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UPDATES

Taxation – Legal Milestones in 2019 and a Look Ahead

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This update covers:

1 The Year that Was

The taxation regime witnessed some significant developments in 2019. Preferential corporate tax rates were introduced for new manufacturing companies. Further, to incentivise the financial sector and boost the economy, Category II AIFs were exempted from angel tax. Buy-back tax for listed companies was also introduced to plug the loophole available to listed companies that chose buy-back as a more tax-efficient option over distribution of dividends.

On the indirect tax front, certain amendments to streamline the existing indirect tax provisions were made. Also, the year 2019 saw landmark judgments from the apex court that are likely to have a far-reaching impact.

The year 2019 witnessed key changes to the GST regime, cross-border taxation framework and tax incentives for manufacturing companies and start-ups. This update summarises some of the major developments in the past year and gives a brief overview of what can be expected in 2020.

2 Major Developments in 2019

2.1 Direct Tax

- Rationalisation of corporate tax rates

  The Government has amended the income tax rates applicable to existing domestic companies and new domestic manufacturing companies (set up and registered on or after 1 October 2019 and commencing manufacturing on or before 31 March 2023). These companies can opt for concessional tax rates of 22% and 15% respectively with effect from assessment year (AY) 2020-21. The effective tax rate including applicable surcharge and cess for existing domestic companies and new domestic manufacturing companies opting for the concessional rates will be 25.17% and 17.16% respectively. However, this comes with the stipulation that such companies will not avail of specified exemption/incentives. Further, companies opting for concessional tax rates will not be required to pay any Minimum Alternate Tax (MAT).

- Introduction of e-assessment procedure

  The Government has tried to infuse greater efficiency and transparency in the assessment process by introducing e-assessment procedure in 2019. To facilitate e-assessment proceedings, specialised units were created by the CBDT at national and regional levels.

  However, while this initiative takes effect for assessments beginning from the financial year 2019-20, it is still at a nascent stage and initial hiccups and technical glitches cannot be ruled out.

- Introduction of tax on distributed income (buy-back) of shares in case of listed companies

  The Finance Act 2019 introduced a levy of buy-back tax on listed companies undertaking a buy-back to avoid payment of Dividend Distribution Tax. Further, upon buy-back tax being paid by the listed company, the shareholders of such listed company will not be subject to tax on receipt of proceeds from such buy-back.

- Notification of Multilateral Convention to implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting - the Multilateral Instrument (MLI)

  India has been a signatory to MLI which is applied alongside existing tax treaties and seeks to curb revenue loss through treaty abuse and base erosion and profit shifting strategies. However, for MLI to come into force, both parties to the tax treaty need to convey their intention by way of a notification.

  The year 2019-20 witnessed notification of the applicability of MLI provisions to several tax treaties. The MLI provisions were made applicable for India's treaty with Singapore and UAE from 1 October 2019 and will be applicable for India's treaties with Japan and UK from 1 April 2020.

- Direct tax jurisprudence

  - *Characterisation of research and information services as knowledge process outsourcing (KPO)*

    Recently, the Supreme Court dismissed a special leave petition filed by McKinsey India against the Delhi High Court order characterising the research and information services rendered by it to its associated enterprise as a high-end KPO service provider.

    The company considered itself a routine business process outsourcing service (BPO) provider. The determination was contentious because the benchmarking and mark-up from a tax perspective is done differently for a BPO and KPO.

    While pronouncing the judgement the High Court noted that the services rendered by McKinsey India were specialised and required specific skill-based analysis and research that was beyond the more rudimentary nature of services rendered by a BPO. The High Court therefore concluded that it would be incorrect to slot the services provided by McKinsey India into that of a BPO when it is more akin to a KPO.

    This ruling by the Supreme Court upholding the High Court's order further underlines the importance of correct classification of activities by outsourcing companies in India.

- *Shareholder liable to capital gains tax on conversion of company to Limited Liability Partnership (LLP)*

  Recently, the AAR has held that conversion of a company into an LLP is a conversion of equity shares into partnership interest resulting in a transfer under the provisions of the Indian tax laws. Therefore, the computation provision under section 48 of the Income Tax Act,1961 is applicable on such transfer and the capital gains arising in the hands of the shareholders can be worked out.

  AAR also noted that even though the value of a partner's interest in LLP was equal to the value of a shareholder's interest in the company, it still gave rise to taxable capital gains in the hands of the applicant shareholder because the consideration received in the form of partnership interest was substantially higher than the face value of equity shares.

  This is the first decision in which such a transaction has been subject to capital gains tax in the hands of the shareholders and distinguishes some earlier judgements of Bombay High Court. Further, even though this decision is pronounced by an AAR and is only binding on the taxpayer seeking the Advance Ruling however, it carries persuasive value for other taxpayers and will be of significance while undertaking transactions involving the conversion of a company into an LLP.

- *Bombay High Court's ruling adds uncertainty surrounding Mauritius treaty benefits*

  The revised India-Mauritius treaty provides a grand-fathering provision for capital gains arising from the sale of investments acquired on or before 31 March 2017. Such gains are generally understood as not taxable in India based on a valid Tax Residency Certificate (TRC) issued by the Mauritius Revenue Authority. However, this general understanding has been disturbed by the decision of the Bombay High Court in the case of *Indostar Capital v. CIT.*

  This decision of the court gives the tax department a long rope to examine the availability of India-Mauritius tax treaty benefits even in cases covered by the grand-fathering provision (i.e. where shares were acquired on or before 31 March 2017). The High Court observed that while a TRC issued by Mauritian authorities can constitute sufficient evidence of residential status as well as beneficial ownership for applying the treaty, the tax department is not precluded from denying tax treaty benefits if it can be established, on facts, that a transaction is an artificial tax avoidance scheme or an artificial device, pre-conceived with the sole object of tax avoidance. Therefore, if the assessing officer has sufficient prima facie material to demonstrate that the entire transaction is bogus, he could refuse to grant a nil withholding certificate under Section 197 of the (Indian) Income Tax Act, 1961.

  Nevertheless, in the Indostar case, the High Court held that the assessing officer did not have enough evidence to establish that the transaction was a sham. The High Court therefore quashed the order that denied a nil withholding tax certificate and directed that the tax already deducted be released to Indostar. However, noting that one of the purposes of Section 197 is to secure the interest of the tax department, the High Court directed Indostar to maintain a certain level of shareholding to protect the interest of the Indian tax department.

  This decision of the High Court presents new tax risks and costs that are fraught with uncertainty for entities based in Mauritius selling investments in India.

2.2 Indirect Tax

- Reverse charge mechanism under GST regime

  Under the Goods and Services Tax (GST) regime, the supply of goods and/or services to unregistered person would be chargeable to Goods and Services Tax (GST) under reverse charge mechanism. Thus, in case a registered person provides goods and/or services to an unregistered person, such registered person would have had to discharge GST on the supply. The government had kept this provision under abeyance as the registered person would have discontinued receipt of goods and/or services from an unregistered person to avoid compliance burden.

  However, the government amended the provision in 2019 to provide that GST would be payable under reverse charge by class of registered persons in relation to the supply of specified categories of goods and/or services received from an unregistered supplier, as may be specified through a notification. Thereafter, the government issued a notification, providing that promoters of construction projects receiving specified goods and/or services for construction of projects from unregistered suppliers, would be liable to pay GST under the reverse charge mechanism.

- Restriction on availing Input Tax Credit

  In order to reduce the misuse in availing Input Tax Credit (ITC), the Government introduced a restriction on 9 October 2019.

  Prior to the restriction, the recipient of a supply could avail ITC on the full amount of GST paid by the recipient, even if the invoices for such supply had not been uploaded by the supplier on the GSTN portal. However, now if details of invoices have not been uploaded by the supplier on the GSTN portal, then the ITC available to the recipient in relation to such invoices is restricted to 10% of the total eligible credit available in relation to the invoices the details of which have been uploaded by the suppliers of the recipient.

- Sabka Vishwas – Legacy Dispute Resolution Scheme, 2019

  The Finance Act, 2019 had introduced a dispute resolution cum amnesty scheme called Sabka Vishwas (Legacy Dispute Resolution) Scheme, 2019 (Scheme) for resolution and conclusion of legacy disputes under the erstwhile indirect tax regimes (central excise, service tax, cesses *etc.*).

  The objective of the Scheme was to free taxpayers from the burden of litigation and investigation under erstwhile tax regime and to reduce erstwhile disputes, so that government officials could shift focus on successful implementation of GST regime. As per news reports, the Scheme was availed by over 1,89,000 taxpayers, leading to a recovery of Rs 39,500 crore bolstering the government's commitment to resolve tax disputes through a practical approach.

- Introduction of electronic invoicing under GST

  The GST Council decided to implement electronic invoicing (e-invoice) under GST for specified persons. So far, only registered persons with aggregate turnover of above Rs. 100 crores have been notified as specified persons. Such persons will be required to issue GST invoice in the schema prescribed on the GST portal and thereafter, upload the details of such invoice on the notified Invoice Registration Portal for validation.

  Each invoice, as a result of validation, will be assigned a unique Invoice Reference Number and will be digitally signed. This process will become mandatory from 01 April 2020 onwards. In the meantime, it is being implemented on a voluntary basis.

- Indirect tax jurisprudence
  - *Refund application under Customs not maintainable, if the bill of entry was not challenged*

    The Supreme Court decided the long-standing question of whether a refund application under the Customs Act, 1962 can be entertained when the bill of entry itself was not challenged. The Court held that refund applications shall be maintainable only if the self-assessed documents are first modified and re-assessed by the appellate route provided under Section 128 of the Customs Act. Accordingly, the option availed by taxpayers of filing a refund claim, against a finalised bill of entry (where duty is paid under protest) without filing an appeal is ruled out.

    This decision will have a nation-wide effect because the existing refund claims filed by assessees will be in jeopardy where the underlying assessment order or bill of entry was not challenged by way of appeal. The assessees who wish to file a refund application in future will have to challenge the bills of entry simultaneously.

  - *Power to attach assets is a drastic step and is to be used sparingly*

    In an order curbing the power of the commercial tax officer to attach assets of a company for protecting the department's interests, the Gujarat High Court held that such power is a drastic one and should be used sparingly and only on substantive weighty grounds.

    It observed that attachment of bank accounts and trading assets should be the last resort, and that blockage of input tax credit by way of computer entry was illegal. It noted that just because a search has been undertaken resulting in seizure of goods, this by itself may not be sufficient to arrive at the subjective satisfaction that it is necessary to pass an order of provisional attachment to protect government revenue. Further, the Court also held that the order for attachment can only be passed by a Commissioner and not by subordinate officers.

  - *Exemption from excise duty does not exempt the goods from Education cess, Senior and Higher Secondary cess or National Calamity Contingent Duty*

    The Supreme Court held that an exemption from the payment of Excise duty will not, by itself, exempt the goods from Education Cess (EC), Senior & Higher Secondary Cess (SHEC) or National Calamity Contingent Duty (NCCD). The Supreme Court noted that when a particular kind of duty is exempted, other types of duty or cess imposed by different legislation for a different purpose cannot be said to have been exempted.

    The Supreme Court has thus, opened flood gates for the taxpayer. The taxpayers are now being pursued by the tax department for the recovery of EC, SHEC and NCCD where they had taken benefit of area-based exemption and not discharged EC, SHEC and NCCD. This situation is worsened by the lack of certainty in the method which the tax department would adopt for calculating the EC, SHEC or NCCD allegedly recoverable from the taxpayer.

3 Looking Ahead

The year 2020 is expected to bring in some important developments on the international taxation front. The government is likely to introduce new rules for profit attribution to a permanent establishment based on the recommendations of the Committee formed by the Central Board of Direct Taxes to examine the existing scheme.

Further, MAT provisions for distressed companies may be abolished given the hardships faced by potential investors. Some concessional regime may also be introduced for the distressed aviation sector to encourage its revival.

On the GST front, a shift in focus is expected from resolution of legacy disputes under the erstwhile indirect tax regimes, to addressing industry issues as well as proactively verifying tax positions under GST law.

For a round-up of some of the key legal developments across sectors in 2019 and a brief insight on what to expect in 2020, please read our sector-wise updates, which can be accessed at: https://trilegal.com/knowledge-repository/page/2/?title=milestone