DIRECT TAX ALERT

N. A. SHAH BULLETIN

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Executive Summary

- Hon'ble Karnataka High Court in the case of **M/s. Sasken Communication Technologies Ltd.**, has upheld the decision of Bangalore Tribunal that non-compete fees paid to key employees (resident of USA) rendering the services in the USA, is covered by Article 16 of DTAA and taxable in USA only.

- Hon'ble Karnataka High Court in the case of **Shri Navin Jolly** allows exemption to the taxpayer u/s 54F of the Income Tax Act, 1961 ("Act"), for the purchase of new residential property, even though the taxpayer was holding more than one residential house property. The Hon'ble court held that for reckoning whether the taxpayer is holding more than one residential property, emphasis has to be placed on the "usage" of the property to determine whether it is a residential property or a commercial property. The Hon'ble court also opined that when a provision of the statute is laid down with an incentive to promote growth and development, the same shall be construed liberally so as to advance the objective of the legislature and not frustrate it.

ITO (IT) – 19(2) vs. M/s. Sasken Communication Technologies Ltd ("Assessee")

ITA NO. 241 OF 2011 (Karnataka High Court)

Facts of the case:

1. Two employees viz., M.S.Kumar and Mr. Kevin Koenig were in employment of M/s SNSL a subsidiary company of the assessee and were employed as Chief Executive Officer and Chief Operating Officer respectively with effect from 01.04.2004. The aforesaid subsidiary company merged with the assessee on 01.04.2005.

2. The assessee therefore offered employment to the aforesaid two persons on 31.03.2005, as they were in key strategic positions of the subsidiary company. Both have accepted the offers of employment. Subsequently Non-compete agreements were entered into on 02.05.2005 and payments under the agreements to the tune of $5,63,000/- (Rs. 2.46 crore each) were made to the employees on 31.05.2005.

3. Three contracts were executed between the two employees and the assessee viz., Employer Agreement, Non-Disclosure Agreement and Employee Non-Compete Agreement.

4. During the year, both the employees have rendered services in USA and no services were rendered in India. Both the employees were non-resident in India and were resident of USA.

5. The assessee made the remittance without deducting tax on the basis that remittance is towards consideration under the Non-Compete Agreement and would fall under "salary" or "profits in lieu of salary" which is covered by Article 16(1) of the DTAA (Dependent personal services) between India and USA, accordingly, not taxable in India.

6. The AO (TDS) held that agreements and the payment made thereunder to the two employees of the company was sham and created for the purposes of avoiding payment of tax in India. Therefore, it was held that tax have to be deducted and interest under Section 201(1A) of the Act was levied.

7. The CIT(A) upheld the order of the AO. On appeal to ITAT, it was held that the amount paid would fall under "salary" or "profits in lieu of salary" and therefore, not taxable under Article 16 of the India – USA DTAA.

8. Aggrieved by the above, the department had filed an appeal before the High Court.

Issue:

Whether the remittance to employees under non-compete agreements are chargeable to tax under Section 5(2) of the Act, and if so, the head of income under which it is liable for taxation under the Act and issue of its taxability under Double Taxation Avoidance Agreement?

Contentions of the department:

1. Since, there was already a Non-Disclosure agreement, there was no need to enter into a separate non-compete agreement which makes it a sham transaction for the purpose of evasion of tax.

2. The clauses in the non-compete agreement creates a prohibition with regard to employment in respect of the companies situate in India and therefore, the rights and obligations of the parties under the Non-Compete Agreement were to take effect in India and therefore, the amount paid to the employees under the Non-Compete Agreement is covered under Section 5(2) of the Act.

3. Lump sum payment made under a restrictive covenant before acceptance of payment cannot be treated as salary and ought to be taxable in India as per Article 23 of the India – USA DTAA.

4. Reliance was placed on decisions of the Supreme Court in the case of 'Performing Right Society Ltd. Vs. CIT (106 ITR 11) and 'PILCOM Vs. CIT, Civil Appeal No.5749 Of 2012.

Contentions of the assessee:

1. Non-Disclosure Agreement and Non-Compete Agreement are different inasmuch as the former applies in case of an employee who is in employment whereas, the latter applies in the case where the employment ceases to exist.

2. Due to the employment agreement, the income was taxable as salary and since the employees have not rendered any services in India, the tax on the income (if any) was leviable only in the USA - being the country of residence of the employees in accordance with the Article 16 of the India – USA DTAA.

3. The decision relied by the department are distinguishable on facts since in those cases, the events (viz. telecast and matches) took place in India. The Tribunal being the final fact finding authority, only a question of law can be framed by the High Court or a case where the Tribunal has not correctly appreciated the facts based on the material available on records.

Decision:

1. The Tribunal had made detailed appreciation of the facts available on records and found that Non-Compete Agreement prohibits the employee from joining any competitive business entity after termination of the employment, whereas, no such clause is available in Non-Disclosure Agreement.

2. The Tribunal also found that the employees were ones occupying higher positions in the subsidiary companies and were in possession of vital and confidential information were required to be retained in the interest of the assessee for carrying on its business effectively. The terms and conditions of the Non-Disclosure Agreement are not exactly the same as the Non-Compete Agreement and the transactions in question were not sham transactions.

3. "Profit in lieu of salary" includes any lump sum or otherwise from any person before joining any employment from that person or after cessation of his employment from that person.

4. It was also a factual finding of Tribunal that since the employees were rendering services outside India i.e., USA and payments were also made in USA, Article 16 of DTAA applies and the same is taxable only in USA.

5. Since there is no findings of fact that have been assailed to be perverse, questions of law framed in fact, do not arise for consideration in this appeal, as the matter stands concluded by findings of fact.

6. The decisions of Supreme Court in the case of Performing Right Society and PILCOM were distinguishable on facts as in those cases the events were held in India and therefore, the income was held to have accrued in India and taxable in India.

7. In view of the above, the appeal of the department was dismissed.

Shri Navin Jolly v/s The Income Tax Officer-11(1), Bangalore (Karnataka High Court)
ITA No. 320/2011

Facts

1. Shri Navin Jolly ("Taxpayer" or "the appellant") is a director in a Bangalore based private limited company. For AY 2006-07, the appellant filed his return of income which was subsequently selected for scrutiny by the Assessing Officer ("AO").

2. During the course of assessment, the appellant had submitted that, in the year under consideration he had earned long term capital gains of Rs.1.55 crore on sale of shares.

3. During the year the appellant had constructed a residential property in Bangalore and claimed exemption of aforementioned gain u/s 54F of the Act.

4. However, AO denied the exemption u/s 54F on the ground that appellant holds 9 residential properties and income derived from these properties is declared under the head "Income from House Property". While denying exemption u/s 54F the AO was not convinced with the argument of the taxpayer that out of nine flats, seven flats have been sanctioned for commercial purpose and only two flats have been sanctioned as residential units which are being used for commercial purposes.

5. Aggrieved, the appellant filed an appeal before the CIT(A). However, CIT(A) ruled against the appellant by observing that on the date of transfer of original asset the taxpayer was in possession of more than one residential house and therefore the taxpayer is not entitled to the benefit of exemption under section 54F of the Act.

6. Aggrieved by the order of the CIT (A) the appellant further preferred an appeal before Income Tax Appellate Tribunal ("Tribunal"). The tribunal also ruled against the appellant on the ground that he held more than one residential unit on the date of transfer and that the nature of utilization of the property is immaterial while deciding the eligibility for the exemption u/s 54F of the Act.

7. Aggrieved, the assessee preferred an appeal before Hon'ble Karnataka High Court.

Issue

1. Whether the usage of property is to be considered while determining whether the assesse holds more than one residential property for the purpose of Section 54F of the Act.

Contentions of the assesse

1. The primary argument of the appellant was that the apartment nos. 204 and 605, viz. Oxford Suites, is a building comprising units offered for serviced apartments which are used by the tenant companies to accommodate their guests. Therefore, the aforesaid serviced apartments are ought not to be treated as residential properties.

2. The appellant submitted that the expression "residence" signifies some sort of permanency and the same cannot be equated with "temporary stay" or "lodger".

3. On without prejudice basis, the appellant also contented that even if the aforesaid 2 units are treated as residential properties, since these are situated in a same building structure, they ought to be treated as one for the purpose of proviso (a)(i) of Section 54F of the Act.

Contention of the Revenue

1. Revenue strongly argued that the sanction of property shall determine whether the property is a "residential property" or not for the purpose of proviso (a)(i) to Section 54F of the Act and its usage has no relevance. It is also urged that requirement as prescribed in proviso to Section 54F(1) is of "owning" a residential house and not of its "use".

2. Reference was also drawn on the provisions of Section 32(1) (claiming of depreciation) of the Act and argued that the legislature under that section has specifically used the expression "used" and "owned" simultaneously which is not the case u/s 54F. Therefore, had there been a similar intention, the words "use" instead of "own" would had been specifically mentioned u/s 54F.

Held

The Hon'ble Karnataka High Court ruled in favour of appellant by giving following rational:

1. A provision in a statute providing incentive for promoting growth and development has to be construed liberally so as to advance the object of the Section and not to frustrate it. Reliance was placed upon Hon'ble Supreme Court's decision in the case of CIT vs. Strawboard Manufacturing. Co. Ltd.', (1989) reported in 177 ITR 431.

2. Usage of the property has to be considered while determining whether a property is residential property or commercial property.

3. The expression 'residence' implies some sought of permanency and cannot be equated to the expression 'temporary stay' as a lodger.

4. High Court also alternatively held that two apartments in a same building structure would amount to a one residential unit and therefore taxpayer is entitled to exemption u/s 54F of the Act. The Court relied upon decision of Delhi High Court in the case of Geeta Duggal in this regard, the appeal against which was dismissed by Hon'ble Supreme Court vide order reported in (2014) 52 taxmann.com 246 (SC)

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We will be glad to provide any information, elaboration and elucidation you may need in this regard.

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