



Emerging Tax Trends

- A Compendium

September 2022, New Delhi

The Associated Chambers of Commerce and Industry of India

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Section 194R – A Jigsaw Puzzle

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Since ages, there has been a practice of providing benefits and perquisites to business connections and stakeholders in the commercial world. Employers have been providing it to their employees, business houses have been providing it to their customers, suppliers, and other important connections in the supply chain. Benefits and perquisites have traditionally been paid in cash or partly in cash and partly in kind.

As providing benefit or perquisite is an old tradition, the tax laws also provided for its taxability. Taxability in the case of employer-employee relationship has been provided in section 17 of the Income Tax Act, 1961 ('the Act'). If the benefit and perquisite is emanating out of business or profession, its taxability is covered by section 28 of the Act.

Even though the taxability of benefit or perquisite is taxable in the hands of the recipient, the Government observed that in many cases recipient failed to report receipt of such benefit or perquisite in their return of income. Accordingly, the Government has introduced section 194R in the Act to provide for deduction of tax at source by the payer of benefit or perquisite to a resident before providing such benefit or perquisite. The said provisions have been made effective from July 01, 2022.

However, as it is said that with great power comes great responsibility, in relation to tax amendments, it can be said that with every amendment comes multiple issues and challenges.

In order to clarify issues and challenges emanating from the provisions of section 194R, Central Board of Direct Taxes ('CBDT'), in exercise of its power under section 194R(2) of the Act, issued guidelines in the form of Circular No. 12 of 2022 dated June 16, 2022. However, the guidelines seem to be one of the various examples where there has been an overlap in the functions and powers of the Legislature and Executive.

Key provisions of section 194R

For academic purposes, key provisions of section 194R are tabulated below:

Applicability	Any benefit or perquisite, whether convertible into money or not, arising from business or the exercise of a profession of the recipient
Rate	10%
Deductor	Any person responsible for providing benefit or perquisite, other than a person being an individual or a HUF, whose total sales, gross receipts, or turnover does not exceed INR 1 Cr. in case of business or INR 50 Lakhs in case of profession, during immediately preceding financial year
Deductee	Any person resident in India receiving a benefit or perquisite
Threshold	INR 20,000 per recipient per annum
Timing of deduction	Before providing benefit or perquisite

Binding nature of Guidelines

Historically, majority of the circulars issued by CBDT in terms of the powers conferred under section 119 of the Act, and it was a settled position that such circulars are binding on the income tax department only and not on the taxpayers. Also, the circulars cannot expand or contract the applicability of the provisions of the Act and impose additional burden on the taxpayer.

However, the Guidelines under section 194R have been issued pursuant to the powers provided to the CBDT under section 194R(2) and 194R(3) of the Act. Section 194R(2) provides that guidelines may be issued by CBDT to “remove difficulty” which arise in giving effect to the provisions of section 194R. Section 194R(3) provides that every guideline issued by the CBDT shall be laid before each House of Parliament and shall be binding on the Revenue as well as the person providing any benefit or perquisite.

We will see in the ensuing paragraphs how the Government in the name of removing difficulties seems to have enlarged the scope of the provisions of section 194R of the Act through the Guidelines.

Some prevailing issues arising out of the guidelines issued by CBDT.

1. Benefit or Perquisite in Cash

It has been provided in the Guidelines that “tax under section 194R of the Act is required to be deducted whether the benefit or perquisite is in cash or in kind.” Accordingly, applicability of section 194R on transactions such as waiver or settlement of loan, interest free loan given by a LLP to a company, write-off of bad debts, etc. could result in litigation amongst the taxpayer and the Revenue.

Provisions of section 194R provide for deduction of taxes in respect of benefit or perquisite, whether convertible into money or not. In this context, the Apex Court in the case of Mahindra and Mahindra held that the term “whether convertible into money or not” used in section 28(iv) of the Act means that the benefit or perquisite should be in non-monetary form. The Guidelines have referred to proviso to section 194R(1) which provides that where the benefit or perquisite is wholly in kind or partly in cash and partly in kind but cash part is not sufficient to meet the liability of TDS on whole of such benefit or perquisite then before releasing the benefit or perquisite, the deductor shall ensure that tax has been paid in respect of the benefit or perquisite. The CBDT has interpreted the proviso as indicative of the legislative intent that TDS also needs to be deducted for monetary benefits. However, it can be said that first proviso to section 194R(1) merely ensures that taxes are fully deposited in relation to the perquisite or benefit, fully in kind or partly in cash and partly in kind. It nowhere extends the applicability of the provisions of section 194R to benefit or perquisite completely in cash.

In view of the above, it needs to be explored whether it is possible for a taxpayer to take a position that the perquisite or benefit in cash would be outside the scope of section 194R or should the deductor adopt a conservative approach in order to protect itself from disallowances and consequential tax, interest and penalties.

2. Free samples to Doctors

The Guidelines have provided that free medical samples provided to doctors are to be regarded as benefit or perquisite liable for TDS under the provisions of section 194R of the Act. However, the CBDT

seems to have ignored the fact that most of the times such free medical samples are not used by doctors for self-consumption. In many cases, such samples are handed over to needy patients. The law provides that the benefit should arise in the hands of the recipient but in the present case, there is seemingly no benefit arising to the recipient. Accordingly, provision of such free medical samples to doctors should not be liable to TDS under section 194R of the Act.

The CBDT should provide clarity on the applicability of section 194R in cases where the free medical samples are not used for self-consumption or monetized by the doctors but provided to needy patients.

3. Dealer Conferences

The Guidelines provide that dealer or business conference would not be considered as benefit or perquisite where the prime object is to educate dealers/customers about any new product being launched, discussion as to how the product is better than others, obtaining orders, teaching sales techniques, addressing queries or reconciliation of accounts. However, such conferences should not be in the nature of incentives/benefits to select few dealers/customers who have achieved particular targets. It is also clarified that any expense on account of leisure component even if incidental to the conference or for the family members or outside the days of conferences would get covered under the purview of incentive/benefits under section 194R of the Act.

Determination and valuation of such component out of the total expenditure on conference is going to be practically difficult. For example, in case a company hosts a dinner party including entertainment after the conference, whether the same will be considered as benefit or perquisite. If yes, there is no clarity on how the valuation of such benefit or perquisite will be done. Accordingly, it could be matter of litigation with tax authorities requiring detailed verification of the invoices and break-up thereof into business and leisure/family related component.

Further, considering organisation of conferences only for select few dealers who have achieved their targets as benefit or perquisite lacks rationale. Any company would like to train and educate its best performing dealers and use its time and money accordingly. Conducting a conference for select few high performing dealers should not be considered as benefit or perquisite so long as it meets the objectives of the Guidelines.

4. Out of pocket expenses (OPEs)

It has been provided by the Guidelines that in relation to OPEs incurred by service provider during the course of providing the services, there will be no requirement to deduct TDS under section 194R of the Act if the invoices are in the name of the client. However, if the invoice is in the name of the consultant, then client will have to deduct TDS on its reimbursement. This will be a very cumbersome process for the client as it will have to check each and every invoice provided by the service provider. Further, Question No. 30 of CBDT Circular No. 715 dated August 08, 1995 clarified that reimbursement should be included for withholding taxes under section 194C and section 194J of the Act.

The CBDT should clarify and provide for deduction of tax under only one section i.e., either section 194R or section 194C/194J otherwise it will result in deduction of taxes under two sections under the same invoice.

5. Vehicle facility to senior advisors/consultants

Many times, businesses hire various subject matter experts as advisors/consultants. These advisors/consultants are given facility of car wholly for official purposes. At times, the car usage can be partly for personal and partly for official purposes. Accordingly, it needs to be analysed whether the usage to the extent for personal purposes qualifies as a benefit for section 194R of the Act. While it may give rise to a benefit to such advisor/consultant, however, the real difficulty would be valuation of such benefit.

Organisations may want to obtain a declaration in this regard from such consultants that the car will not be used for personal purposes. Alternatively, certain amount may be recovered from such advisors/consultants which can be attributed to the value of personal use.

Conclusion

Considering the current state of issues and challenges arising from the provisions of section 194R of the Act, it hampers the ease of doing business in India and would further burden the already overburdened judiciary. Accordingly, the government should come out with another set of clarifications to address the pending issues else different taxpayers may end up adopting a different approach while deducting TDS under section 194R of the Act.

Lastly, a detailed analysis of the business model & transactions should be undertaken by the business houses to determine what constitutes benefit or perquisite and whether the same is arising from business or profession to understand the liability to deduct TDS under section 194R of the Act. This will help the businesses in complying with the provisions and avoiding unnecessary litigation costs.

The Conundrums of Section 194R

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Background

- On 1 July 2022, the provision of section 194R of the Income-tax Act, 1961 (IT Act) became effective. This section provides tax withholding at the rate of 10% in respect of benefit or perquisite granted by the taxpayer. The rationale behind the introduction of this section, as explained in the Memorandum to the Finance Bill, 2022, is that while a benefit or perquisite arising from a business or exercise of profession is chargeable as business income, in many cases, such receipts are not reported by the recipients in their tax return. Hence, to widen and deepen the tax base, section 194R is inserted to provide that the person responsible for providing to a resident, any benefit or perquisite, whether convertible into money or not, arising from carrying out of a business or exercising of a profession by such resident, shall ensure that tax has been withheld in respect of such benefit or perquisite. No tax is to be deducted if the value or aggregate value of the benefit or perquisite paid or likely to be paid to a resident does not exceed INR 20,000 during the fiscal year.
- As there were several practical difficulties in the implementation of this section, the Central Board of Direct Taxes (CBDT) issued a clarificatory Circular¹ dated 16 June 2022 wherein it tried to address some of the concerns raised by the taxpayer. Subsequently, another Circular² was issued wherein some of the challenges raised by the first circular were addressed.

Few practical challenges

- **Applicability to Authorised Retailer Scheme (ARS)**
 - **Typical business model:**
 - Company to sell its product (say MRP of INR 125) to its dealer (say at INR 80)
 - Dealer to sell this product to ARS/retailer (say at INR 100)
 - Retailer to sell the said product to the consumer at MRP of between INR 100 and INR 125
 - The list of sales made to ARS and quantity is shared by the dealer with the Company
 - ARS are entitled to slab-based discounts/rebates, which shall depend upon the number of products purchased by them
 - Presuming that ARS is entitled for a rebate of INR 10 per product, the rebate shall be given in any of the following modes:
 - Company to credit INR 10 into the bank account of ARS or
 - Company to credit INR 10 into the bank account of the dealer. Dealer, in turn, would credit this INR 10 into the bank account of ARS

¹ Circular No. 12 of 2022 dated 16 June 2022.

² Circular No. 18 of 2022 dated 13 September 2022

- Whether the above transaction could be regarded as benefit or perquisite and thereby section 194R of the IT Act is attracted?

- **Possible view**

- While Circular No. 12/2022 states that the sales discount/cash discounts/rebates allowed to customers constitute benefit and accordingly section 194R of the IT Act is attracted, the same are kept outside the purview of section 194R of the IT Act as it would put the seller through a difficulty. Thus, the Circular specifically excludes sales discounts/cash discounts/rebates outside the purview of section 194R of the IT Act.
- The term 'sales discount'/'cash discount'/'rebate' has not been defined in the IT Act and hence the support of dictionary meaning needs to be taken. Broadly, as per Oxford Learner's Dictionary, 'rebate' is an amount of money that is paid back because too much has been paid. Thus, on a plain reading, in the case of a rebate, the amount is first paid by one person and then another person returns a certain portion to the first person.
- In the instant case, the ARS is first required to make full payment (which could be less than the MRP but more than the amount paid by the dealer to the Company).
- Depending upon the quantum of products purchased by ARS, the Company will pay part of the price to the ARS – either directly or through the dealer. In other words, the rebate is a volume-based discount that is granted subject to ARS achieving the requisite turnover.
- Unlike cash discount/sale discount, the selling price is not reduced upfront, but the discount amount/rebate amount is credited into the bank account of ARS.
- The following para of Circular 12/2022 needs consideration:
no tax is required to be deducted under section 194R of the Act on sales discount, cash discount and rebates allowed to customers.
- In the instant case, ARS could be regarded as ultimate customers and dealers are more like an intermediary between ARS and the Company.
- The first discount offered to dealers (i.e. INR 45) could be termed as a sales discount and therefore outside the purview of section 194R of the IT Act.
- As far as INR 10 is concerned, the same could fall within the ambit of 'rebate' and therefore not covered by section 194R of the IT Act.
- Hence, one could contend that such a transaction should not attract section 194R of the IT Act.

- **Cross charge of common expenditure/overheads**

- In the case of a Business Group, it is a customary practice to share assets (e.g., office premises, employees, etc.) amongst its group entities to achieve economies of scale.
- The overhead cost is then cross-charged by one entity to another. Where employees of Company 1 are deputed to Company 2 and Company 2 reimburses the salary cost of these employees to Company 1, would it be regarded as a benefit extended by Company 1 to Company 2?

- **Possible view**

- One could contend that there is no benefit or perquisite provided by Company 1 to Company 2 on account of deputation for the following reasons:

- The salary cost of such employees is borne by Company 2
- The employees during their period of deputation work under the supervision and control of Company 2
- Company 1 is also not responsible for the performance of employees
- The whole arrangement passes the litmus commercial expediency for a variety of reasons, for example, availability of surplus resources or pool of employees with Company 1, stewardship/ fiduciary relationship of Company 1 and Company 2 in its capacity as a shareholder
- o Thus, it could be contended that no benefit or perquisite is resulting in this arrangement and therefore section 194R of the IT Act should not be attracted.
- o Support for this view could also be found in the second circular wherein it is stated that reimbursement to a pure agent shall not be liable for tax withholding under section 194R of the IT Act even though the invoice is in the name of the service provider.

Conclusion

While both the circulars have attempted to address the practical challenges faced by the taxpayer, they have resulted in additional queries which need to be addressed at the earliest. Some of the other issues (not captured in the above discussion) are:

- Applicability to rights shares/bonus shares issued by a private company. If yes, how to value them?
- Write off of loan by a private company (i.e., a non-specified entity). The hardship faced by a specified entity and a non-specified entity are alike, however, the relaxation is granted to only the specified entity
- Applicability to referral bonus granted by various gaming apps
- Painting at a dealer's shop or display of signboard in a dealer's shop highlighting a Company's brand
- Applicability in respect of trade liability written off i.e., bad debts written off

While the law on the subject will evolve over the next few years, there is a pressing need to address several practical and real-life challenges paid by taxpayers in the implementation of the law.

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Section 194R on Business Conferences – The Rocky Road Ahead

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Businesses rely on their network to be successful. When it comes to being an entrepreneur, it's not always about what the entrepreneur knows, it's also about who the entrepreneur knows. It doesn't matter how new or experienced an entrepreneur is, or how big or small the business is, aspects such as networking and the efficient management of contacts are essential tools for them to evolve in today's modern business world and help take the business to the next level.

In current scenarios, it can be difficult to make those connections, but conferences are one way of saying hello to potential business partners and even shaking hand on new deals. Therefore, conferences are important, specialized professional events to help grow businesses through connecting with industry peers, as well as potential and current customers.

The concept of corporate event encompasses company dinners, meetings, conferences, symposiums and even recreational activities for employees. Read in light of the newly introduced section 194R, questions arise whether conducting such business conferences can have implications on the companies organizing such events?

Introduction to section 194R

Section 194R of the Income-tax Act, 1961 ('the Act') has been recently introduced by the Government of India vide Finance Act 2022. This new provision casts an obligation on the person responsible for providing any benefit or perquisite to a resident, arising from the business or exercise of profession by such resident, to deduct tax at source. The tax is to be deducted at source at a rate of 10% on the value or aggregate value of such benefits or perquisites exceeding the threshold of INR 20,000 in a financial year.

The intention of this section is to expand the scope of deducting tax on benefits or perquisites and to increase transparency in the reporting of benefits and perquisites received by an individual. Even though the taxability of benefit or perquisite is taxable in the hands of the recipient, the Government observed that in many cases recipient failed to report receipt of such benefit of perquisite in their return of income. Accordingly, now section 194R puts an obligation on the payee to deduct tax on the provision of benefit/perquisite, whether in cash or kind, arising out of business/profession of the recipients.

What is benefit or perquisite?

Interestingly, the terms 'benefit' and 'perquisite' are not defined under any provisions of the Act in the given context. Thus, the meaning of these two terms is to be derived from general parlance or from various jurisprudence available on this subject. Dictionary meanings of the term 'benefit' suggests that it refers to an irretrievable advantage or a privilege given by one person to another. It means an advantage,

profit, gain, interest, use, whatever contributes to promote prosperity or add value to the property. Similarly, the term ‘perquisite’ means a privilege or benefit given in addition to one’s salary or regular wages; or something which arises by reason of a personal advantage. ‘Perquisite’ is said to be allowed when the recipient has a vested right therein, without any contingency.

In view of the above discussion, can one say that the provisions of section 194R of the Act will have implications on the companies conducting such business conferences?

Recent circulars on the matter

Central Board of Direct Taxes (‘CBDT’) has clarified the expenditure pertaining to dealer/business conference would not be considered as benefit/perquisite for the purposes of section 194R in a case where dealer/business conferences are held with the prime object to educate dealers/customers about new product, sales techniques, answer their queries etc. CBDT vide its recently issued circular (no. 18/2022) has further clarified that it is not necessary that all the dealers are invited in a dealer/business conference for the expenses to be not considered as benefit/perquisite for the purpose of Section 194R of the Act.

However, if the conference has been conducted to grant certain benefits/perquisites to select dealers/customers who have achieved particular targets, the same could attract provisions of section 194R of the Act (subject to satisfaction of other conditions).

How should one read the phrase “expenditure pertaining to”? Will any gifts distributed in such dealer/business conferences can be said to be expenditure pertaining to such conferences is an open question. The tax authorities may take a view that the expenditure that are absolutely necessary for the conducting such educational conference can be covered under the exclusion provided by the CBDT. If such a view is taken by the tax authorities, the businesses will be required to evaluate which expenditure can be said to be absolutely necessary for conducting such educational conference.

Further, the CBDT listed down following examples where expenses incurred on the dealer/business conference (conducted with the prime objective to educate dealers/customers) would be considered as benefit/perquisite:

- Expense attributable to leisure trip or leisure component, even if it is incidental to dealer/business conference
- Expense incurred for family members accompanying the person attending dealer/business conference
- Expenditure on participants of dealer/business conference for days which are on account of prior stay or overstay beyond the dates of such conference

Now, the term “leisure component” yet again has not been defined under the Act and there are no significant court decisions on the matter as well. The dictionary meaning of the term ‘leisure’ means ‘the time when you are free from work or other duties and can relax’ or ‘free, unoccupied time during which a person may indulge in rest, recreation, etc.’

Given that there is lack of clarity with respect to the usage of term “leisure component” in the CBDT Circular, the tax authorities may contest that anything provided to participants which is not entirely for the usage and consumption in the conference and holds significant value (i.e. value of more than INR

20,000 as prescribed under section 194R of the Act) could fall under the scope of “leisure component” and might invite applicability of section 194R.

Another aspect which may cause further practical difficulties is determining the person to whom the benefit/benefit is provided. The conference costs could be bulk costs and allocation of the same to specific attendees will also be challenging. In this regard, the CBDT in its recent circular has clarified that if benefit/perquisite is provided in group activity whereby it is difficult to match the benefit/perquisite to each participant using a reasonable allocation key, the provider of such benefit/perquisite (at his option) may not claim such expense as deductible expenditure in his computation of total income. This is a helpful option given to manage the practical challenges. However, it does seem unreasonable that legitimate business expenses incurred by a business should be disallowed because there are practical challenges in identifying who the beneficiary is.

Binding nature of the circular

It is also relevant to discuss if Taxpayers have a choice to follow the circular or can take a different view. The Hon’ble Supreme Court¹ examined the effect of the circulars which are in force and are issued by the CBDT in exercise of the power vested in it under section 119 of the Act. Circulars can be issued to explain or tone down the rigors of law and to ensure fair enforcement of its provisions. These circulars have the force of law and are binding on the income tax authorities. It is also well settled that such circulars can bind the Income Tax Officer but will not bind the appellate authority or the Tribunal or the court or even the taxpayer.

However, unlike instructions issued by CBDT under section 119 of the Act, as per section 194R(3) of the Act, the guidelines read with the Circulars issued by CBDT are binding on any person providing benefits or perquisites as referred to in section 194R of the Act. While circulars issued by CBDT per se are not law in its entirety, it may be advisable to follow the guidelines and comply keeping in mind the expenditure and hardship that could be caused due to non-compliances.

Though, one aspect relevant to note is that section 194R(2), which gives powers to the CBDT to issue such circulars gives such this power only to remove a difficulty in giving effect to the provisions of section 194R. Therefore, a fundamental question that will need to be answered if the clarifications issued are indeed falling within this framework. For instance, the option of disallowing expenditure in cases where the beneficiary cannot be determined could impinge on legitimate claim to expenditure, and hence can such a claim be denied to address a practical issue.

Open issues

Having said the above, the following points may require further clarification by CBDT-

- How to identify whether an expenditure is absolutely necessary for conducting educational conferences?
- What should be the treatment of cost of lunch/dinner offered to the attendees of educational conferences?
- Treatment of freebies/goodies, souvenirs, free company products etc., distributed during conferences

¹ Catholic Syrian Bank Ltd. v/s. CIT 2012(3) SCC 784

- Position on expenses incurred in relation to conferences organized specifically for customers/dealers meeting their sales targets, when such conferences are conducted to educate the limited set of people
- What is meant by “leisure trip” or “leisure component”. The issues such as whether conducting a conference in a hotel or in a different city/country shall qualify as “leisure trip”; or whether the lunch organized during an event shall fall under the ambit of “leisure component” are yet to be addressed.
- Whether an expenditure incurred for inviting eminent speakers/celebrity to take seminars can attract section 194R provisions?
- Can the circulars take away the right of a taxpayer to claim legitimate business expenditure?

Considering the current state of issues and challenges arising from the provisions of section 194R of the Act, disputes could arise and further burden the already overburdened judiciary. Accordingly, the government could come out with another set of clarifications to address the pending issues else different taxpayers may end up adopting a different approach while deducting TDS under section 194R of the Act.

Lastly, a detailed analysis of the business model & transactions in relation to conducting such conferences should be undertaken by the businesses to determine what constitutes ‘benefit’ or ‘perquisite’ and whether the same is arising from business or profession of the recipients to understand the liability to deduct TDS under section 194R of the Act. Thus, where a taxpayer decides to not deduct taxes u/s 194R of the Act, he is very likely to encounter long lasting litigation as well as interest cost and penalty proceedings.

Section 194R-TDS on Benefits and Perquisites

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In the Finance Act 2022, a new TDS Section 194R, has been inserted in the Income Tax Act. The newly inserted section has introduced a withholding tax on the benefits and perquisites arising in course of business or profession which will be applicable from 1st July 2022.

According to Section 194R a person who makes payment wholly in cash or in kind or partly in cash and partly in kind any benefit or perquisite valued more than Rs.20,000/- in any financial year to any resident person during the course of business or professional transactions will be liable to pay the tax. Payment of benefit to Non-resident is not taxable under this provision.

This tax will be levied on any person including non-residents with the exception of Individuals or Hindu undivided family whose total sales, gross receipts or turnover is less than or equal to ₹1 Crore (Business) or ₹50 Lakhs (Profession).

Tax Rate Payable:

The tax will amount to 10% of the benefit or perquisite provided and shall be deducted before paying or providing such benefit to the person concerned.

Reason for introduction of section 194R:

As per clause(iv)of section 28 of the Income Tax Act the value of any benefit or perquisite whether convertible into money or not arising from business or exercise of profession is to be charged as business income in the hands of the recipient of such benefit or perquisite. However, in many cases such recipient does not report the receipt of benefits in the return of their income. Accordingly in order to widen and deepen the tax base it was proposed to insert a new section 194 R to the Act to provide that the person responsible for providing to a resident, any benefit or perquisite whether convertible to money or not arising from carrying out of a business or exercising profession by such resident, shall, before providing such benefit or perquisite as the case may be to such resident ensure that tax has been deducted in respect of such benefits or perquisite at the rate of ten percent of the value or aggregate of value of such benefit or perquisite. For the purpose of this section, the expression 'person responsible for providing' has been proposed to mean a person providing such benefit or perquisite or in case of a company, the company itself including the principal officer thereof.

Instances of benefits or perquisites:

1. Incentive to buyers in the form of Car, Computer, Gold Coin etc.
2. Sponsorship of trip of the recipient and his family
3. Free tickets to an event.
4. Free accommodation and Meals.
5. Free medicine samples to a doctors.

6. Free products to influencers.
7. Amount paid to professional for lodging/food/ticket.

Clarifications issued by CBDT under Circular No.12/2022 dated 16th June 2022 and Circular No.18/2022 dated 13th September 2022.

- Regarding requirement to check if amount is taxable u/s 28(iv) before deduction under the act it was clarified that the payer is only obliged to deduct TDS u/s 194R but is not required to check the taxability or the section under which it may be taxable in the hands of payee/recipient
- In case of nature of benefit, it was clarified that the benefit can be in any form, be it cash, kind or even partly in kind and partly in cash.
- Regarding benefit being capital asset, it was clarified that TDS u/s 194R needs to be deducted irrespective of the nature of the benefit or perquisite or whether. In any case the payer is not required to check if the benefit or perquisite is taxable in the hands of recipient but in the case of one-time loan settlement with borrowers or waiver of loan granted on reaching settlement with the borrowers the bank would not be required to deduct tax at source under section 194R.
- Applicability of 194R in cases of discount on price, either through price adjustment or through increased quantity has been specifically excluded with exception to situations where discount is through free samples or goods. The tax has to be withheld in name of entity and not an individual receiving such benefit.
- Valuation of the benefit/perquisite was clarified to be based on the Fair Market Value (FMV) except in the cases where-
 - The benefit/perquisite provider has purchased the benefit/perquisite before providing it to the recipient. In that case the purchase price shall be the value for such benefit/perquisite
 - The benefit/perquisite provider manufactures such items given as benefit/perquisite, then the price that it charges to its customers for such items shall be the value for such benefit/perquisite.
- In case of reimbursement of out-of-pocket expense, it will be a benefit/perquisite where the liability towards an expenditure is met by the person other than the person carrying out a business/profession.
- For example, a consultant is rendering services to a company wherein such consultant incurs boarding and lodging expenses and –
 - Where the invoice for such expense is in the name of a company, though paid by the consultant and reimbursed by company – It shall NOT be a benefit/perquisite and no TDS is required to be deducted u/s 194R.
 - Where the invoice is not in the name of company and payment made by a company directly/reimbursed to consultant –It shall be construed as a benefit/perquisite for the purpose of Section 194R.

Further it has been clarified in the case of out of pocket expenses –

- where the conditions for being a 'Pure agent' are satisfied and the amount incurred by him for which he is reimbursed by the recipient would not be treated as a benefit/perquisite for the purpose of section 194R of the Act.
- where taxes have already been deducted under the other provisions of the Act, the provision of sec.194R shall not apply.
- Regarding dealer conferences held to educate dealers about the products/services should be construed as benefit/perquisite or not, it has been clarified that-
 - Where the prime objective is to educate the dealers about the products of the company, the same shall NOT be construed as benefit/perquisite
 - However, any form of incentives provided to select dealers will be a perquisite/benefit. If the expenditure incurred is not possible to be allocated to specified dealers for 194R provisions, then such expenditure to be disallowed Suo-moto from computation of profits.
 - Over stay prior to the dates of conference or beyond the dates of such conference would be considered as benefit/perquisite for the purposes of section 194R of the Act. However, a day immediately prior to actual start date of conference and a day immediately following the actual end date of conference would not be considered as over stay.
- Compliances to be adhered to wherein benefit/perquisite is in kind or partly in kind and partly cash, however cash component is not sufficient to meet the TDS
 - Payer is responsible to ensure that TDS is deposited before release of the benefit/perquisite.
 - Recipient of asset shall be eligible to claim depreciation once such asset has been offered to tax as his income on fulfilment of other conditions of claiming depreciation as provided under the Act.
 - Reliance can be put on a declaration and advance tax payment challan provided by the payee.
 - Reporting in the TDS return i.e., Form 26Q along with challan details
 - Gross up option also available to the Payee.
- Provisions of sec. 194R shall not apply to benefit/perquisite provided by an organization in scope of The United Nations (Privileges and Immunity Act) 1947, an international organization whose income is exempt under specific Act of Parliament (such as the Asian Development Bank Act 1966), an embassy, a High Commission, legation, commission, consulate and the trade representation of a foreign state.
- Issuance of bonus/right shares by the company shall not be subject to 194R provisions.

Global Emerging Trends: Environmental Taxes and their Impact on Indian Businesses

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Businesses worldwide have always focused on increasing profits and maximising shareholder returns, resulting in them often overlooking their role in the excessive environmental degradation. As the world becomes aware of the environmental and climate risks, stakeholder expectations from businesses are undergoing a rapid change. Corporates are trying to develop new ways of doing business while emphasizing on environmental aspects. Thus, to continue to thrive and be a responsible organisation in the evolving world, it is crucial to develop an approach that factors in the wider demands of people, the planet and the environment.

Environmental, Social and Governance (ESG) is no longer a ‘good-to-have’ discussion. Despite being a non-financial aspect, it has become a major talking point across boardroom conversations. Many companies are gradually developing robust ESG strategies. The rapid pace of ecological damage has become a challenge for governments globally and hence, compelling them to project plans to diminish environmental deterioration while minimising the impact on economic progress. Environmental taxes and green tax incentives under direct and/or indirect tax laws, carbon credits, Emission Trading Systems (ETS) framework are some initiatives towards creating decarbonised economies and favourable conditions for sustainable development. Issue of environmental taxes is important for developing and emerging economies. In this regard, the UN has recently published a Handbook on Carbon Taxation with an aim to guide developing economies in introducing and implementing such taxes.

This article discusses the global move towards environmental taxes, the broad approach followed by India till now and the impact on Indian businesses.

Defining environment taxes

Environmental tax is a tax whose base is a physical unit (or a proxy of it) that has a proven specific negative impact on the environment. The taxes are usually levied on energy, transport, pollution and resources. They present disincentives to polluters, forcing them to reduce emissions and seek out cleaner alternatives. Taxes place a direct cost on environmental damage and become a stepping stone for consumers and businesses to assess their behaviour and discover alternative and economical ways to reduce any activities that are harmful to the environment.

Global development on environmental taxes

Countries and companies worldwide have entered into the race for net zero¹ and are identifying opportunities to undo decades of environmental damage.

¹ net zero refers to the balance between the amount of greenhouse gas produced and the amount removed from the atmosphere.

- China, is the world's largest carbon dioxide (CO₂) emitting country and has launched the world's largest carbon market in 2021. It has a goal of reaching net-zero emissions by 2060.
- Despite being one of the world's biggest CO₂ emitters, the US currently doesn't levy a carbon tax at a national level. But several states have introduced carbon pricing schemes that cover emissions within their territory. The US has pledged to cut emissions by 50% by 2030 and achieve net-zero by 2050.
- India's contribution to global CO₂ emissions is roughly 7%, making it the third highest in the world. It does not have an explicit carbon tax but has taxes on major fuels like petrol, diesel and on coal either imported or domestically produced. It has a goal of reaching net-zero emissions by 2070.

Other global initiatives towards sustainability

A. Government initiatives

- The European Commission has taken an initiative and proposed a levy of Carbon Border Adjustment Mechanism (CBAM), which aims to ensure equivalent carbon pricing between imports and domestic products. The levy will be calculated in terms of greenhouse gas emissions embedded in cement, electricity, fertilisers, iron and steel, and aluminium, as imported into the EU Customs Union.

Levy of CBAM may impact the pricing of goods exported to the EU by Indian exporters. Hence, due to the financial and administrative burden imposed by the CBAM, Indian goods may become less competitive in the EU market. On the flipside, this may act as a stimulator to Indian companies exporting their goods to the EU to become greener.

- Plastic Tax: The UK has implemented tax on plastic packaging manufactured in or imported into the UK.

B. Corporate initiatives

- Google aims to operate and run 24X7 on carbon-free energy by 2030.
- CBRE, an American commercial real estate service and investment firm, has launched the Green Machine Campaign with a mission to plant 10 million trees.
- PwC has made a worldwide science-based commitment to achieve net zero greenhouse gas emissions by 2030.

The Indian landscape

• Taxes imposed by the Government of India (GoI)

India has levied various environmental taxes for a number of years, predominantly on goods that give rise to environmental pollutants, including fossil fuels. Some examples include

- ✓ Basic Excise Duty applies to specified oil and gaseous products
- ✓ Special Additional Excise Duty and Additional Excise Duty (Road and Infrastructure Cess) additionally apply to gasoline and diesel fuel
- ✓ Clean Environment Cess applies to coal, lignite and peat consumption

- ✓ Waste tax: GST on Waste, parings and scrap, of plastics
- ✓ Forest development tax is levied on the forest produce disposed by the Forest Department
- ✓ Green taxes² encourage people not to harm the environment or help pay for goods that are beneficial for the environment.
- ✓ GST compensation cess on coal production was introduced after the clean energy cess was abolished in July 2017.

These taxes aim to lower the environmental impact in a cost-effective manner and through encouraging behavioural changes.

- **Green tax incentives initiated by the GoI to stimulate innovation and new technology**

In addition to encouraging the adoption of known pollution-abatement measures, environmental taxes or tax-based incentives can also promote innovation, as stakeholders seek new, cleaner solutions. India has continuously offered incentives/deductions to motivate innovators to develop environmental-friendly technologies and products. Many of such initiatives include:

- ✓ Accelerated depreciation to
 - power generator or distributor on certain energy-saving devices
 - renewable energy devices
 - water supply project/water treatment systems
 - certain solid waste control equipment
 - certain air pollution control equipment
- ✓ Tax holiday for
 - certain businesses (engaged in renewable power generation /distribution)
 - certain businesses (engaged in water supply project/ water treatment system and irrigation project)
 - undertakings related to sanitation and sewage system or solid waste management
- ✓ Certain exemptions and reduced rate of custom duty/VAT, specifically relating to import of renewable energy equipment.
- ✓ Weighted deduction for innovative companies doing R&D (engaged in business of biotechnology)
- ✓ Deduction on capital expenses incurred on scientific research for new infrastructure facility (includes solid waste management system etc.)
- ✓ Generation-based incentive for wind electricity producers
- ✓ Deduction of interest to consumers on loan for purchasing electric vehicles
- ✓ Financial support for costs related to grid-connected rooftop solar and small solar power plants
- ✓ Concessional Excise duties on items like biogas lights, goods for substitution of ozone-depleting substances (ODS)
- ✓ Custom duty exemption on projects with non ODS technologies

² Green taxes are imposed by The Ministry of Road Transport and Highways on transport vehicles older than 8 years and on personal vehicles after 15 years.

- **Impact on Indian business**

Owing to the above initiatives taken by the Government, Indian organisations have also started working towards incorporating ESG parameters into their growth and investment strategies.

- **Green Initiatives by some Indian organisations**

- o Godrej Consumer Products Limited is now 100% Extended Producer Responsibility compliant. It takes back the post-consumer plastic packaging waste equivalent to the plastic packaging it sends out.
- o ITC currently utilises wind, solar and biomass energy. It also has a target of 50% reduction in specific emissions and 30% reduction in specific energy consumption by 2030 over its 2014-15 baseline.
- o Reliance Industries Ltd (RIL) is transferring its gasification assets to a wholly-owned unit, which will help it produce hydrogen to establish a hydrogen ecosystem.
- o Zomato has introduced 100% plastic neutral deliveries. Also, their initiative of 'no cutlery required' has encouraged consumers to exclude single-use plastic from orders.

- **Impetus to Innovation**

- o Mahindra & Mahindra Limited is all set to launch their new electric SUV.
- o Adani New Industries Ltd and Total Energies of France have entered into a new partnership to jointly create the world's largest green hydrogen ecosystem.
- o ACME Cleantech Solutions, a renewable energy company, has initiated a proposal to invest approximately USD 6,500 million in green hydrogen and ammonia plant, along with an associated solar power unit.

All of these indicate that companies are increasingly viewing their tax strategy through an ESG lens.

Reporting frameworks on tax

Through the introduction of disclosure requirements, a mechanism for reporting and transparency on taxes is being developed. Some frameworks are:

A. Global framework

- The Global Reporting Initiative (GRI) framework³ is the most widely used one for ESG reporting across the world and becoming a benchmark for evaluating sustainability reporting. GRI 207 is the first and only public global standard for comprehensive tax disclosures.
- International Business Council of the World Economic Forum countries has introduced Tax metrics including the Total Tax Contribution⁴ (TTC) metric, which requires reporting by member organisations.
- A form of public country-by-country reporting has been made mandatory as per a new EU directive for many businesses operating in the EU.

³ The Companies following GRI standards in their sustainability reporting are expected to follow the GRI standard if it is material, although adherence to the GRI is voluntary.

⁴ The total of all cash taxes and levies paid by a company to any level of government. Distinguishes between taxes which are a cost to the company when paid (taxes borne) and taxes which the company collects on behalf of governments (taxes collected).

- The UK has mandated the use of the Taskforce on Climate-related Financial Disclosures (TCFD) framework for climate-related disclosure requirements across the UK's economy.

B. Indian framework

- Currently, there are no mandatory disclosure requirements on tax in India. However, the SEBI has introduced an ESG reporting structure- Business Responsibility and Sustainability Report (BRSR), incorporating several KPIs of the international framework in an attempt to bring it on par with global ESG reporting trends. Under BRSR top 1000 listed entities by market capitalisation will provide holistic and granular-level information of a company's non-financial disclosures.
- Corporations such as TCS, Jubilant Pharmova Limited, Jindal Steel Limited and CII have been members of the GRI community for around a decade. As per 2020 sustainability reporting trends in South Asia, India has the maximum number of companies with sustainability reporting out of which 15%⁵ use the GRI framework as a reporting criteria.

The road ahead

There has been a significant change in the way governments and businesses are addressing climate change. Given the impact and increasing interest of shareholders in environmental taxes, it is likely that in the future, corporates may get compared using tax metrics. Most easily available tax metrics for comparison are cash effective tax rates, disputed tax liability to percentage of yearly profits and TTC.

However, it is not only the governments' and corporates' responsibility to address environmental issues. Implementing taxes, bringing in ETS, using renewable energy etc., are merely industrial initiatives and may not be sufficient to deal with the environmental catastrophe. A combination of thought and action is required to create sustained outcomes for brighter tomorrow. The step-by-step journey towards a greener future has already started and everyone needs to contribute.

⁵ Total number of publicly listed organizations on BSE is 5500 and sample size taken for research is 503 companies.

Green Tax – Life Jacket for the Environment in the Indian Context?

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Climate change – these two words have transpired from theory to reality very quickly in recent years with extreme weather patterns being experienced throughout the country. These changes highlight the need to imbibe and practice sustainable behaviour at a very fast pace. The Government has made some progress in this direction by trying to reduce the dependability on conventional energy sources and move towards renewable energy sources and green fuels. However, given the magnitude of the situation and complex mechanism, India's commitment to be net zero by 2070 looks ambitious and requires enhanced active measures to augment the desired outcome.

Globally, green tax or eco-tax is a concept that several jurisdictions have adopted for creating a pool of resources for green initiatives and creating a deterrent for polluting behaviour. The question is whether the existing levies in India for example cess on coal, green tax on renewal for old vehicles and pollution cess/ surcharge on tourists in hilly states in isolation are potent enough to discourage polluting behaviour and create a significant fund for green initiatives. It is in this context that the question of levying a comprehensive green tax on the Indian ecosystem requires significant deliberation. Apart from generating revenue for the government for funding green initiatives, the levy of green taxes could encourage the adoption of green technologies and business practices, thereby, helping the country achieve its objective of sustainable growth. The extensive groundwork required for sustainability technologies and new business processes/ practices could also open a huge potential for employment in the country. Green technologies require significant funds for development and may not be economically viable for businesses at large until such technologies reap the benefit of economies of scale. For a developing nation like India, funding technologies which can revolutionise sustainability efforts has been a challenge. In fact, it has always been a maze to find the right sources of revenue without increasing the pressure on inflation in the economy. In the current Indian context, it seems to be the right time to explore the possibility of introducing an evolved scheme of green tax in India.

To introduce green tax in a notable manner, the Government needs to clearly define its approach at the outset – whether the tax would be a blanket levy for all businesses (like GST) or only for polluters based on the 'polluter pays' principle. Probably, the latter makes a more compelling case for the Indian economy, however, such levies should be brought in with thresholds linked to the overall carbon footprint of the businesses. For example, the UK has imposed a mix of different levies such as the Plastic Packaging Tax on the manufacture or import of plastic packaging material, climate change levy on the supply of gas and electricity, the aggregate levy for exploitation of certain natural resources and several of these are linked to different thresholds. To begin with, the policymakers in India would need to put together a list of top polluting materials and industries and identify the point of levy for this tax in the supply chain. It would also be interesting to see the implementation framework for such levy i.e., whether it would be better placed under a central regime like GST in the form of cess (like compensation cess) or a standalone surcharge or cess, which would be monitored independently.

The green tax framework in India should also allow polluters to offset their carbon footprint by the purchase of carbon credits and hence, reduce the impact of the levy of green tax on their businesses. Such a framework would also encourage businesses with green technologies to monetise their carbon credits, thereby, subsidising the cost of green practices. This implies that the introduction of an effective green tax policy for polluting industries also requires the presence of dynamic carbon markets in India. To ensure the seamless functioning of carbon markets in India, issues related to carbon credits such as the GST treatment on domestic trading or exports of carbon credits, regulatory approvals and audits, would also need to be well thought through by the policymakers.

Furthermore, the government would need to evaluate the challenges associated with the introduction of green taxes such as the impact on inflation (which could possibly dent economic growth) or the possibility to place Indian players at a disadvantage as compared to their counterparts in other jurisdictions across the globe where such levies may not exist.

In order to make the levy of such green tax effective, mandates for reporting of green taxes as part of the statutory disclosures like filings with the Ministry of Corporate Affairs or a specific mention in the statutory books of accounts could also be considered to ensure better compliance and governance by corporates. This would not only help in highlighting the green taxes being borne by the company but also help in achieving better disclosures as expected through mechanisms like Business Responsibility and Sustainability Reporting (BRSR) which have been introduced by SEBI for the top 1000 listed entities in India. In effect, such statutory disclosures regarding green taxes could force businesses to adopt green technologies for gaining investor confidence, demonstrating a sense of responsibility towards the society and also making businesses more profitable by reducing the impact of green taxes. Several jurisdictions across the globe have adopted measures to mandate businesses to make certain declarations around their tax policy and tax pay-outs to ensure higher levels of corporate governance.

While the levy of green taxes may seem to be an interesting proposition, such taxes alone may not be the answer to the climate situation we are facing today. At a policy level, other aspects such as incentivising green behaviour by way of concessional taxes (like a lower rate of GST on electric vehicles) or other subsidies for businesses introducing substantial green technologies (like incentives in certain states for green investments) should be factored in by the Government. Additionally, with the expected shift of the industry to green technologies in the coming years, the quantum of green taxes collected by the Government would eventually decline forcing the Government to look for new avenues for funding green initiatives. Hence, the Government's approach with respect to green taxes must be multi-pronged addressing various dimensions which may be of concern in the medium to long term. At the same time, businesses would need to be much more proactive in this area and channelise their energies on embracing green behaviour. India has a long way to go in meeting its net zero commitment and strategies in this direction would need to continuously evolve with the change in business practices.

Multilateral Instrument – Practical Considerations

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Background

- With the advent of technology, the extant tax laws are becoming redundant to tax new age companies. Resultantly, the gap in taxing cross border transactions is increasing further and resulting into Base Erosion and Profit Shifting (BEPS). With a view to address BEPS challenges, the OECD and G20 members formulated 15 Action Plans.
- To give effect to these Action Plan, changes in Double Tax Avoidance Agreement (DTAA) is required. Traditionally, changes in DTAA require deliberation and renegotiation between two countries. With so many DTAA in place, amending every DTAA would be next to impossible. To address the practical challenges, OECD provided for Multilateral Instrument (MLI) (i.e., Action Plan 15).
- MLI allows governments to modify the application of their own network of DTAA in a synchronised manner to incorporate the agreed anti-avoidance provisions originating from the BEPS Actions without renegotiating each of these DTAA bilaterally. MLI will modify all the Covered Tax Agreements (CTA) i.e., DTAA notified in the MLI document. Both MLI and DTAA will operate simultaneously.
- In this article, efforts are made to bring out some of the practical considerations of MLI implementation.

Impact on Capital Gains

- Article 9 of the MLI brings in anti-avoidance measures relating to capital gains earned from sale of shares or interest of entities deriving their value principally from immovable property. The subject Article is modelled after Article 13(4) of the OECD Model Tax Convention as modified by Action 6 of the BEPS Action Plan.
- Article 13(4) of the OECD Model Tax Convention provides that capital gains arising from alienation of shares which derive their value principally from immovable property may be taxed in the country in which the immovable property is located.
- A view was taken that the threshold limit was to be evaluated only on the date of share transfer and thereby, the taxpayers could arrange/rearrange their affairs in such a manner that the immovable property trigger was not satisfied on the date of transfer.
- The provisions of Article 9 of the MLI seeks to plug these loopholes by providing that Article 13(4) of the OECD should apply to situations where shares/comparable interests derive their value substantially from immovable property at any time during a defined period (i.e., 365 days preceding the date of sale) as against the time of sale of shares.

- Further, Article 9 seeks to expand the scope and applicability of Article 13(4) by bringing within its ambit other participation rights and comparable interests such as interests in a partnership or trust.
- Some of the practical difficulties arising from Article 9 of MLI is summarised hereunder:
 - ◆ Article 9 of the MLI does not deal with minimum standards. Thereby, most of the countries either reserve Article 9 partially or entirely thereby defeating the objective of the said Article.
 - ◆ The testing period provided by Article 9 to meet the threshold of 50% of value of immovable property is anytime during the 365 days preceding the date of transfer. The said test gets impractical to be applied where the share/interest derives value across multiple jurisdictions, the assets/its value could be dynamic in nature and availability of the financial information for the 365-days period.
 - ◆ The proportion of income taxed in a jurisdiction gets complex to be computed where more than two countries get the taxing right on account of the 365 days testing period since the value of assets will be different on the date of transfer.

Impact on Dividend

- Finance Act, 2020 abolished the dividend distribution tax. With this, dividend from Indian Companies is taxed in the shareholders' hands. Non-resident shareholders can avail the beneficial DTAA rates.
- Article 8 of MLI provides that the DTAA rate shall be available only if the following conditions are fulfilled:
 - The shareholder is the beneficial owner
 - Such beneficial ownership is held throughout a 365-days period that includes day of the payment of dividend
 - ◆ The above-mentioned conditions will be applicable to all the CTAs unless such condition is already embedded in the DTAA.
 - ◆ Thus, the taxpayer can claim the DTAA benefit only if he was holding shares beneficially throughout the period of 365 days. The Indian company, while withholding the tax should maintain appropriate documents to satisfy itself that the condition laid down by Article 8 of MLI is met.

Impact on the Most Favoured Nation (MFN) Clause

- Some of the DTAA's executed by India contain the MFN Clause. As per this Clause, where after signing DTAA, India or the first mentioned country (say X) enters a DTAA with another OECD member country (say Y) which is more beneficial (either scope or tax rate), such beneficial scope or rate shall be extended to India's DTAA with X.
- With MLI in place, application of MFN will be a challenge. To gain a better understanding of this issue, reference may be made char below:

Particulars	India	XYZ	PQR (whose benefit is proposed to be incorporated in India-XYZ DTAA)
MLI signed and ratified	Yes	Yes	Yes
	Yes	Yes	No
	Yes	No	Yes
	Yes	No	No

As per India-XYZ DTAA, the dividends are taxed at 10% in India. However, as per the India-PQR DTAA, the dividend is either exempt in India or is taxed at 5%. In either case, India-XYZ DTAA or India-PQR DTAA, there are no specific conditions mentioned. However, considering MLI, there is a requirement of holding beneficial interest for throughout the 365-days period. Applying the MFN clause to take the benefit of India-PQR DTAA could result into following challenges:

- Whether MLI will apply when either XYZ or PQR are not signatory to MLI?
- Where XYZ is signatory to MLI and has notified its DTAA with India as CTA, can the taxpayer take recourse to India's DTAA with PQR? If yes, can the taxpayer contend that since PQR is either not a signatory to MLI or has not notified its DTAA with India as CTA, the condition laid down by MLI should not be applicable to its transaction. In other words, can the taxpayer take recourse to MLI and contend that the restriction imposed by MLI be not applicable.
- Where PQR is signatory to MLI and has notified its DTAA with India as CTA but XYZ is not party to MLI/ not notified its DTAA with India as CTA, will the condition specified in MLI (which is more stringent than the one stated in India-XYZ DTAA due to MLI) be applicable and thereby the taxpayer would not be able to claim the concessional tax rate/ concessional scope? Or can a taxpayer contend that the reference is only with respect to scope and not to the conditions imposed by MLI?

Conclusion

MLI has changed the way DTAA's were read. Taxpayers now need to be aware about the additional conditions imposed by MLI before taking/ granting the benefit of DTAA. While checking the MLI provision, the taxpayer also needs to check whether the other country has notified its DTAA with India as CTA or not. If not, then the MLI provisions will not apply even though India has mentioned its DTAA with that Country to be CTA.

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Planning IPO – Why ESG Should be on Your Checklist?

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Global IPO market has grown stronger over the last few years. It's a milestone for a company to go public and showcase transparency and larger purpose of bringing value to stakeholders. However, with the outbreak of COVID-19 resulting in market volatility, the world has observed a radical shift in investing patterns. It was seen that Environment, Social & Governance (ESG) compliant companies performed better and were much more resilient during the stressful market period. This has resulted in investors taking more responsible decisions and focus on value driven investments, leading to decrease in their risk appetite.

The rise in sustainability awareness among investors has reflected in companies adopting and implementing sustainable strategy in their business models. Integrating ESG policies into business models reflects long-term prospects of a company, improved market reputation, robust competitiveness, outperforming their competitors financially, resulting in transforming entire value chain and ecosystem. Further, customers also expect companies to contribute towards the betterment of environment and society and prefer brands which align with their belief systems.

Companies envisioning IPO need to plan to walk the path and declare their commitment to ESG early at Pre- IPO stage to boost credibility and visibility. Thus, voluntary ESG communication/ disclosures at Pre- IPO stage is a key factor for a successful capital market debut. The early stage of ESG insight and measurement benefits IPO valuation and financial performance. This includes own ESG assessment which enhances transparency level, attraction of responsible investor's interest including that of investment funds as investors perceives ESG compliant companies less risky. Further, higher transparency towards its stakeholders reduces the asymmetric information demonstrating the company more trustworthy.

The three ESG metrics- environmental, social and governance, quantify company's impact on the environment, society, and the responsibility towards its employees and the company's outlook towards its governance. To uncomplicated the ESG evaluation process for investors, rating institutions have established the concept of ESG rating/ score.

ESG score demonstrates company's inclination towards mainstreaming ESG, which has become one of the most critical factors for stakeholders, especially at pre-IPO stage. Companies with strong ESG scores have great competitive edge which enables them to generate returns beyond normal. Resultantly, investors would not demand higher compensation in return and the IPO would not be under-priced, when compared to a non-ESG compliant company. It is observed that ESG rating will soon become mandatory just as credit ratings for companies looking to raise capital.

During the book-building process, underwriter attempts to determine the price at which an IPO will be offered. Further, in the process of an IPO, institutional investors are commonly involved and are often considered as well-informed investors. Furthermore, the underwriter needs to create incentives for the institutional investor to reveal what price they are willing to pay to facilitate the process of correctly pricing the IPO shares.

Venture capitalists and private equity investors have increased their requirements to conduct due diligence and incorporate ESG aspects while evaluating prospective investments as ESG integrated funds remain relatively safeguarded. They want to know at early stage whether the company carries any sustainability risks that could negatively impact the value of the company. Largest investors worldwide are allocating capital to companies that are well equipped to benefit from the transition to a green & sustainable economy and are willing to protect their portfolios against downside ESG risks.

As part of Pre- IPO research and ESG assessment, companies should reassess existing models with objective of understanding its degree of sustainability, evaluate their performance in all material ESG aspects, devise strategy which is driven from top management, connected to company's purpose that create and capture long term competitive advantage.

Looking Ahead

A company's ability to create positive environmental and societal impact, is rapidly reshaping competitive advantage and companies must simultaneously integrate an ESG aspects into every component of the business to capture the value from this transformation.

To tap maximum responsible investors, companies need to broaden their outlook to consider ESG more than just compliance. For companies planning IPO, ESG is 'pre-financial' information rather than a 'non-financial' information and act as a listed company before going public.

Equity Compensation by Start-ups!

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Introduction

Entrepreneurship has taken centre stage in India and this culture does not stop at well placed employees setting up a start-up, it has also percolated to employees shunning secured jobs in established companies for taking up more exciting and risky opportunities in start-ups.

Multiple people play a role in a start-up's journey from being a bootstrapped venture to becoming a Unicorn. This value discovery exercise is a result of endeavours of employees and consultants as much as the founders.

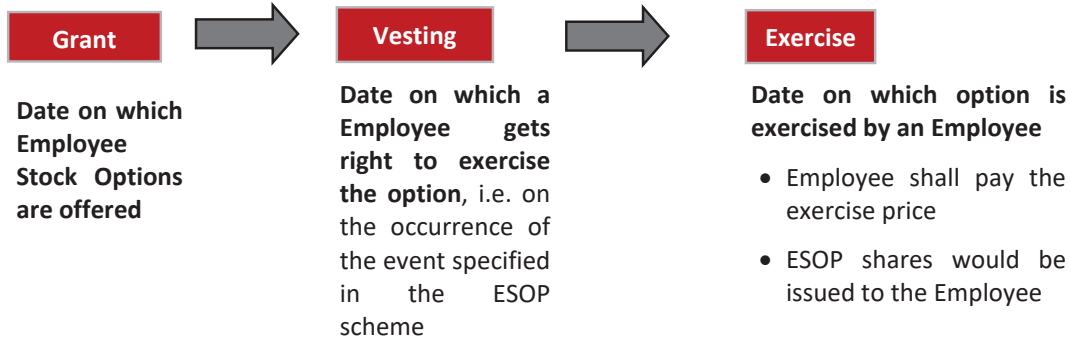
Start-ups wherein monetary resource are scarce, resort to equity compensation as a means of reward mechanism which also serves the purpose of aligning everyone's interest towards growth trajectory of the company. Equity compensations go a long way to showcase that its people would get a share of the pie on the start-ups growth journey during a liquidity event (listing, stake sale, etc). Further, equity compensation also proves helpful for start-ups as the same help preserve cash and manage the tax outlay for such personnel. The right mix of in-hand salary coupled with equity compensation is used by start-ups to attract, motivate, and retain the required resource pool over a longer period of time.

Equity compensation can be facilitated in various forms,

- Employee Stock Options (ESOPs),
- Employee Stock Purchase Plan(ESPP),
- Stock Appreciation Rights(SAR),
- Restricted Stock Unit(RSU),
- Sweaty equity
- Management Stock Option Plans(MSOPs).

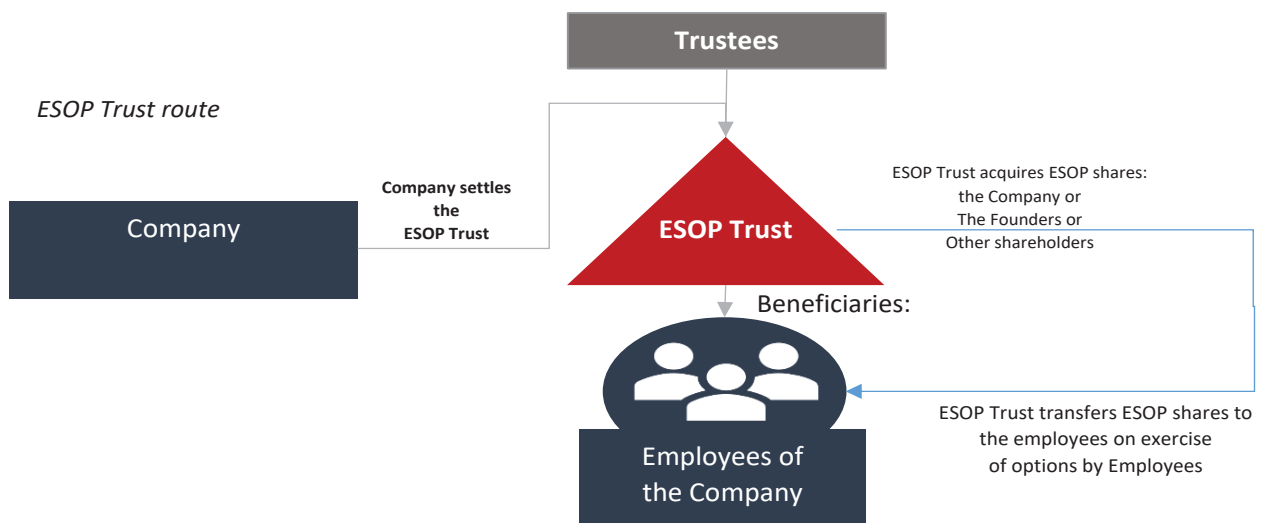
Generically an equity settled plan can be referred as an ESOP which entails creation of ESOP Policy, implementation thereof after obtaining the requisite board's and shareholder's approval, granting the options(by issuing grant letters), vesting for eligibility to acquire underlying shares, actual exercise of the option and resultant allotment of shares. Upon allotment of shares, the holders might choose to hold on to the shares for further upside or transfer for monetisation.

Journey of ESOPS



Structuring an ESOP

ESOP modality involve taking various decisions with respect to the overall scheme including, inter-alia, trust routes, vis-à-vis, direct route, fresh issue or ESOP pool, pool size, intended coverage of the scheme, discount factor, valuations. Each such aspect entails various considerations (people decisions as well as tax and legal structuring decisions come into play) which need to be borne in mind.



Each route may have its own sets of challenges and implications which needs to be factored in while structuring the plan. For instance, the Trust route might be preferred for creating a pool of shares for employees but the same might entail undue challenges and procedural compliances towards dealing with the stock at liquidity event, setting up trust, holding PAN, tax implications, funding, et al. Under the simpliciter direct route, the company grants the option to the employees and fresh equity gets issued to the employees upon exercise.

Select regulatory framework

It would also be pertinent to highlight that the benefit in through ESOP can only be extended to eligible employees which have been spelt out in Rules to Companies Act, 2013 and the same specifically exclude the promoters (founders) and directors, holding more than 10% of the capital of the Company.

A specific relaxation from the above limitation has been afforded only to eligible start-ups (being Start-up Company recognized by the Department for Promotion of Industry and Internal Trade (DPIIT)) which are exempted from participation restrictions for a 10 year period from their incorporation or registration with the DPIIT.

The aforesaid relaxation brings respite only for eligible start-ups which are very small sample out of the overall start-up space: 565,076 (Startup India Hub) out of which only 71,304 start-ups have been granted DPIIT recognition till date. The Income-tax Act, 1961 also subsumes some relaxations for the eligible start-ups, however, the income-tax recognitions have been so parsimonious (mere 448 start-ups¹ have been recognised) that it's futile to discuss the income-tax relaxations for start-ups.

The taxability event in case of ESOP, is the actual exercise date and not the grant date. To reiterate, the actual taxability arises to the employee on the benefit derived in the form of getting the share of the company at a discounted price, upon issuance of shares pursuant to exercise of the option.

Monetising ESOP

Such benefit can only be derived by the employees through monetisation of the shares allotted to them through the ESOP. However, in the case of start-ups, the underlying shares are often illiquid and thus taxing the employees in such a scenario can lead to undue hardship in the form of an unfunded tax liability (that too at the normal applicable slab rates). For liquidity creation in such cases, the ESOP shares are often simultaneously bought out by the Promoters at a pre-determined price depending on the stage of the company

The missing link

The Indian start-up community has been expecting various further relaxation from the legislators including wider coverage of amendments in Finance Act, 2020 (incorporate all the DPIIT-recognised start-ups), include start-ups that were once DPIIT-recognised but now have annual revenue of over INR 100 Cr and ESOP taxability only on transfer of ESOP shares.

On the start-up front, the claim of expense towards the ESOP has been a matter of debate by virtue of the divergent views in various judicial pronouncements by various forums. The dichotomy is based on the premise that the ESOP entails issuance of shares leading to change in the share capital and thus is a capital nature item which would not be allowable as a business expense. Other more popular school of thought which has received the High Court's blessing avers that the primary objective of issuing shares to the employees at a discount is to compensate employees for their continued service and the expense related to ESOPs is allowable as a deduction.

From the start-up perspective, it is imperative to account for the ESOP cost in the financials and also claim the same whilst filing their tax returns. Thus, valuation of the options needs to be carried out from an accounting perspective at the very grant of the options to the Employees. Such valuation helps in

¹ https://www.startupindia.gov.in/content/sih/en/about_startup_portal.html

determination of the ESOP expense which is recognised on straight-line basis over the vesting period of the underlying options. The valuation of such stock options after taking into cognizance various underlying factors is to be carried out based on intrinsic value method or Fair Value Method (done based on option pricing methods such as Black Scholes Merton or a Binomial Model). From an income tax perspective, since the differential between the exercise price recovered from the employees and the FMV of the shares is taxable as perquisite for the employees, the FMV determination of the shares needs to be carried out. Such FMV shall be the value as determined by Category 1 Merchant Banker (registered with SEBI) either on the exercise date or any earlier date not older than 180 days prior to the exercise date.

Further, the present corporate laws put in place several limitations with respect to ESOPs including minimum vesting period of 1 year. The Company law Rules also place an embargo on the Employees with respect to the options granted to them: they are not permitted to transfer, pledge, hypothecate, mortgage or otherwise encumber any employee stock options granted to them. Thus, only the employees to whom the options have been granted can exercise such options for issuance of shares.

MSOP

Start-ups often resort to Management Stock Option Pool (MSOP) and other avant-garde structures for facilitating similar offerings to non-employees and efficiently manage the other impediments. Start-ups have also started resorting to externalisation of their holding structures wherein the ESOPs are sought to be granted by the overseas holding company which helps create out a lot of issues in the overall ESOP plan and also helps navigate the implications on the tax front for the employees.

Start-ups have an important role to play in the today's innovative space and equity compensation is one of the strategic tools for such start-ups to align the best resource pool whilst managing liquidity and tax efficiency. The whole equity compensation planning and roll-out process would need to be thought through to ensure its smooth implementation and the desired results.

Concluding thoughts

The recent years have witnessed the come-back of classic ESOP, which ensures that employees also have skin in the game and are invested in the success of a start-up. Pureplay cash compensation is no longer lucrative for young talent in the fast-growing start-up ecosystem. This is very much evident from new-fangled ESOP variants being rolled out by start-ups, viz. TSOPs (Unacademy launched ESOPs for teachers on its platform), PSOPs (Urban Company launched a partner stock option plan for its service partners) and MSOPs (BharatPe offered shares to merchants).

Resorting to equity compensation by Indian start-ups has played an instrumental role in spreading awareness and have also proved to be a means for corporates to showcase their commitment to sharing their success stories with the people who have played role in the same.

Enhancing Cross Border Trade Through Free Trade Agreements: Indian Perspective

Udayan Choksi, Partner, Khaitan & CO.

India has shown a clear advancement towards putting into place Free Trade Agreements (FTA) with key trading partners. Recently, India and the United Arab Emirates (UAE) and separately India and Australia signed a Comprehensive Economic Partnership Agreement (CEPA). The agreements are expected to boost annual bilateral trade to \$150 billion within 5 years of its adoption.

Earlier this year, India and the United Kingdom (UK) launched negotiations for a FTA, which is expected to come into effect 2022-23 and discussions are taking shape towards concluding an FTA with the EU as well. These are expected to significantly enhance trade with India from the region.

The UAE was India's third largest trading partner in 2020-21 with the country exporting goods worth \$16.7 billion and importing items valued at \$26.6 billion. India's major imports from the UAE include petroleum and petroleum products, precious metals, gems and jewellery, minerals, chemicals and wood products. UAE has also investments worth \$11 billion into India since 2000 and is among the top 10 investors for the country. The UK is already the seventh-largest export destination for India, and India's trade and investment relationship with the UK has been successful. Bilateral trade between the two countries (export and imports together) increased by 22.7 percent from FY2009- 2010 to US\$13.1 billion in FY2020-2021; imports from the UK increased by 11 percent, while Indian exports to the UK went up by 31 percent over this period.⁶ With exports to the UK growing considerably faster than imports from the country, India has maintained a trade surplus with the UK since 2004. The FTA is expected to facilitate the target of doubling bilateral trade between India and United Kingdom by 2030.

A clear pattern of preferential trade arrangements with major economies is emerging and is aimed at a manifold enhancement in trade conditions between India's trading partners. The nature of the trade agreements is also advanced, as India and Australia are comprehensive economic arrangements with a wide framework for covering not just trade in goods but also services, e-commerce, digital trade, SPS & TBT conditions, etc.

With respect to the CEPA with UAE and Australia, exports from India that could benefit from the CEPA include textiles, gems & jewellery, petroleum products, engineering and machinery products and chemicals. Market access in services, including mutual recognition agreements for various professions, is also an area of primary interest for India. The CEPA also cover other areas including investments and government procurement.

The FTA with the UK is expected to increase India's exports in Leather, Textile, Jewellery and processed Agri products India is also expected to register a quantum jump in the export of Marine Products through the recognition of 56 marine units of India. Mutual Recognition Agreements (MRAs) on Pharma could provide additional market access. There is also great potential for increasing exports in service sectors like IT/ITES, nursing, education, healthcare, including AYUSH and audio-visual services. India would also be seeking special arrangements for movement of its people.

A key concern always is that the origin countries should not be misused by entities from third countries to ship their products to India at concessional import duties negotiated under the FTA and the rules of origin criteria under the FTA are strictly satisfied and not circumvented. Rules of origin determine where goods originate, i.e. not where they have been shipped from, but where they have been produced or manufactured. As such, the 'origin' is the 'economic nationality' of goods traded in commerce. The tariff classification, value and origin of a good are determining factors based on which the customs tariff treatment is applied. The rules of origin provided under the relevant Trade Agreement and the related rules, determine whether goods qualify as originating from that country for which the special arrangements under the Trade Agreement apply. Only where all the requirements are met, the imported goods are provided with a Certificate of Origin ("COO") and are eligible to be imported with a beneficial customs duty rate.

However, with the enforcement of the Customs (Administration of Rules of Origin under Trade Agreements) Rules, 2020 ("CAROTAR") which came into force on September 21, 2020, the possibility of abuse of preferential tariff arrangements has significantly reduced. Under the provisions of the CAROTAR, an importer is, inter alia, mandated to undertake due diligence before importing the goods and ensure that they meet the prescribed originating criteria under the relevant trade agreement and related rules. Under certain circumstances, the Customs can deny the preferential duty rate claimed and also require verification of the COO from the partner country.

As seen with the CEPA with UAE and Australia, and is likely to be with the UK FTA being finalised, stringent rules of origin requirements, providing for a not only specific value addition in the exporting country, but also additional conditions or 'product specific rules' will be in place to prevent circumvention or abuse of the preferential tariff.

The UAE CEPA provides for 'Bilateral Cumulation' whereby originating products that are used in the production of a product in the other country as materials for finished products are deemed to be originating in the exporting country, subject to direct transport and other conditions. Even if the originating product is transported outside the FTA partner, it is considered to retain its originating status under certain conditions. The CEPA also contains specific provisions on third-country invoicing, making it easier to ensure that preferential tariffs are not denied even in complex supply chains.

The recent CEPAs show an evolving trend in the level of commitments beyond trade in goods in respect of other trade related aspects such e-commerce, trade in services, rules of origin, digital trade, and IPR, and with each new FTA, there is emerging clarity on levels of commitment, verification procedure and other aspects affecting the trade.

India is also prolific user of trade remedies and has initiated about 700 trade remedy investigations. Recent FTAs have also provided for trade remedy commitments as well as a permanent safeguard mechanism, which will safeguard businesses from any unwarranted effects arising from surge in volumes of any particular product.

It is without any doubt that the present trend of concluded FTAs and ongoing negotiations is an important and significant step for enhancement of trade between India's key trading partners. Several practical questions that arise at the time of actual implementation of trade are also being addressed. Overall, the proliferation of the present FTAs is an important development which will have a paradigm impact on trade between the partner countries and will significantly impact businesses of all scale, specially the MSME sector, which also has a substantial presence in the trade.

Hybrid Working and Associated Tax Issues

*Noopur Agashe, Chartered Accountant
Sameer Kundra, Chartered Accountant
Malvika Mathur, Chartered Accountant*

*There was once a man who worked remotely,
For his passion and poise, accredited patently!
Unaware of his acts, unfortunately,
Got bashed by the tax laws massively.*

Workplace – A Major Reset

‘The future needs flexible workplaces, a work-from home ecosystem and flexible work hours...’

The Prime Minister said the above when addressing the nation on the 75th Independence Day. Work, earlier associated with a designated workplace in most instances, has undergone radical and fundamental changes. Employees are now more free to fulfil their employment obligations from any geographical location. While the proposition of ‘flexible workplaces’ has been exhorted, the accompanying tax issues are yet to be fully evaluated and known to the larger audience.

Courtesy the pandemic, working from home has become an ordinary and acceptable form of structuring work arrangements. Although the pandemic’s vigour and potency have reduced, many employers are no longer mandating working from their work locations. Employees are keen to hold on to work from home’s ease and flexibility, while occasionally willing to physically connect at the workplace to maintain camaraderie. That being the case, employers are continuing to deal with the additional issues of maintaining employee engagement where they offer such flexibility, and attrition in case of not being a flexible employer.

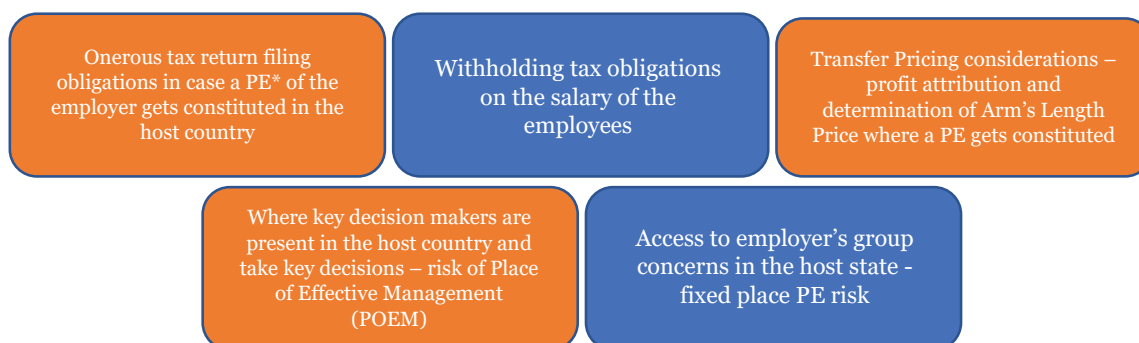
Regardless of how convenient it sounds for employees, work from home poses practical challenges, especially while working from a different tax jurisdiction. We shall discuss some of the tax issues associated with such hybrid working.

Tax Obstacles in Hybrid Working

Remote working, hybrid working and ‘work from anywhere’ arrangements can be obstacles for corporate and individual taxes. In the absence of properly framed policies, employers may simply remain oblivious of their employees’ locations and face complex tax challenges if working from other tax jurisdictions.

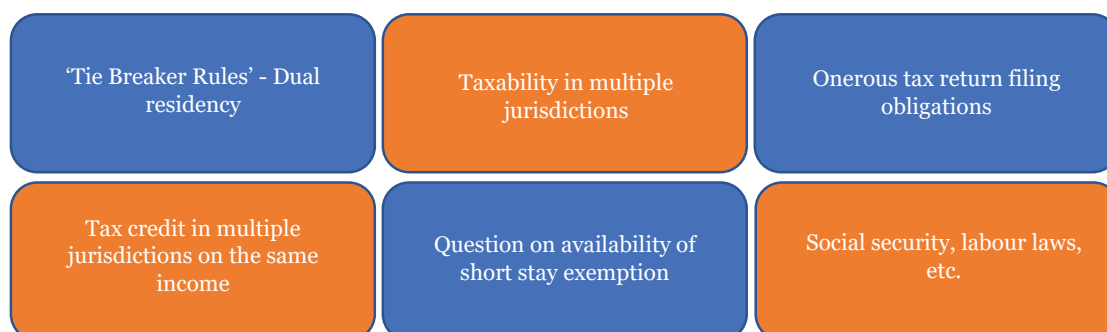
In such scenarios, the following implications may arise:

→ Tax implications for employers



*We have separately discussed the Permanent Establishment (PE) related aspects in the ensuing paragraphs.

→ Tax implications for employees



Hybrid Working - OECD¹ Directives

In certain cases, owing to the flexibility of 'work from anywhere' given by the employer enterprise or clubbing of annual vacation with 'work from anywhere', the employee may work from another tax jurisdiction.

The OECD has provided guidance related to the 'home office' being the place from where an employee conducts its activities in a foreign jurisdiction. As per the OECD directives, where the business activities are conducted at an individual's home and such activities are intermittent or incidental, such home will not be considered to be at the employer enterprise's disposal. Where, however, a home office is used continuously for carrying on business activities and the enterprise has clearly required the individual to use that location, the home office may be considered to be at the enterprise's disposal. Thus, the PE exposure for an enterprise is directly proportional to the effective power that the enterprise exercises to use that location, the extent of presence and the activities performed in the host location.

If the enterprise does not have a right to be present at a location and does not use it, the location cannot be considered as being at the enterprise's disposal. However, notably, India has issued its reservation to the

¹ Organisation for Economic Co-operation and Development

effect that in certain circumstances, even such a location can be considered as being at the enterprise's disposal.

(A) Hybrid Working in the Pandemic-Hit World

- The individuals, who got stranded in a country other than their country of employment, due to the sudden pandemic, had to forcibly work remotely from such other country, either from their home offices, or any other place of stay during the intermittent period. Such events could be classified as 'force majeure', i.e. situations arising due to certain factors beyond anyone's control (here, the pandemic and related mandatory government directives) and not because of an enterprise's requirement. As per the OECD's guidance, to the extent it does not become the new norm over time, teleworking from home should not create a PE for the business or employer.
- While various countries had issued guidance or pronounced rulings on the force majeure's impact on PE constitution during the pandemic, India had not formulated any guidance. Thus, India's position in such cases remains obscure currently.
- Separately, while the above guidance was relevant for determining the exposure from a fixed place PE perspective, in some jurisdictions, employees' presence even for a day can trigger service PE under some Double Taxation Avoidance Agreements (DTAAs) which India has signed with other jurisdictions. For instance, under the India-USA DTAA, there is no prescribed threshold on the number of days of the presence of employees in the host country where services are rendered to an associated enterprise. Accordingly, the service PE exposure in such cases would depend on the nature of activities performed or service rendered by the foreign company through such personnel stranded in India.

(B) Remote Working in the Post Pandemic Times

While the COVID-related travel restrictions have now been lifted completely in most parts of the world, apparently, 'work from anywhere' is slowly becoming the 'new norm' and is here to stay. However, since the shelter of force-majeure related arguments would no longer be available, the dynamics of how the tax authorities would view such arrangements would largely depend on each tax jurisdiction's stance. The determinative factors could be functions carried out, duration of stay, etc.

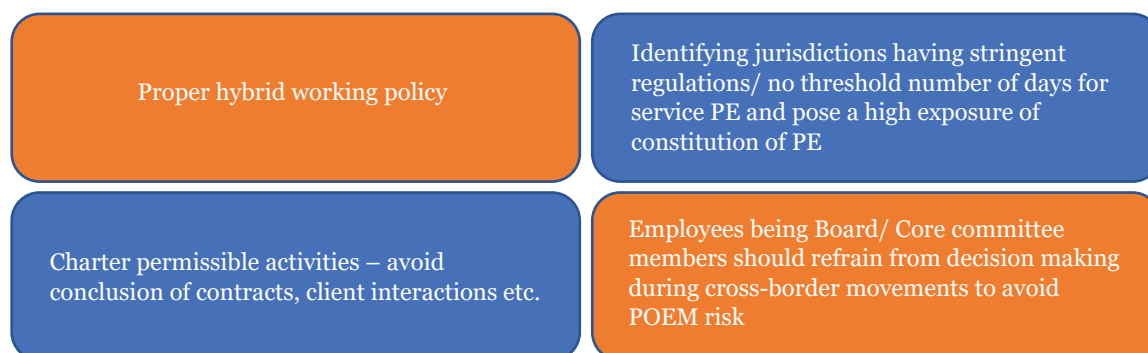
For instance, recently, the Denmark Tax Council² held that the home office of a German company's employee constitutes PE in Denmark, considering that a significant part (nearly 40%–50%) of the employee's work (core business activities) was being performed in Denmark, including developing a new market in Denmark. Contrastingly, in another case, the Danish Tax Council³ ruled that the employer's PE would not get constituted in Denmark as the employer had no interest or prospect to expand in the Danish market. The employee also had no managerial powers or authority to enter into negotiations on the employer's behalf, and the decision to perform most of his work from his home office was solely due to personal circumstances.

² Spurger [TS-510-FC-2022(DEN)]

³ H1 [TS-1195-FC-2021(DEN)]

Safeguards – Precaution is Better than Cure

To avoid the potential risks of constituting a PE in the host jurisdiction, employers may implement the following measures to safeguard themselves from potential PE implications



Impact of Hybrid Working – Within India

While the impact of working from another jurisdiction appears to be potentially more instigating, merely changing location within the same international territory may not involve equally intense tax issues. One such issue pertaining to such intra-territorial remote working is the deductibility of reimbursement of out-of-pocket expenses incurred by employees on setting up home offices. Such arrangement may or may not invoke a separate tax treatment in the hands of such employees, depending upon the arrangement.

In India, recent industry-specific amendments include the notification of a new rule for Special Economic Zones (SEZ) units, as per which an SEZ unit can permit certain prescribed classes of employees to work from home or from any place outside the SEZ, subject to certain conditions. As per various reports, the SEZ Act is likely to be revamped into a proposed regulation, DESH⁴, in the near future. How it would incorporate hybrid working aspects remains to be seen.

Food for Thought

While the tax exposures for both the employer and the employee seem to exist and are likely to continue for a long time, these can be controlled by following proper safeguards. However, how tax authorities would bring under their radar such foreign employers whose employees are working or will work from India following the hybrid working model remains unanswered. One possible way is through exchange of information between nations through inter-governmental agreements. Tax authorities may, however, find it difficult to police the nexus between the employee working in the host state and the employer. Observing how tax authorities will deal with cases with dissimilar facts will be interesting.

⁴ Development of Enterprise and Service Hubs

Hybrid Working – A Boon, With Its Own Issues

Vikas Vasal, National Managing Partner, Grant Thornton Bharat
Richa Sawhney
Ankita Chowdhry

The pandemic has redefined the way in which we all work and there appears to be no going back, at least in near future. In many industries/sectors the debate has shifted from ‘whether or not’ to ‘how much’ of the remote working is feasible and how to facilitate the same. The concept which originated in the western world, in the IT industry and earlier considered alien to India, took wings during pandemic and now most large businesses in India have adopted it in some shape and form.

Hybrid working ‘forced’ upon us, is now a ‘requirement’

It was during the pandemic and the associated lockdowns that corporate India began to understand, experiment and value the benefits of Work from Home (WFH) for employees. The benefits of reduction in travel time and costs, smaller office spaces and reduced overheads cost, increased flexibility, access to larger and diverse talent pool and more time for family, all came to limelight. These have benefitted both the employers and the employees.

As the pandemic receded and we adjusted to it being an epidemic, the business world witnessed another new phenomenon - the ‘Great Resignation’, due to a re-set of priorities by the individuals and families. While some employees want to resume working from office, most would prefer a permanent WFH or a hybrid model staying in their home towns, closer to their families. This resulted in acute shortage of talent across sectors, especially in the technology related/enabled sectors. The cliché ‘war for talent’ again surfaced in the board room discussions and threatened the fast-paced growth of the companies especially in the knowledge-based sectors. Hence, new concepts, like WFH, Work from Anywhere (WFA) or Hybrid Working (few days in office and few days of remote working) came to the forefront.

A recent survey by Grant Thornton Bharat revealed that 56% of the Indian employers who participated in the survey, have introduced WFH for their workforce. Further, more than 50% of the respondents believed that a hybrid or outsourced model with better data security controls for HR and payroll functions is preferable.

While the hybrid model has allowed employees to work from anywhere in the world, it has its own set of issues from tax and regulatory perspective for both - the employees and the employers.

Tax implications for employees

- **Perquisites – perceived benefit or a necessity**

Work from home implies setting up home offices and related costs. If an employee has to work from home, he/she has to necessarily build in some infrastructure to carry out the work.

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While cash allowance for WFH is fully taxable, any benefit provided by the employer to the employee such as table, chair and certain other electronic items could be regarded as a taxable perquisite.

If the asset is owned by the employer and provided to the employee for use, the taxable perquisite would be 10% of the original cost of the asset. In case the employer has taken such assets on hire/lease, the taxable perquisite would be the actual hire charges incurred by the employer.

It is pertinent to note that these perquisite tax rules were framed prior to the pandemic era, where working in / from the office was a norm. Now, with change in the working conditions, there is a need to revamp these rules to align them with the current business reality.

- **Cross-border taxation conundrum for employees**

Hybrid working and WFA could also lead to tax exposure in more than one country (tax jurisdiction). Taking India as an example, the residential status of an individual is determined based on his/her period of stay in India during a financial year and the last ten previous financial years. The residential status in turn determines the taxability of different sources of income.

As per the Income tax Act, 1961 (the Act), an individual who qualifies as a resident and ordinary resident (ROR) is liable to tax on his global income. An individual who is a Non-Resident (NR) or Not-Ordinarily Resident (NOR) is taxed on income which is received or is deemed to be received in India or accrues or is deemed to accrue or arise in India.

Similarly, different countries have different conditions to determine the residential status and corresponding taxability of income earned by an individual.

Therefore, flexibility in working from any location, may expose an individual to tax in more than one jurisdiction. This is where the interplay of Double Taxation Avoidance Agreements (tax treaties) would come into picture. Accordingly, the possibility of claiming short stay exemption and double taxation relief would have to be evaluated.

Another related aspect that needs to be looked into is the taxation of stock options, as there could be some trigger for taxation based on the location and stay of an individual employee.

Tax Implications for employers

Another aspect that needs to be considered in case of employees of foreign company working in another country under the flexi model is the risk of the foreign company creating a PE in the other country. This risk could be both on account of fixed place PE and service PE.

Fixed place PE is created by virtue of the presence of a fixed place of business, through which the business of an enterprise is wholly or partly carried on. It needs to have a certain degree of permanence, and it should be at the “disposal” of the enterprise.

The time required to create a fixed place PE is not prescribed in the Indian domestic law or the tax treaties in general. The Organisation for Economic Co-operation and Development (OECD) has referred to a six-month threshold for creating a fixed place PE. This is not a definitive rule and depending on facts and circumstances of a case, a lesser period of presence may also lead to creation of fixed place PE.

OECD has indicated that where home office is used on a continuous basis and the employer requires the employees to WFH (e.g. by not providing an office to an employee in circumstances where the nature of the employment clearly requires an office), it may be said that the home office is at the disposal of the enterprise and could create a PE exposure.

There are a few rulings¹ wherein it was held that the home office qualifies as PE in that country. Hence, hybrid working (across countries) and WFA may create fixed place PE exposure in the country where the employee is working remotely.

Further, in such cases the tax authorities may also take a view that the employer is furnishing services through employees in that country and hence, there is a risk of the employer creating a service PE in the other country. This would happen if the employee stays in the other country for a period exceeding the prescribed threshold. Number of days for creation of a service PE varies in different tax treaties and could be as less as one day in some cases.

In an event a PE is created in the other country, then the next issue to be addressed is the profits (income) attributable to such PE owing to the working of such employee. Besides, various tax filing compliances based on the local laws would also have to be complied with.

Macro considerations

Different countries have/are considering changes in their domestic legislations to facilitate remote/hybrid working. In this context, a case in point closer home is regarding the Special Economic Zone (SEZ) units.

The Ministry of Commerce and Industry (MOCI²) has brought in enabling legislation allowing IT/ITES SEZ units to permit the employees to work from home on fulfillment of certain conditions. To ensure harmonised implementation of the WFH rules, it has also notified the Standard Operating Procedures (SOPs).

Accordingly, WFH can be provided to maximum 50% of total employees (including contractual employees) for a maximum period of one year. The Development Commissioner of SEZs can grant approval to extend this benefit to more than 50% employees and extend the period of one year, if there is a bonafide case.

As per press reports, in order to provide more flexibility to employees, create better job opportunities in the Tier II cities and to boost exports, the government is considering to allow 100% WFH for employees of SEZ units covering all sectors.

Beyond tax – other legislations and considerations

Employers also have to consider whether WFH policy would have any implications under any other non-tax regulations e.g. Shops and Establishment Act, implications under Prevention of Sexual Harassment Act (POSH) when employees meet and work outside office premises on regular basis etc.

Employers also must relook at their IT and security policies, confidentiality of information, compensation structures, attendance and leave records etc.

¹ Sutron Corporation v. DIT [2004] (138 TAXMAN 87) (AAR - NEW DELHI); Spurger [TS-510-FC-2022(DEN)]

² Vide Special Economic Zones (Third Amendment) Rules, 2022 inserted Rule 43A

Moonlighting, where an employee works for more than one employer or takes independent assignments besides his current employment, is an interesting ongoing debate in the social media these days. This is however a serious issue from the employer's perspective.

Way forward

It would not be an exaggeration to say that in true sense, this concept was 'forced' upon us during the pandemic, with little or no choice, and gradually we realised its advantages and adopted it.

Considering the unintentional tax consequences of WFH, organizations need to re-evaluate their corporate policies and the tax and regulatory implications, to ensure that they are following the law of the land where the employees are located – both in letter and in spirit.

Needless to add that, any relaxation in tax laws provided by the government would further give a boost to WFH policy, which is now here to stay. On the flip side, the governments would also have to evaluate, if these flexi working policies are creating global nomads who are not paying taxes in any jurisdiction.

There are no easy answers to all these issues, and the corporate policies and tax regime will evolve over time.

Taxability of Interest Payouts A “Taxing” Conundrum

*CA Anant Bhatia, Partner, Bhatia and Bhatia, Chartered Accountants
CA Megha Gupta, Associate Director, Bhatia and Bhatia, Chartered Accountants*

Backdrop

A company is typically financed or capitalized through a mixture of debt and equity. Thin capitalisation refers to the situation in which a company is financed through a relatively high level of debt compared to equity. The capital structure of a company often has a significant impact on the amount of profit it reports for tax purposes as the tax legislations of countries typically allow a deduction for interest paid or payable in arriving at the profit for tax purposes while the dividend paid on equity contribution is not deductible. Therefore, debt is considered as a more tax efficient method of finance than equity. Multinational groups are often able to structure their financing arrangements to maximize these benefits. For this reason, country's tax administrations often introduce thin capitalisation rules that place a limit on the amount of interest that can be deducted in computing a company's profit for tax purposes. Such rules are designed to counter cross-border shifting of profit through excessive interest payments, and thus aim to protect a country's tax base.

Global Scenario

Thin capitalisation regimes of several countries follow different approaches in order to limit the deductibility of interest expense. The approach can be typically applied in two ways:

1. Limitation on loan amount: Under this approach, the total debt (relative to assets or alternatively equity) or debt from related parties (relative to equity) is restricted, beyond which interest on debt is not deductible.
2. Limitation on interest deductibility amount: Under this approach, interest on debt is allowed for tax purposes as a certain percentage of some variable such as EBITDA (“Earnings before interest, taxes, depreciation and amortization”).

Indian Scenario

The Indian Government is proactively adopting the recommendations of the Base Erosion and Profit Shifting (“BEPS”) project. Under the initiative of G-20 countries (of which India is a key member), the Organisation for Economic Cooperation and Development (“OECD”) in its BEPS project had taken up the issue of base erosion and profit shifting by way of excess interest deductions by the MNEs in Action Plan 4.

In line with the recommendations of OECD BEPS Action Plan 4, the Finance Bill 2017 has proposed to limit the interest expenses of more than INR 1 crore claimed by an entity to its associated enterprise to

30% of its earnings before interest, taxes, depreciation and amortization (“EBITDA”) or actual interest paid or payable to associated enterprise, whichever is less, by introduction of a new section 94B in the Indian Income Tax Act. This measure has been introduced by the Indian Government to counter crossborder shifting of profit through excessive interest payments and thus aims to protect India’s tax base.

The restriction on interest cost is not confined to only loan provided by non-resident associated enterprise but will be extended to loans from third parties wherein implicit or explicit guarantee is given by the associated enterprise or where the associated enterprise deposits matching funds with the lender.

The definition of debt is broad enough to cover any instrument triggering a payment of interest and hence all hybrid and quasi equity instruments such as compulsory convertible debentures (CCDs), convertible bonds, etc. would also be covered. We would be discussing some recent judiciary in the ensuing paragraphs.

Recent judicial pronouncements

In the case of M/s. TE Connectivity Services India Private Limited (IT(TP)A No.191/Bang/2022), the basic objection was that the interest paid on CCDs is not an interest on debt but on equity and hence, not allowable. The Revenue has relied upon certain comments of RBI in 2007 Policy on convertible debentures in which it is stated that fully and mandatorily convertible debentures into equity within a specified time would be reckoned as equity under FDI policy. The Bangalore Tribunal in this case has ruled that the definition of convertible debentures given by RBI is in the context of FDI policy to exercise control on future re-payment obligations in convertible foreign currency. Such definition of the term convertible debentures cannot be applied in other context such as allowability of interest on such debentures during preconversion period or regarding payment of dividend on such convertible debentures during preconversion period or regarding granting of voting rights to the holders of such convertible debentures before the date of conversion. Hence, the Tribunal concluded that CCDs cannot be treated as equity under the Indian Income Tax Act.

Interplay with transfer pricing

The transfer pricing rules may apply to disallow interest deductions, notwithstanding that no interest deductions are denied by the thin capitalization rules. For instance, where the interest rate agreed among the related parties is considered to be in excess of arm’s length interest rate, a deduction for the excessive component may be denied under the transfer pricing rules even though the debt level is not considered to be excessive under the thin capitalization provisions.

Further, one has to be cognizant of the definition of Associated Enterprise (“AE”) provided under section 92A of the Indian Income Tax Act. For instance, External Commercial Borrowings (“ECBs”) could also trigger AE relationship if the lending by one entity exceeds 51% of the book value of total assets of the another entity.

Concluding remarks

While the Indian Government has implemented one of the best practice approaches to limit the interest deduction based around a fixed ratio rule which limits an entity's net interest deductions to a fixed percentage of its EBITDA, there could be challenges on various aspects such as:

- Whether tax EBITDA or accounting EBITDA should be considered;
- Treatment of interest which is capitalised instead of debiting the same to profit and loss account;
- Treatment of exempt income, extraordinary items, interest on supplier's credit, etc. while determining EBITDA, etc.

It would be good to proactively seek clarifications on these issues to pre-empt disputes.



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About ASSOCHAM

The Knowledge Architect of Corporate India

The Associated Chambers of Commerce & Industry of India (ASSOCHAM) is the country's oldest apex chamber. It brings in actionable insights to strengthen the Indian ecosystem, leveraging its network of more than 4,50,000 members, of which MSMEs represent a large segment. With a strong presence in states, and key cities globally, ASSOCHAM also has more than 400 associations, federations, and regional chambers in its fold.

Aligned with the vision of creating a New India, ASSOCHAM works as a conduit between the industry and the Government. The Chamber is an agile and forward-looking institution, leading various initiatives to enhance the global competitiveness of the Indian industry, while strengthening the domestic ecosystem.

With more than 100 national and regional sector councils, ASSOCHAM is an impactful representative of the Indian industry. These Councils are led by well-known industry leaders, academicians, economists and independent professionals. The Chamber focuses on aligning critical needs and interests of the industry with the growth aspirations of the nation.

ASSOCHAM is driving four strategic priorities – Sustainability, Empowerment, Entrepreneurship and Digitisation. The Chamber believes that affirmative action in these areas would help drive an inclusive and sustainable socio-economic growth for the country.

ASSOCHAM is working hand in hand with the government, regulators, and national and international think tanks to contribute to the policy making process and share vital feedback on implementation of decisions of far-reaching consequences. In line with its focus on being future-ready, the Chamber is building a strong network of knowledge architects. Thus, ASSOCHAM is all set to redefine the dynamics of growth and development in the technology-driven 'Knowledge-Based Economy. The Chamber aims to empower stakeholders in the Indian economy by inculcating knowledge that will be the catalyst of growth in the dynamic global environment.

The Chamber also supports civil society through citizenship programmes, to drive inclusive development. ASSOCHAM's member network leads initiatives in various segments such as empowerment, healthcare, education and skilling, hygiene, affirmative action, road safety, livelihood, life skills, sustainability, to name a few.

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