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Newsletter

Sharp View

May 2023



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MAY 2023

May is a typical summer month across India with temperatures rising day-by-day. This period witnesses increase in the consumer demand towards refrigeration products like consumer durables and food & beverages.

Besides, 1 May is a notable day, as it is celebrated every year as International Labour Day in many countries around the world.

In India, Labour Day was first celebrated in Chennai (then known as Madras) on 1 May 1923, i.e. 100 years back. The leader of Labour Kisan Party of Hindustan 'Comrade Malayapuram Singaravelu Chettiar' initiated the government to consider it as a national holiday. Since then 1 May is observed annually in India to symbolise the efforts and work of the countless labourers.

The Indian government is keen on taking various incentives to promote health, safety and security of labourers. Government's attention is also focused on promotion of welfare and providing social security to the labour force both in organized and unorganized sectors. Being an item of the concurrent list under the Constitution, the State governments are also competent to enact labour legislations.

The central government has made reforms in the labour laws by bringing them down to 29 and categorising them into 4 codes. These labour reforms will enhance ease of doing business in the country.

We expect India to witness many positive measures on the labour laws front on the background of increased labour awareness, education and the use of digital technology.

We salute all the workers for their strenuous work and dedication for the progress of our country!!!





ASSURANCE

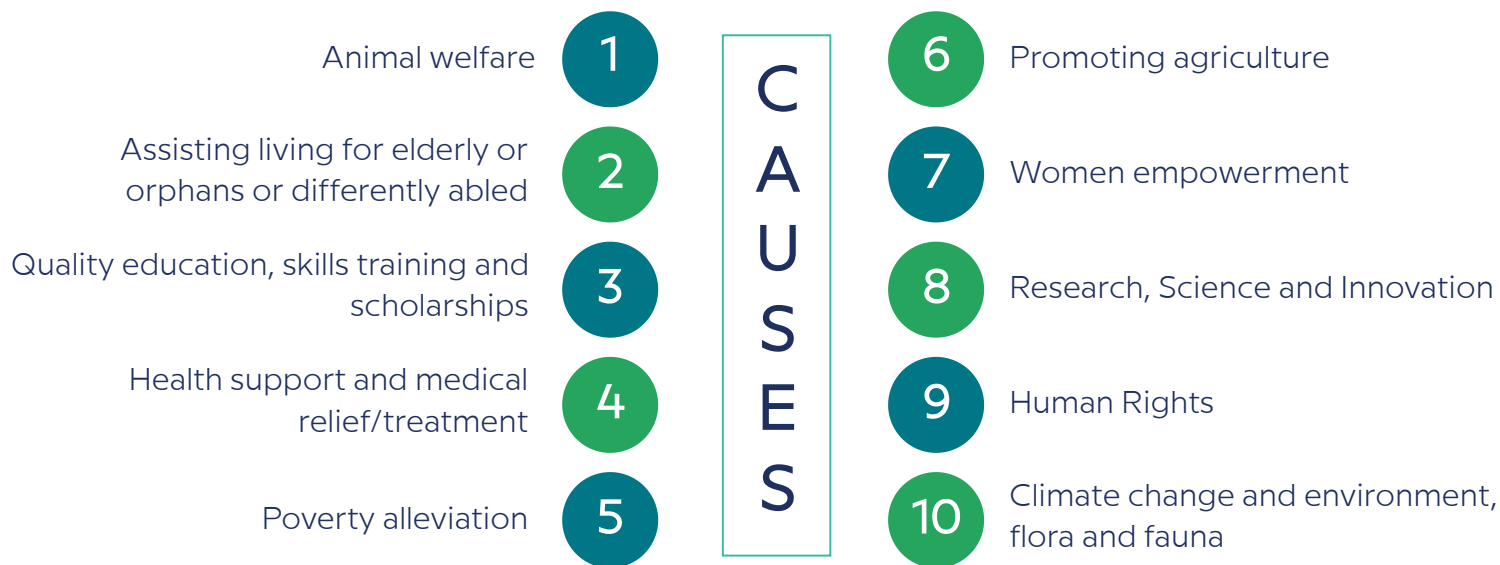
Endowment funding route

Non-profit organisations and other corporates with philanthropic interests are venturing to serve the causes that they support through the endowment funding route. Setting up an endowment fund gives them a way to generate money over time to serve their cause. Generally, in endowment funds, the corpus is kept intact/permanent at low risk and steady income is earned from investment. Ms. Shreedevi Nayak and Mr. Arjun MK (Bengaluru office) present a snapshot of endowment funds, their governance model, accounting treatment, taxability, and regulatory aspects in India.

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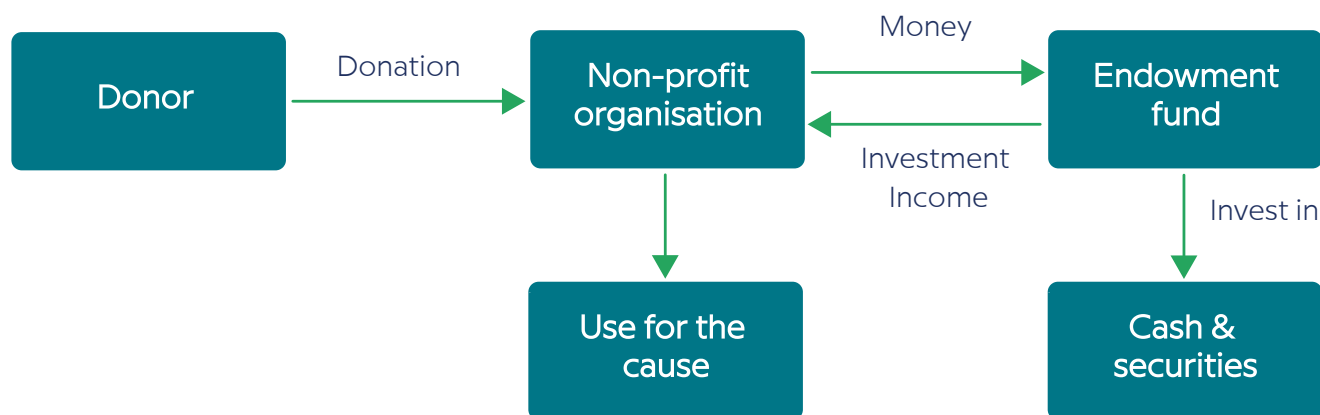
Endowment funding route

All of us have heard about the common endowments managed by schools, colleges, universities, hospitals, and churches. Lately, corporates, businessmen, and industrialists who have philanthropic interests also started showing their interest in forming private endowment funds to serve various good causes that they believe in. They are usually established as private trusts, which keep them independent from the organizations that they work for. The various causes that they support includes:



What is an endowment?

An endowment is a sum of money that donors contribute to the upkeep of a non-profit organization (NPO). The NPO is the beneficiary of the endowment fund. What makes an endowment fund unique is the fact that the donation amount stays intact, i.e., the principal is typically held in perpetuity and invested. The fund earns interest income and dividend income based on the investment portfolio where the money is invested. These investment earnings are used to finance charitable activities or other humanitarian objectives that influence a positive change in the society.



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Endowment funding route

Governance model of endowment funds in India

Unlike a typical investment fund that is managed by an investment manager or an individual investor, an endowment fund is generally managed as a NPO or charitable foundation or private trust. The Board of trustees ('Board') represents those charged with professional governance while top investment fund advisers and talented investment managers run the show.



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Endowment funding route

Endowment fund policies

The Board needs to set up rules to give the fund manager guidelines about how they can invest money, its usage and withdrawal guidelines. Investment policy focuses on 'WHAT' – multiple investment strategies, corpus allocation and targeted income yield. Withdrawal policy specifies 'HOW MUCH' - annual spending limits and conditions/restrictions on the money that can be withdrawn. Usage policy specifies 'HOW' - the purpose and objective of spending.

Investment avenues

The NPOs take a conservative and prudent investing approach to ensure they keep getting steady returns in the long term without risk.



Some of the top investment options includes absolute return funds and global equity funds. Absolute return funds invest in funds with absolute return, security selection, and hedging strategies, with the objective of consistent capital appreciation whereas global equity fund's objective is to achieve long-term capital growth by investing in emerging markets.

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Endowment funding route

Benefits of an endowment fund

Setting up an endowment fund gives NPOs a way to generate money over time to serve their cause. An endowment provides a pipeline of funds that the institution can stretch over a longer period of time to diversify sources of income. Some of the key benefits of having endowment fund:

➔ Permanence and Longevity - Corpus is kept intact/permanent at low risk and steady income from investment

➔ Enhanced financial stability and high liquidity – continuous availability of funds year over year, and cash is available to withdraw as and when there is a need

➔ Improved perception - sending a message of planned long-term financial growth

➔ Relieves pressure on the annual fund – support to the annual operating budget

➔ Transparent investment policies

Fund/grant agreements

The fund/grant agreements are entered into between the NPO and a donor whereby the donor wants their donations to be used for a specific purpose. For instance, if a donor invests in a scientific and research endowment fund to support the research and deliverables of a particular field of study, such purpose and restriction of use of the funds would be expressly stated in the fund agreement. In such cases, the NPO becomes legally obligated to utilise the fund solely for that purpose and not for any other purposes. *Funds not subject to donor-imposed restrictions are designated by the Board to function as endowments commonly referred to as 'Funds Functioning as Endowment' (FFE).*



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Endowment funding route

Accounting for endowment funds

The financial statements of the endowment funds generally consisting of Balance Sheet, Receipts & Payments Account and Income & Expenditure Account. These are prepared under historical cost convention.

Donations and grants received are recognised as income on receipt of such donation in the period received. Grants received from donors which are earmarked with specific budget (specific grants) are accounted based on fund accounting system. Donations made with a specific direction that they shall form part of the corpus of the Fund are classified as corpus donations and are directly accounted in the Balance Sheet. The receipts and payments pertaining to the specific fund is accounted in the fund account and the unutilized amount is shown as a liability. Salary cost is allocated to the specific project based on the time spent on specific project estimated on reasonable basis in line with the budget agreed with the donors. Administration and other common expenses are apportioned to the projects to the extent allowable as per the agreements with the donors.

Funds with donor-imposed restrictions either gets accomplished or the stipulated period gets elapsed. Unspent amount, if any, at the end of the project period will be returned to the donors if so, required by the agreements with the donors, or adjusted against Reserves in the absence of instructions from the donors to the contrary.

Expenses incurred by the Fund which are reimbursed by the donors, are recognized as expenses on actual payment. The reimbursement received from the donors is recognized as income on actual receipt of the amount. Any amount reimbursed in excess of the actual expenses incurred is considered as income and recognized accordingly in the Income & Expenditure account.

Assets that represent the endowment fund (investments, cash and cash equivalents, etc.) as well as the fair value of the investments arrived using the Net Asset Value shall be disclosed in the notes to accounts.

Accounting standards

Accounting Standards apply in respect of any enterprise engaged in commercial, industrial or business activities, irrespective of whether it is profit oriented or it is established for charitable or religious purposes. An enterprise would be excluded from this applicability only if no part of the activity of such enterprise is commercial, industrial or business in nature. If even a small portion of activities fall into any of the above categories, the entire enterprise will be liable to apply Accounting Standards. In the absence of any authoritatively established accounting principles for endowment funds which do not carry out any commercial activity, the *Guidance Note on Financial Statements of Non-Corporate Entities* issued by the ICAI may be of relevance.

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Endowment funding route

Taxation of endowment funds

Though endowments taxes exist in some of the foreign countries, they are tax-free vehicles in India as their legal structure is a NPO serving charitable or religious activities under the Indian Income-tax law. The benefit of constituting an endowment fund is to secure tax efficiencies by registering the corpus and availing the applicable exemptions under the relevant provisions of the Income Tax Act. However, there are certain conditions that are required to be satisfied with, for availing the tax exemption, such as object of constitution of the Fund, minimum spending limits (presently 85%), application of income only in India, prohibition on the use of income/property for the benefit of founder/trustees/donors etc.

Regulations in India

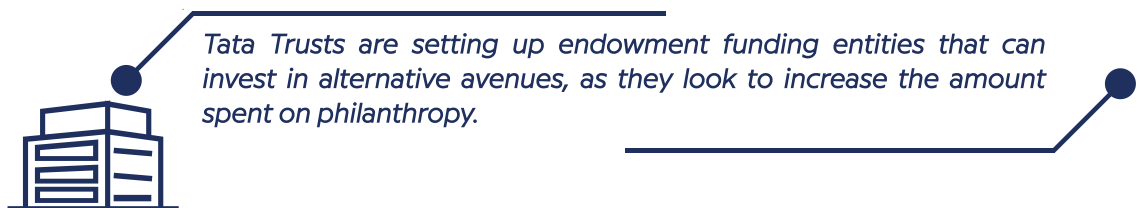
Endowment funds are not specifically regulated in India. They maintain their 'personal/private' character and is not presently governed by the central/ state legislation. It does not come under SEBI as it is not classified as a venture capital fund or a mutual fund. It also does not come under the classification of NBFC or a core investment company under the RBI norms. If the NPOs are registered as Section 8 Company under the Companies Act, they fall under the monitoring of Ministry of Corporate Affairs.

If more Indian corporates decide to go for the endowment funding route, soon will be those days when such entities will be regulated once it gains more traction. Government scanners will be vigilant to identify if any endowments are not operating as NPOs or that they have served as tax shelters.



IN THE NEWS

Why Tata Trust formed a new endowment trust - Ratan Tata Endowment Foundation in September 2022



Tata Trusts are setting up endowment funding entities that can invest in alternative avenues, as they look to increase the amount spent on philanthropy.



Keen to scale up charitable funding



Estate planning for an everlasting legacy- Investing Ratan Tata's 3500+ crore net worth with trust and using the proceeds from the corpus likely for future charity and philanthropy



To reduce heavy reliance on dividend income from Tata Sons - 267 crores in FY 22



Intact corpus ensures sustainability of fund and its causes



Endowments are not taxed due to their charitable or educational mission



GRC

Intellectual property rights - Navigating the legal grey area of employer and employee invention

The Indian Patents Act deals with registering an invention in the name of the true and first owner or their assignees. Getting an employee invention registered in the employer's name in an employee-employer relationship is a challenging area and there is no legal clarity on it. Ms. Abhilasha (Vadodara office) demonstrates various situations and throws light on how such agreements can be defined to reduce possible employer-employee conflicts.

Introduction

In the current era of ground-breaking ideas and exploratory ventures, where emerging startups and scientific exploration have become the norm, it is crucial to give due consideration to the proprietary entitlements of these inventions or research within corporate entities. Many corporate employers invest significant sums of money in research and development to create a successful invention to monetize it in their own name. As a result, companies have started to include clauses in employment contracts that assign ownership of current and future inventions and related rights to the company. However, the Indian Patents Act, 1970 ('IPA') does not have any specific rules for situations where there is no agreement or assignment of ownership between employers and employees in the future. This article seeks to examine the challenges faced by corporate employers in asserting their right to apply for a patent, and how these challenges can be reconciled with the provisions of the IPA.

Assignment of present and future inventions

Indian Patents Act, 1970 deals with the assignment of present inventions, but there are no provisions to deal with the assignment of 'future inventions' or 'agreements to assign.' This lack of clarity has created a challenge for corporate employers who invest significant resources in research and development, and the use of mind resources (employees) to create successful inventions. The challenge is further toughened by the provision which stipulates: 'who can make an application to patent an invention?' It is only the 'true and first inventor' or his 'assignee' who can make an application.

True and first inventor: The term 'true and first inventor' has been judicially interpreted to mean a person who contributes to the formulation of the inventive concept. Under the IPA, it appears that such a person must be a natural person and cannot be a juristic person such as a corporate entity. Thus, the only way a corporate employer can assert a right to apply for a patent is if such employer is an assignee.

Assignee: An assignee means a person to whom some right, interest, or title to intellectual property is transferred.

Therefore, the employer must qualify either as true/first inventor or an assignee for filing the patent application and for the grant of a patent.

In the event where an existing invention has already been assigned, the assignee has the right to apply for a patent regardless of any employer-employee relationship. Similarly, if an 'agreement to assign' or an 'assignment already executed' exists for an already existing invention, the assignee may also apply for a patent as an assignee in equity.

However, if no such assignments or agreements exist for future inventions, the question of how a corporate employer can assert its right to apply for a patent remains.

The UK Approach:

In the United Kingdom ('UK'), it was long settled that in employer-employee contracts, the right to patent the invention vests with the employer. This principle is based on the understanding that it is implicit in employer-

Intellectual property rights - Navigating the legal grey area of employer and employee invention

employee relationships as in the case of other contracts of personal service such as master-servant relationships, that rights in the works executed by the employee vest in the employer. The UK approach may be summarised as follows:

i

In the case of employer-employee relationships, if an invention is made in the course of employment or specifically assigned duties, the invention is the property of the employer only.

ii

Law shall imply a term in the contract of service or employment that such inventions shall belong to the employer. Such a term can only be displaced by an express covenant to the contrary.

However, these principles are difficult to reconcile with the provisions of the Indian Patents Act, 1970, which only entitle a 'true and first inventor' or his 'assignee' to make an application. The fact that a corporate employer cannot be a 'true and first inventor' is clear, but can a corporate employer, in whom arguably the invention vests, apply as an 'assignee' of the employee if there is no transfer of the invention from the employee to the employer?

Another important aspect to consider is the scope of the assignment of invention rights. Employers may try to claim ownership not only of inventions directly related to an employee's job/duties but also any invention that is 'reasonably related' to the company's business. This broad scope can create disputes over ownership of inventions that an employee may have developed outside of their work hours or without using any company resources.

To mitigate these potential legal disputes, employers should clearly define the scope of the assignment of invention rights in employment agreements.

- This can include specifying the types of inventions that the employer claims ownership over and the extent of the employee's obligation to disclose and assign such inventions.
- Employers may also consider providing incentives to employees for developing inventions that are unrelated to their job duties, such as profit-sharing agreements or bonuses.
- On the other hand, employees should carefully review their employment agreements and seek legal counsel before signing them. It is important to fully understand the scope of the assignment of invention rights and any potential limitations on the employee's ability to pursue their own inventions. In some cases, employees may be able to negotiate the terms of the agreement to provide greater protection for their own intellectual property rights.

In addition to the legal considerations, there are also ethical concerns surrounding the assignment of invention rights.

- Some argue that employers have a moral obligation to share the benefits of employee inventions with the inventors themselves. This can include providing financial compensation or other recognition for their contributions to the company's success.

Intellectual property rights - Navigating the legal grey area of employer and employee invention

- Furthermore, the assignment of invention rights can impact employee morale and job satisfaction. If employees feel that their contributions are not being adequately recognized or rewarded, they may become disengaged or even leave the company. This can lead to a loss of valuable talent and a negative impact on the company's bottom line.

To address these ethical concerns, employers should consider implementing policies and practices that recognize and reward employee inventions. This can include creating an innovation program that encourages and supports employees in developing new ideas, providing opportunities for employees to showcase their inventions within the company, and offering financial or non-financial incentives for successful inventions.

In conclusion, the assignment of invention rights in an employer-employee relationship is a complex and evolving legal issue. Employers have a vested interest in claiming ownership of the employee inventions to protect their intellectual property and maintain a competitive edge. However, this can create legal and ethical challenges, particularly when it comes to defining the scope of the assignment of invention rights and protecting employee morale and job satisfaction.

Employees should carefully review their employment agreements and seek legal counsel to ensure that their intellectual property rights are protected. Employers should consider implementing policies and practices that recognize and reward employee inventions to promote innovation and maintain a positive workplace culture.

Ultimately, the key to resolving this legal conundrum lies in striking a balance between the employer's interests and the employee's rights. By working together to define clear policies and practices that protect both parties, employers and employees can ensure a fair and productive working relationship that benefits everyone involved.





TAXATION

Supreme court judgement on the levy of service tax on 'engineering design & drawings'

Taxability of software designs and drawings has always been a nebulous area due to its inherent nature of being an intangible asset. Mr. Shouvik Roy (Mumbai office) discusses the outcome of a landmark apex court judgement where 'engineering designs and drawings', when put on a 'media' are liable to tax a 'goods' as well as 'services.'

Taxation

Supreme court judgement on the levy of service tax on 'engineering design & drawings'

Commissioner of Customs, Central Excise & Service Tax v M/S Suzlon Energy SC judgement dated 10 April 2023

Synopsis

The Supreme Court of India ('SC') has held in the captioned judgement that the import of 'engineering design & drawings' falls under the category of 'design services' under section 65(35b) read with section 65(105) (zzzzd) of the Finance Act, 1994, and are subject to levy of service tax. Such services cannot be excluded from the definition of 'design services' under the Finance Act, 1994, on the solitary and primary ground that the designs and drawings had been shown as 'goods' under the Customs Act and in the bill of entry.

The SC further ruled that same activity can be taxed as 'goods' and 'services' provided the contract is indivisible, and hence, on the aspect of services there may be a levy of service tax.

Facts

- Suzlon Energy Ltd. ('respondent') is a manufacturer of wind turbine generators (WTG). The respondent entered into 'product development and purchase agreement' with M/s Suzlon Energy GmbH (M/s 'SEG'), which is its sister concern situated in Germany, to be used exclusively for manufacturing of WTG in the territory of India.
- M/s SEG reduced the designs to a blue print on paper and exported the same to India.
- While importing the designs, the respondent, i.e. Suzlon Energy filed 'Bill of Entry' with the customs authorities and classified the same as 'Paper' and claimed benefit of 'Nil' rate of customs duty (which was the applicable rate as per Customs Tariff for paper.)
- The respondent claimed that since the designs and drawings imported by it via proper customs procedure, by filing the bill of entry were 'goods' (and therefore not 'services'), they would be exempt in this case, from levy of service tax.
- In the course of Department audit it was noticed that the respondent had not paid service tax on 'engineering design & drawings' of various models used in the manufacturing of WTG, which was classifiable under the category of 'design services' for the entire period from June 2007 to September 2010.
- On 25 March 2012, the Commissioner of Customs, Central Excise & Service Tax ('appellant' in this case before the SC) held the respondent was liable to pay service tax as 'design services' on importing various models of 'engineering design & drawings' for the purpose of manufacturing of wind turbine generator (WTG), as defined under Section 65(35b) r/w section 65(105)(zzzzd) of the Finance Act, 1994. The Commissioner also levied interest as well as penalty on the respondent.
- On respondent filing an appeal before CESTAT against the aforesaid order of the Commissioner, the Custom Excise and Service Tax Appellate Tribunal ('CESTAT') set aside the department's order for payment of service tax. CESTAT held that 'design and drawings' are 'goods' and not 'service'. It further held that the taxation of goods and services are mutually exclusive levies, therefore the same activity cannot be taxed as both goods and services.
- The appellant department then filed an appeal against the CESTAT order before the SC.

Taxation

Supreme court judgement on the levy of service tax on 'engineering design & drawings'

SC judgement and its ratio decidendi

- The Bench observed that the respondent was engaged its overseas German sister concern for preparation of 'engineering design & drawings' to be used in manufacturing of WTG.
- The design was reduced as blue print on paper and delivered to the respondent on the same medium.
- It was opined and held that such 'designs' were subjected to the service tax even as per the clarification by the Board dated 18 March 2011 on the issue of applicability of indirect taxes on packaged software.
- Therefore, the respondent was liable to pay service tax on the 'design services' received from abroad under reverse charge.
- Further, M/s SEG is an overseas subsidiary of the respondent (Suzlon Energy India). Accordingly, the amount received by M/s SEG from the respondent for its service in preparing the 'engineering design & drawings' was liable to service tax under reverse charge, (to be discharged by the Indian service recipient, i.e the respondent) in terms of the concept of 'associated enterprise'.
- On the issue of blue print of design being treated as 'paper' and claim of no duty payable on the same, the Bench observed neither any customs duty was paid due to exemption from payment of duty treating it as 'paper' nor the service tax was paid. Thus, the whole transaction had escaped taxation.
- The Bench relied on the SC judgement in BSNL v. Union of India, wherein it was held that there can be two different taxes/levies under different heads by applying the aspect theory and thus held here, that the same activity can be taxed as 'goods' and 'services' provided the contract is indivisible and on the aspect of services there may be levy of service tax. On the sole ground that 'engineering design & drawings' prepared and supplied by overseas sister company were shown as 'goods' under the Customs Act and in the bill of entry, such services cannot be excluded from the definition of 'design services' under the Finance Act, 1994.
- The Bench opined that, since there exists a distinction between a contract of sale of goods vs. a contract of service, the intention of the contracting parties must be ascertained as to whether they intend transfer of both goods and services, either separately or in an indivisible manner or in a composite manner. The appellant revenue department too had argued the difference between the term 'sale of goods' and 'contract of service' quoting certain examples in the field of medicine.
- The Bench held that the view taken by the CESTAT that the same activity cannot be taxed as goods and services is erroneous and accordingly the CESTAT order was set aside and appeal allowed in favour of Revenue Department.



Taxation

Supreme court judgement on the levy of service tax on 'engineering design & drawings'

Comments



Taxability of software designs and drawings has always been a nebulous area due to its inherent nature of being an intangible asset.

This judgement distinguishes the earlier landmark judgements of SC in the case of Associated Cement Companies and Tata Consultancy Services wherein it was held that intellectual property, once put on to a media would become 'goods' and sale of canned software is to be taxed as 'goods.'

It is now conclusively held by this judgement that import of designs and drawings attracts service tax as a service, in addition to Customs Duty (though the Customs duty may be Nil as per Customs tariff). This ratio will have implications in the GST regime also, as the Department may now charge IGST on the service portion, (in case of an indivisible contract) and also the basic customs duty, as per Customs Tariff Act, on the same transaction.

This decision could have far-reaching ramifications on various issues like import of software, and import of other intellectual property.



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