the Budget 2021 would have an impact on valuations in M&A transactions. Goodwill is proposed to be excluded as a depreciable asset and depreciation claim on any past goodwill in prior years will not be available going forward. Additionally, it is proposed to cover slump exchange under the tax framework for slump sale, and to tax slump sale transactions based on the fair market value of the business undertaking transferred. *Please click here for a more detailed analysis on Budget 2021.*

For a round -up of some of the key legal developments in the financial year 2020-2021 across other practices and a brief insight on what to expect in the year ahead, please read our practice-wise updates, which can be accessed here.

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