MPC & CO LLP
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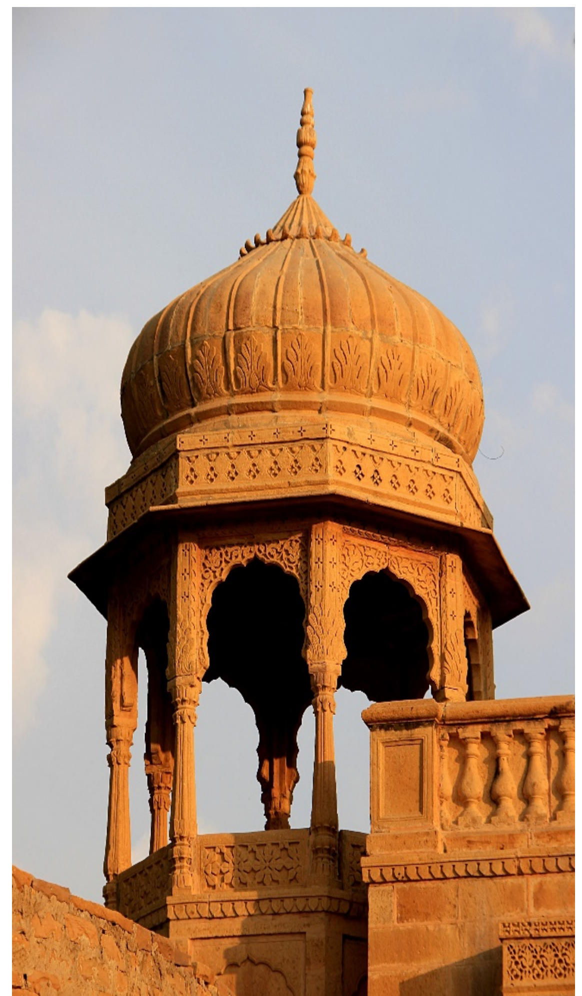

FOREWORD

Dear Reader,

The Indian Budget for the F.Y. 2025-26 will be presented on February 1, 2025 by the Finance Minister, on behalf of the Government of India.

There are great expectations from the Government like in respect of considerable increase in allocation of outlays for various infrastructure and defense projects to boost the economy. The Finance Minister is expected to make new proposals in respect of taxes especially Customs Tariffs. She is expected to make an announcement on likely introduction of a simplified version of the Indian Income-tax Act, as promised by her in the last Budget.

We will cover the proposals as made, changes as may be proposed in the tax and other regulations in our special Budget Update to be issued separately.

In this Update, we cover important case laws under direct tax including notes on regulatory changes.

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DIRECT TAXES

INTERNATIONAL TAXATION

CASE LAWS

ITAT rejects contention made by assessee for Base Erosion and Mirror ALP in respect of Transfer Pricing Adjustment

Shell Global Solutions International BV [TS-528-ITAT-2024(Ahd)-TP]

In a recent decision Hon'ble Income Tax Appellate Tribunal (ITAT), Ahmedabad bench, inter-alia, dismissed the contentions made by the foreign assessee in respect of Base Erosion in the case of Arm's Length Price (ALP) adjustment and Mirror ALP primarily relying upon the decision of Special bench of ITAT in the case of the **Instrumentarium Corporation Ltd. V/s CIT ITA No.1548 and 1549/Kol/2009 (SB)**.

On the facts of the case, the assessee is engaged in coordinating operation of a number of Royal Dutch Shell entities world-wide and providing research and technical services to petroleum related industrial segments. During the relevant year, the assessee provided LNG and re-gassification services and Manpower Services to its Associated Enterprises (AEs). After reference to Transfer Pricing Officer (TPO) by Assessing Officer (AO), TPO noted that average rate charged by the assessee for LNG and re-gassification from its AE was Euro 217.56 while similar services were provided to third party at Euro 2,267.90, and for Manpower Services average rate charged from the AE was Euro 217.56 while rate charged from third parties was Euro 323.58. As a result, TPO made upward Transfer Pricing (TP) adjustment. The assessee filed an appeal before Dispute Resolution Panel (DRP) which rejected the objections raised by the assessee citing that the same has been rejected in the earlier years.

Aggrieved, the assessee filed an appeal before the ITAT. Before ITAT, the assessee contented that by virtue of upward adjustment made to the ALP of the international transaction in the hands of the assessee, corresponding adjustment to the expenses incurred in the hands of the Indian AE was warranted. Also, while the assessee is liable to pay tax at the rate of 10% on the TP adjustment made, the Indian AE, which is liable to pay tax at the rate of 33% shall be liable to refund due to corresponding increase in the expenses, leading to base erosion. This argument of the assessee was rejected in the previous years by ITAT based on the ruling of the special bench of ITAT in the case of Instrumentarium Corporation Ltd. (Supra), wherein the ITAT ruled out the argument of there being base erosion on account of ALP determination in the hands of the assessee.

The assessee contented that argument of base erosion was rejected in preceding years since the AEs were incurring losses. However, in present case assessee has made profits, and also paid taxes in the impugned year, hence contentions made by the assessee needs to be accepted.

The Hon'ble ITAT, however relied on Special Bench decision of Instrumentarium Corporation Ltd. (Supra) wherein it was held that as per current provision of the law any adjustment to the ALP of the international transaction of a foreign entity does not warrant an adjustment in ALP of its Indian AE also.

The assessee further contended that since this impugned transaction have been

accepted at arm's length in the hands of AE, no adjustment is warranted in the hands of the assessee, being 'mirror ALP'. In this regard, the assessee referred to its earlier year's ITAT order where the ITAT had held that the argument of the mirror ALP can only be accepted if - 1) a TP reference is made in the case of AE 2) a TP assessment is undertaken in the case of AE and 3) no TP adjustment made in the case of the AE.

However, ITAT noted that the earlier ITAT order in case of the assessee referred to the decision of the Filtrex Technologies P.Ltd. (supra) wherein it was categorically held that there could not be any case of mirror ALP at all. The Hon'ble ITAT also referred to the decision of Special Bench in the case of Instrumentarium (supra) wherein it was held that in respect of a same transaction the Revenue can opt to determine total income on the basis of ALP determined in the hands of one party to the said transaction, wherever tax base would erode and can desist from doing so in the assessment of the other party to the said transaction wherever there would not be tax base erosion. Therefore, it cannot be said that consequent to acceptance of return of income filed by one party to the transaction, the price paid by the other party in the international transaction has to be accepted as at Arm's Length.

The assessee further, contented that the TPO has not applied CUP method correctly in respect of LNG and re-gassification charges by comparing the fixed charge component and optional services charges component correctly with the third-party charges. The Hon'ble ITAT remitted the matter back to TPO for afresh analysis in this regard.

Further, the assessee contented that income received by the assessee for rendering services was taxable in source country only on receipt basis. Since the adjustments made to the income on account of ALP adjustments was not received, the same would not be taxable. It was mentioned that the same issue is pending before the Special Bench of the ITAT in the case of **Ampacet Cyprus Ltd (ITA 1518/Mum/2016 and ITA 560/Mum/2017**. In view of the same, the Hon'ble ITAT remitted the issue back to the AO to adjudicate the matter after applying the decision of the special bench as and when decided.

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REGULATORY

CBDT issues guidelines on application of the Principal Purpose Test under Double Taxation Avoidance Agreement

The Principal Purpose Test ("PPT") provides for denial of benefits under Double Taxation Avoidance Agreement ("DTAA") where it is reasonable to conclude, having regard to all the relevant facts and circumstances, that one of the principal purposes of an arrangement or transaction was to obtain a benefit, directly or indirectly, under a DTAA, unless it is established that granting that benefit would be in accordance with the object and purpose of the DTAA. The PPT is intended to ensure that DTAAs apply in accordance with the objects and purpose for which they were entered into, i.e. to provide benefits in respect of bona fide exchange of goods and services, and movement of capital and persons.

In some of the DTAA entered into by India, the PPT has been incorporated in the DTAAs through bilateral process (such as in the case of Chile, Iran, Hong Kong, China etc.)

India entered into Multilateral Convention to Implement Tax Treaty Related Provisions to Prevent Base Erosion and Profit Shifting ("MLI") with most of its treaty partners. The MLI modifies Indian DTAAs with the Treaty partners that entered into the MLI and covered India's DTAA with them as the Covered Agreement. MLI also contains PPT as a key provision, to curb revenue leakage by preventing treaty abuse. The PPT's text in the MLI reads as under:

> "Notwithstanding the other provisions of this Convention (or Agreement), a benefit under this Convention (or Agreement) shall not be granted in respect of an item of income if it is reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining that benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit, unless it is established that granting that benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of this Convention (or Agreement)."

For India, the date of entry into force of the MLI is October 1, 2019, whereas in the case of the Treaty Partner the same is based on the deposition of the instrument of ratification to the Depository of OECD.

In order to provide clarity and certainty on the application of the PPT provision under India's DTAAs, the Central Board of Direct Taxes (CBDT) has issued the following broad guidance vide Circular No.1/2025 dated January 21, 2025:

a) For DTAAs where the PPT has been incorporated through bilateral processes, the PPT provision shall apply from the date of entry into force of the DTAA or the Amending Protocol incorporating the PPT, as the case may be.

b) For DTAAs where the PPT has been incorporated through the MLI, the PPT provision shall be applicable as under:

    i. With respect to taxes withheld at source on amounts paid or credited to non-residents, where the event giving rise to such taxes occurs on or after the first day of the financial year that begins on or after the latest of the dates on which the MLI enters into force for the Contracting Jurisdictions to the DTAA;
    ii. With respect to all other taxes levied by India for financial years beginning on or after the expiration of a period of six calendar months from the latest of the dates on which the MLI enters into force for the Contracting Jurisdictions to the DTAA.

It has been specifically stated that where India has made Treaty-Specific bilateral commitments in the form of grandfathering provisions under the DTAA (such as with Cyprus, Mauritius and Singapore), such commitments shall remain outside the purview of the PPT provisions.

The CBDT has also clarified that the application of PPT provision is expected to be a context-specific fact-based exercise to be carried out on a case-by-case basis, keeping in view the objective facts and findings. In this regard, besides the BEPS

Action Plan 6 Final Report, subject to India's reservations, wherever applicable, tax authorities may refer to the Commentary to Articles 1 and 29 of the UN Model Tax Convention (updated in 2021) as additional/supplementary sources of guidance while deciding on the invocation and application of the PPT provision, subject to India's reservations, wherever applicable.

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DOMESTIC TAXATION

CASE LAWS

Reduction of share capital by a company amounts to 'transfer' of shares in the hands of the shareholder

In a recent decision in the case of **Principal Commissioner of Income Tax-4 and Anr. vs Jupiter Capital Private Limited (SLP No.63 of 2025**), the Supreme Court has held that reduction in share capital of a company and subsequent proportionate reduction in the shareholding of the shareholder would be considered as 'transfer' of shares within the meaning of Section 2(47) of the Income Tax Act ("the Act"), being covered by the expression "sale, exchange or relinquishment of the asset".

In the present case, the assessee, Jupiter Capital Private Limited, had made an investment in Asianet News Network Private Limited in the form of 15,33,40,900 shares (out of total shares of 15,35,05,750), which constituted 99.88% of the total number of shares of the subsidiary company.

As Asianet was incurring losses, it filed a petition before the High Court of Bombay for reduction of its share capital to set off the losses against the paid-up equity share capital. The High Court ordered for a reduction in the share capital of the company from 15,35,05,750 shares to 10,000 shares. Consequently, the share of the assessee was reduced proportionately from 15,33,40,900 shares to 9,988 shares. However, the face value of shares remained the same at Rs. 10 even after the reduction in the share capital. The High Court also directed the company (Asianet) for payment of Rs. 3,17,83,474/- to the assessee (Jupiter) as a consideration.

The assessee claimed long term capital loss consequent to the reduction in the share capital. The Tax Officer disallowed the claim of the assessee holding that the reduction in shares did not result in the transfer of a capital asset as per Section 2(47) of the Act. The Tax Officer was of the view that in the present case it was only reduction of shares by way of extinguishing the number of shares and not 'extinguishing the rights of the shareholders'. The Tax Officer held that extinguishment of rights would mean that the assessee has parted with those shares or sold off those shares to a second party, which in the present case was missing.

In the appeal before CIT (A), the CIT (A) also rejected the claim of the assessee observing that the shareholding ratio of the assessee remained constant even after implementation of the share reduction scheme.

The ITAT, however, held the issue in favour of the assessee by following the judgment of the Supreme Court in the case of Kartikeya

V. Sarabhai vs Commissioner of Income Tax (1997) 7 SCC 524. The ITAT held that the assessee has extinguished its right of 15,33,40,900 shares and in lieu thereof, the assessee received 9,988 shares at Rs. 10/- each along with an amount of Rs. 3,17,83,474/-. Therefore, the basis adopted by the CIT(A) for not following the judgment of the Supreme Court in the case of Kartikeya V. Sarabhai (Supra) was not proper. The ITAT observed that there is no reference to the percentage of shareholding prior to the reduction of share capital and after reduction of share capital in the judgment of the Supreme Court in Kartikeya V. Sarabhai (Supra).

The High Court concurred with the view of the ITAT and dismissed the appeal filed by the revenue.

In the appeal before the Supreme Court, the Supreme Court observed that the issue is covered by its earlier decision in Kartikeya V. Sarabhai (Supra), wherein it held that when as a result of the reduction of the face value of the shares, the share capital is reduced, the right of the preference shareholder to the dividend or his share capital and the right to share in the distribution of the net assets upon liquidation is extinguished proportionately to the extent of reduction in the capital.

The Supreme Court observed that in the present case, the face value per share has remained the same before the reduction of share capital and after the reduction of share capital. However, as the total number of shares have been reduced from 15,35,05,750 to 10,000 and out of this the assessee was holding 15,33,40,900 shares prior to reduction and 9,988 shares after reduction, it can be said that on account of reduction in the number of shares held by the assessee in the company, the assessee has extinguished its right of 15,33,40,900 shares, and in lieu thereof, the assessee received 9,988 shares at Rs. 10 each along with an amount of Rs. 3,17,83,474/-.

The Supreme Court held that sale is only one of the modes of transfer envisaged by Section 2(47) of the Income Tax Act, 1961. Relinquishment of any rights in it, which may not amount to sale, can also be considered as transfer and any profit or gain which arises from the transfer of such capital asset is taxable under Section 45 of the Act.

The Supreme Court quoted the decision of the Gujarat High Court in the case of CIT vs Jayakrishna Harivallabhdas (1998) 231 ITR 108, wherein it was clarified that receipt of some consideration in lieu of extinguishment of rights is not a condition precedent for the computation of capital gains. The Supreme Court, therefore, held that the present case would fall under the expression "sale, exchange or relinquishment of assets" as used in Section 2(47) of the Act and consequently, the assessee would be entitled to claim long term capital loss.

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Payment to JV partner for out of court settlement is not a revenue receipt u/s 28(ii)(b) of the Income-tax Act, 1961

Modi Entertainment Ltd. v. ITO [TS-909-ITAT-2024(DEL)]

Recently, the Delhi Tax Tribunal has held that out-of-court settlement consideration is a capital receipt, not taxable under Section

28(ii)(b) of the Indian Income-tax Act, 1961, as the Assessee was not managing the whole or substantially the whole of affairs of the Indian Company.

As per provisions of Section 28(ii)(b), any compensation or other payment due to or received by an Assessee, **managing the whole or substantially the whole of the affairs in India of any other company**, upon termination of his office or modification of terms and conditions of his office, shall be chargeable to tax under the head "Profit and Gains from Business or Profession".

The Assessee had entered into a joint venture ('JV') by the name of M/s Abraxas Media Pvt. Ltd. ('Abraxas') with M/s Disney Enterprises ('Disney') in which its stake was 49% and the balance 51% stake was held by Disney. Thereafter, Disney entered into a marketing license agreement and television distribution agreement wherein, Abraxas was granted various licenses *qua* consumer product merchandising and distribution of "Disney" television programs in India. Upon expiry of the license agreement, the Assessee objected to the termination of license as being in violation of the terms of agreement with Abraxas. Aggrieved by such termination, the Assessee initiated legal proceedings against Disney. However, to avoid such litigation, Disney entered into an out of court settlement with the Assessee pursuant to which it transferred its 51% stake in Abraxas to a wholly owned subsidiary of the Assessee in Mauritius at $1 and also paid an amount of $10 million (approx. INR 408.5 million) as compensation.

In the tax scrutiny proceedings before the Tax Officer, the Assessee took a position that such compensation was in respect of erosion in the value of investment in Abraxas and accordingly, was a capital receipt not chargeable to tax under the Act. However, the Tax Officer proceeded to tax such compensation as revenue receipt under Section 28(ii)(b). The same was also upheld by the Commissioner (Appeals) on the premise that such compensation was paid to the Assessee on account of loss of profits.

On further appeal, the Tribunal, restricting itself to the applicability of Section 28(ii)(b), observed that the Assessee is not "managing the whole or substantially the whole of the affairs of an Indian Company" to be brought within the ambit of Section 28(ii)(b). Further, neither the agreement(s) between the Assessee and Disney nor the order of the Tax Officer and Commissioner (Appeals) could prove the Assessee to be managing the whole or substantially the whole of the affairs, as mentioned above. Thus, the Tax Tribunal held that the out-of-court settlement compensation of INR 408.5 million received by the Assessee cannot be brought to tax under Section 28(ii)(b) once it is established that the Assessee is not managing the whole or substantially the whole of the affairs of the joint venture partner.

Further, the Revenue's alternative argument that such receipt may be taxed as "non-compete fee" under Section 28(va) was also dismissed by the Tribunal as it was not argued before the lower tax authorities.

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Interest earned on surplus funds temporarily kept in fixed deposits in the course of acquisition of a capital asset is to be considered as the capital cost

International Coal Ventures Pvt. Ltd [TS-934-HC-2024(DEL)]

The High Court of Delhi has held that where the funds are temporarily kept in fixed deposits in the course of acquisition of capital asset during pre-commencement of the business, the interest income' from such deposits would be considered as a part of the capital cost.

In the instant case, the Assessee received funds from promoters for acquiring a coal mine outside India. After abandoning its initial proposal to acquire the coal mine, the Assessee kept such funds in short-term fixed deposits till another proposal could come through. However, the proposal for acquisition of the coal mine was ultimately cancelled and the funds were refunded to the promoter. In the meanwhile, the Assessee earned interest income from the short- term deposits and also made interest payments to the promoter towards funds borrowed by the Assessee.

The Assessee claimed that income by way of interest is not chargeable to tax under the head 'income from other sources' as it was inextricably linked to acquisition of coal mine – a capital asset. The Assessee claimed that the amount of interest payable on the funds borrowed for acquiring such asset is required to be added to the total cost of the asset. Similarly, interest earned on such funds, which were temporarily kept in an interest-bearing account pending utilization, was liable to be adjusted from the cost of such asset. The Assessing Officer ('AO'), however, treated the difference between the interest income and the interest expense of the Assessee as 'Income from Other Sources'.

The Commissioner (Appeals) ['CIT(A)'] rejected the contention of the Assessee. The CIT(A) was also of the view that the AO had erred in permitting a deduction in respect of amount paid by the Assessee to promoters as interest, for determining the net amount that was chargeable to tax under Section 57(iii) of the Income-tax Act, 1961. However, on a further appeal, the Tax Tribunal held that the Assessee was entitled to set off the interest paid against the interest received and adjusting the balance receipt against Capital Work-in-Progress, thus upholding the view of the Assessee. Therefore, the Revenue filed an appeal before the High Court of Delhi.

During the course of hearing, the High Court of Delhi noted that the expenses incurred during the pre-operative stage of setting up a business are capitalized based on the rationale that the cost incurred for setting up a profit-making apparatus is required to be accounted for as the value of the asset. It was noted that the same principle shall apply for the revenue inextricably linked to the acquisition of an asset which requires substantial time to construct. The court noted that there is a distinction between the price of an asset and its cost. The amounts received which are directly linked to the acquisition or construction of the asset mitigate the cost of the asset and therefore, it is essential to reflect the correct cost of the asset.

Furthermore, taking note of the Accounting Standard – 16 and India Accounting Standard (Ind AS) 23, the High Court of Delhi observed that in order to fairly disclose a capital value of an asset (which takes a considerable time to bring it to intended use)

on historical cost basis, each and every element of expenditure, which directly contribute to the cost of that asset, shall be included within the cost of the said asset. The High Court of Delhi relied on the judgement of Apex Court in the case of *Challapalli Sugar Limited v. CIT (1975) 98 ITR 167* wherein the above view of capitalizing the pre-commencement expenditure was upheld.

The Court also noted that the judgment in *Tuticorin Alkali Chemicals & Fertilizers (1997) 227 ITR 172 (SC)*, relied by the Revenue, was already distinguished by the Apex Court in the case of *CIT v. Bokaro Steel Ltd. [1999] 236 ITR 315 (SC)*, as in the former case the income was generated on the ‘surplus’ funds whereas in the latter case, the receipts were intrinsically connected with the construction of a capital asset. It was further observed that the similar findings were made by the coordinate bench of the High Court of Delhi in the case of *Indian Oil Panipat Power Consortium Limited v. ITO [2009] 181 Taxman 249 (Delhi)*, wherein, it was held that income earned on funds primarily brought for infusion in the business could not have been classified as income from other sources. The income earned in a period prior to commencement of business was in the nature of capital receipt and, was therefore required to be set off against pre-operative expenses.

Based on the above, the High Court of Delhi held that the funds in question were not ‘surplus’ funds and the same were earmarked for a specific purpose of acquiring a coal mine. Therefore, the interest earned on the funds, being temporarily kept in fixed deposits in the course of acquisition of the coal mine to set up its business, would require to be accounted for as the part of the value of the capital asset and is required to be credited to Capital Work in Progress. The Court clarified that such an accounting treatment shall be applicable only if the nature of the asset is such that requires time for construction or for putting it in use. The High Court of Delhi thus dismissed the appeal of the revenue.

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CORPORATE LAW

CASE LAWS

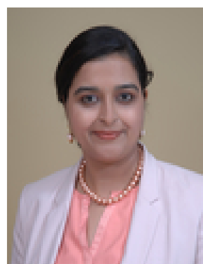
Extension of time for allowing companies for Holding of Annual General Meeting (AGM) through Video Conferencing (VC) or other Audio-Visual Means (OAVM) under Circular No. 09/2024 dated September 19, 2024

The Ministry of Corporate Affairs (MCA), in its earlier Circular issued in September 2023, had extended the time till September 30, 2024, with respect to allowing the companies to hold their Annual General Meetings [AGMs] / Extraordinary General Meetings [EGMs] through Video Conference (VC) or Other Audio-Visual Means (OAVM.

In above context, the MCA, vide its recent Circular 09/2024 dated September 19, 2024, has again extended the time with respect to allowing the companies whose Annual General Meetings [AGMs] are due in the year 2024 or 2025, to conduct their AGMs through Video Conference (VC) or Other Audio-Visual Means (OAVM) on or before September 30, 2025.

Further, it has also been clarified that the above provision shall not be construed as conferring any extension of time for holding of AGMs by the companies under the Companies Act, 2013 (the Act) and the companies which have not adhered to the relevant statutory timelines shall be liable to legal action under the appropriate provisions of the Act.

Similarly, in the same circular, the MCA has also allowed the companies to conduct their Extraordinary General Meetings [EGMs] through Video Conference (VC) or Other Audio-Visual Means (OAVM) up to September 30, 2025.



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