KATALYST
ADVISORS LLP

Katalyst Kaleidoscope

April 2019: Tax and Regulatory Insights

A. Income-tax Highlights

1. Looking forward to Financial Year 2019-20

With the beginning of this financial year, there are certain key areas which are being watched upon by many and are crucial to how the tax framework would shape-up.

a) Full Budget, 2019

The Full budget 2019 would be pronounced post elections and formation of the elected Government. While one cannot guess the extent of amendments which could be made, ones which are very eagerly awaited are **a)** Clarity on reduced tax rates for companies having turnover of less than INR 250 Crores. The Interim-budget continued to apply this test as on 31 March, 2017 while this may not be the intent; **b)** Clarity on the scope and applicability of the Banning of Unregulated Deposit Schemes Ordinance, 2019; c**)** MAT on companies since most of the tax incentive schemes have been withdrawn.

b) New Direct tax Code, 2019

The Direct tax code was scheduled for release for public comments on 28 February, 2019. The committee sought an extension of additional 3 months i.e. until 31 May, 2019. While a lot will depend upon the election result, it is interesting to watch if the new code will result in ease of doing business with limited compliance and least tax disputes (incidentally, the CBDT has also appointed a committee “to examine the suggestions and issues on litigation management” in February, 2019 and it is likely that some of the recommendations of that committee may find their place in the new Direct Tax Code).

c) End of an era - Tax on capital gains at full rate under revised tax treaty[1] with Singapore & Mauritius

India’s tax treaty with Singapore & Mauritius was revised in 2017 and a transitory window was provided, wherein the tax on capital gains arising from alienation of shares, was levied at 50% of the rate applicable on such transactions under the Indian Income-tax Act, 1961 (the Act). Beginning from 1 April 2019 this window has expired and, such capital gains will now begin to be taxed at the full rate being the rate applicable under the Act on such transactions.

[1] CBDT Press Release 23 March, 2017

2. Disproportionate allotment of shares to existing shareholders at less than market value not taxable under section 56(2)(vii)

The Mumbai ITAT in the case[2] of ACIT v. Subodh Menon, following the ruling of Sudhir Menon HUF v. ACIT, held that additional allotment of shares to an existing shareholder of a company at less than fair market value determined in accordance with the prescribed methodology, as part of a bonafide business transaction, should not be subject to section 56(2)(vii) of the Act. In this case the issue of shares was not on dis-proportionate basis (i.e. allotment of shares higher than the proportion offered) but the assesses' share was reduced in the Company pursuant to this issue implying that he gained nothing.

The ITAT further affirmed that Section 56(2)(vii) is an anti-abuse provision and should not be applied in situations where the transactions are bonafide.

Katalyst Comments: *The ruling is one of the firsts few on the said section and will help in interpreting the provisions thereof. However, it may become challenging to apply the said ruling during the preliminary assessments for two following reasons a) the section, per se, does not differentiate between proportionate or disproportionate issue of shares and as such, applies to any and every issue of shares which is lower than the prescribed value; b) the assessment of bonafide of the transaction, in case where the situation breaches the prescribed value, will have to be dealt with only by the Courts.*

3. Prescribed valuation methodology under Rule 11UA for the purposes of Section 56(2)(viib) cannot be resorted to, where the AO can be satisfied with the valuation

In the case[3] of India Today Online Private Limited, ITAT Delhi held that the valuation report submitted by the assessee for the purpose of Section 56(2)(viib) has to be accepted unless a discrepancy in the valuation is found.

Section 56(2)(viib) provides that where a closely held company issues its shares at a premium, then the amount in excess of the FMV of such shares will be charged to tax in the hands of the recipient company as income from other sources, unless valuation is justified through a valuation report.

The value is determined in accordance with the rules prescribed whichever is higher.

Katalyst Comments:

(i) The ITAT ruled that the value substantiated by the assessee is the appropriate value for the purpose of Section 56(2)(viib), unless a specific discrepancy can be found by the tax authorities in such valuation. However, the Section 56(2)(viib) clearly requires the value for the purpose of this section to be the value as substantiated by the assessee or value determined in accordance with the Rule 11UA; ***whichever is higher*** *(this decision was rendered pre insertion of Rule 11UA)****.***

[2] ITA No. 676/Mum/2015

[3] India Today Online Pvt. Ltd [TS-130-ITAT-2019 (DEL)]

(ii) *The larger question is that the entire concept of share premium being even potentially considered as income seems bizarre and appears to be a response to extreme situations of money laundering; the consequence is a huge amount of litigation and difficulties faced by tax payers due to such outlier legislation.*

4. Admission of new partners and retirement of old partners in quick succession

The Bombay High Court[4] in the case of Principal CIT vs. Electroplast Engineers was dealing with the question, as to whether there would be capital gains in the context of retirement of partners in the firm. The facts were that a partnership firm having operating business for 13 years, admitted new partners, revalued the assets/ recognized the goodwill for first time crediting the same to existing partners and gave cash to the retiring partners on retirement (which was brought in by the new partners). The tax authorities raised the dispute taking recourse under Section 45(4) of the Act, which deals with the transfer of a "capital asset" by the firm pursuant to dissolution or otherwise. The HC held that, there was no transfer of capital asset under the facts as envisaged under Section 45(4) because the firm merely made cash payments to the retiring partners and such cash is not a capital asset.

Katalyst Comments: *The HC made an interesting observation in the order, mentioning that the revenue authorities have not even contested if the re-constitution of the firm in this case is a colorable device. In effect, what was possibly achieved by the parties involved was to transfer the business of the firm to a new set of partners, without triggering any tax liability. The Chennai Tribunal in case of DCIT Vs Kali BMH Systems Private Limited (ITA 1631/1632/ Madras 2015), dealing with similar facts has held that such re-constitution of the firm was a colorable device and held against the assessee.*

Such transactions are frequently used in situations where the firms have valuable assets like immovable properties and existing partners attempt to transfer the same to new partners using the similar methodology. Such transactions would, going forward, mostly likely get scrutinized under GAAR especially vis-à-vis commercial rationale.

5. For the purpose of Section 45(3), value recorded in the books of the firm, on the date of the transfer is relevant – subsequent revaluation by the firm cannot be brought to tax under Section 45(3)

The facts of the case[5] were that assessee contributed capital asset to a partnership firm as on 1 April, 2011 and subsequently, the partnership assets were revalued (on 29 May, 2011) and firm was then converted in to a private limited Company on 29 June, 2011. The assessee offered the capital gains to tax basis the value recorded by the firm, in its books on the day of contribution. However, the subsequent revaluation by the firm, within short term, was not offered to tax. The assessing officer sought to take the revalued amount as full value of consideration and re-compute the capital gains thereon.

[4] TS-168-HC-2019(BOM)

[5] 410 ITR 236 (Madras)/ 102 taxman.com 330 (Madras) [2019]

The HC upheld the ITAT's order, holding that, for the purpose of the section 45(3), the full value of consideration shall be the value recorded by the firm on the date of the transfer. The Revenue authorities preferred a Special Leave Petition in the Supreme Court, which the SC dismissed.

Katalyst Comments: *The subject case provides much-needed clarity with respect to the reference date for determining full value of consideration under Section 45(3). However, one needs to be cognizant of the need to demonstrate commercial rationale for revaluation within quick succession without any reconstitution of the firm, especially in the context of General anti-abuse Regulations.*

6. Delhi High Court (Delhi HC)[6]: Make My Trip - not liable to deduct TDS on payment gateway charges paid to Banks

The Assessee is engaged in the business of arranging travel through its online travel portal. The customers make payment only by using the facility of an Internet Payment Gateway. Facility charges are deducted by this payment gateway and the net price after such deduction is automatically credited to the bank account of the merchant.

In the extant case, the question of law was whether tax should be withheld on account of payment gateway charges u/s 40(a)(ia). The HC noted that the amount retained by the bank is a fee charged for having rendered banking services and "cannot be treated as a commission or brokerage paid in course of use of any services by a person acting on behalf of another for buying or selling of goods."

Further, by notification dated 31 December, 2012, the Central Board of Direct Taxes (CBDT) notified that no tax shall be withheld on specified payments to banks listed in the Second Schedule to the RBI Act which, inter alia, exempted credit card or debit card commission for transaction between the merchant establishment and acquirer bank. Thus, the HC ruled in favour of the assessee.

7. CBDT notifies ITR forms for AY 2019-20[7]

The CBDT has notified new tax return forms applicable for financial year 2018-19. Notable impact could be as follows -

a) Regarding Individuals (resident or non-residents)

- Will now need to report the investments in un-listed entities.
- Residents will now need to report details pertaining to the investments made in recognized Start-ups. This has been possibly brought in to ensure that the share capital infusions reported by start-up companies reconcile with the reporting made by the shareholders.
- Assessees having Foreign assets to report more of Foreign Depository account, Foreign custodian account, Foreign Equity and Debt Interest and Foreign cash value etc. in addition to existing reporting requirement in the tax return.

[6] TS-161-HC-2019(DEL)
[7] CBDT Notification No. 32/2019 dt. 1 April, 2019

b) Regarding Non-residents

- They will need to report their number of days spent in India. This will mean that the residential status could be tested by the tax authorities.
- They will also need to report overseas residency and tax identification number. This possibly is arising out of the increased exchange of information between the tax authorities of multiple countries. Needless to say, any inconsistencies in reporting could get questioned.
- Any income where a treaty benefit is claimed, such income/ transaction particulars will now get captured in the tax returns.

Katalyst Comments: *With every passing year, tax returns forms are seeking to gather more information with increasing details. While this is merely compliance, the individuals who are mobile and have cross-country assets/ ownerships will need to be cautious. With more details being provided, one should expect a greater level of tax queries, not only from income-tax authorities but may be from other agencies too.*

B. SEBI Highlights

1. Brand usage fee/ royalty paid by the listed Companies – effective date extended from 1 October, 2018 to 1 July, 2019[8].

SEBI has extended the effective date of LODR regulation 23(1A) notified on 9 May, 2018 (requiring compliance effective from 1 October, 2018), to 1 July, 2019. This regulation requires listed entities to ascertain if payment for brand usage or royalty exceeds 2% of consolidated annual turnover of the listed entity for the last audited financial statements; if so such entities are required to obtain approval of the shareholders for such transaction.

Katalyst Comments: *The issue under Regulation 23 per se continues to be as to whether the materiality is to be applied on an aggregate basis or vis-à-vis each entity. The intent, being better governance, is to test the quantum of related party transactions, from the perspective of the listed entity (including its subsidiaries). This amendment further strengthens the governance norms and is possibly deferred for implementation for administrative reasons.*

C. Corporate Law Highlights

1. LLPs vis-a-vis manufacturing & allied businesses

The Central Registration Centre (CRC) of MCA at Manesar in an Office Memorandum[9], stated that the definition of “Business”, as defined in section 2(1)(e) of the LLP Act, 2008, includes trading, profession, service and occupation but “manufacturing & allied activities” have been positively excluded from the definition. It is further stated that LLPs have primary objective, mainly for professional services and not manufacturing. However, the said OM has been subsequently withdrawn by the MCA.

[8] SEBI/LAD-NRO/GN/2019/07 - SEBI/LAD-NRO/GN/2018/10
[9] Ref No. CRC/LLP/e-forms dated 6 March, 2019

Katalyst Comments: *As mentioned, the MCA has withdrawn the OM; in the light of Government's initiative to improve case of doing business in India, such OM should not have been issued in the first place, since LLP offers a more flexible structure to undertake business and therefore, such narrow interpretation should not have been adopted in the first place.*

2. Company formation – Enchanced features

The "Simplified Proforma for Incorporating Company Electronically" (SPICe) form had been earlier introduced, whereby the procedures for obtaining Director Identification Number, name reservation, incorporation, allotment of Permanent Account Number and Tax Deduction Account Number were integrated. Now, as per an MCA initiative, the SPICe (INC-32) form shall be accompanied by 'e-form AGILE' (INX-35) containing an application for registration of the following:

- Goods and Service Tax Identification Number;
- Employees' Provident Fund Organisation; and
- Employees' State Insurance Corporation.

Katalyst Comments: *In view of the above, SPICe form would also now have to be accompanied by a linked e-form AGILE (Application for Goods and Service Tax Identification Number, Employees' State Insurance Corporation registration plus Employees' Provident Fund Organisation registration); this helps in a 'single window' flavor and should make such registration less cumbersome.*

D. RBI and Foreign Exchange Regulations Highlights

1. Amazon structures the Investment into More Supermarkets via Witzig

With the recent changes in the FDI Policy[10], Amazons' investment in More Supermarkets through an entity called Witzig and its intent to consolidate Witzig onto its Amazon Prime Now (Amazon's food & grocery platform) suffered a set-back.

The current executed structure by Amazon makes it possible to acquire a stake in Witzig and also possibly consolidate the Witzig into Amazon Prime Now, possibly at the cost of "no-control" for Amazon in Witzig.

[10] Press Note no 2 of 2018 dated 26 December, 2018

Particulars	What does the FDI Policy prescribe?	What has Amazon done?
FDI into inventory-based model	Not permissible	• More Supermarkets hold the inventory and marketplace platform. • Investment by Amazon is not an FDI, since for a down-stream investment by Witzig to be counted as FDI, Amazon should have had > 50%. Amazon only acquired 49% equity stake, leaving Witzig as India owned and controlled.
Integration of More Supermarkets onto Amazon Prime Now	An entity having equity participation by e-commerce marketplace entity or its group companies, will not be permitted to sell its products on the platform rum by such marketplace entity.	• Amazon acquired 49% equity, split into - differential voting shares. 17% with 1:1 voting rights and balance without any voting rights. • With less than 26% voting rights, Witzig will not qualify as a "Group Company" for integrating onto Amazon Prime Now.

Katalyst comments: *While the structure adopted by Amazon does fit into the framework of the FDI Policy on e-commerce, it will need to be seen if the Regulators will respond with the amendments. The amendments, if any, are only likely to be prospective and may still not disturb what Amazon has achieved.*

2. RBI Circular[11] on resolution of stressed assets held "unconstitutional" by SC

The RBI Circular dated 12 February, 2018 required the banks to categorize certain defaulting accounts with borrowing of > INR 2,000 Crores as Non-performing assets (including default of even 1 day) and achieve either a resolution process within 180 days or initiate insolvency proceedings. The Supreme Court has struck down the said Circular as ultra-vires and beyond the authority of the Reserve Bank.

Katalyst Comments*: The Supreme Court ruling will affect the on-going debt resolution process of approximated INR 2.2 lakh Crore including unwinding of the insolvency processes. While the social impact of this change has already been huge including loss of jobs, it will be interesting to see how the economic impact will flow. The RBI has issued a media statement saying that they will likely come-up with another Circular, which will be well within their authority.*

3. Investment limit by FPIs in Government Securities raised[12]

The revised limit for FPI investment in Central Government securities (G-secs), State Development Loans (SDLs) and corporate bonds shall be 6% (previously 5.5%), 2%, and 9% of outstanding stocks of securities, respectively, in FYE20.

RBI further apprises that the allocation of increase in G-Secs limit over general and long-term sub-categories, has been set at 50:50 for FYE20.

[11] RBI/2017-18/131 dated February 12, 2018
[12] RBI/2018-19/152, A.P. (DIR Series) Circular No. 26

E. Indian Accounting Standard (IND AS) Highlights

1. RBI defers implementation of Ind AS for Schedule Commercial Banks and Regional Rural Banks.

Considering the pending amendments to the Banking Regulation Act, 1949, as well as the level of preparedness of several banks, RBI has taken a decision to defer the applicability of Ind AS vide notification[13] dated 22 March, 2019 till further notice. Further, RBI is yet to issue prudential norms and operational guidelines to facilitate the implementation of the new accounting standards.

As per previous RBI press release dated 5 April, 2018 Ind AS was supposed to be applicable to banks from FY 2019-20.

2. MCA amendments to Ind AS – Amendment and Second Amendement Rules dated 30 March, 2019

The Ministry of Corporate Affairs (MCA) on 30 March, 2019 notified[14] few amendments to Ind AS effective from financial year beginning on or after April 1st, 2019. Major changes are as follows:

a) In place of previous standard IND AS 17, **IND AS 116** shall be applied for accounting of leases by lessee and lessors. A major change brought in IND AS 116 requires only the lessor to classify a lease as operating or finance lease; for lessee's, the distinction between operating and finance lease has been down away with. Therefore, a lessee would be required to recognize right of use as an asset and a corresponding liability. Recognition of an asset and liability would significantly impact the P&L account, since the lessee would also be required to recognize notional depreciation and notional interest on such leases.

b) Amendment in **Ind AS 12 (Income tax)** relates to tax consequence of an item whose tax treatment is uncertain. Hence, if there is uncertainty over tax treatment of an item, the entity should predict the uncertainty and show the effect in books including the impact on taxable profit/loss tax base, unused tax losses, unused tax credit and tax rates.

c) Amendments in **Ind AS 103 (Business Combination)** now requires an acquirer obtaining control of a business being a joint venture, wherein the acquirer previously held any equity interest, to remeasure its previously held interest in the joint venture at fair value through profit or loss on the acquisition date itself as though the acquisition is in stages.

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[13]RBI/2018-2019/146, DBR.BP.BC.No.29/21.07.001/2018-19

[14] [14] G.S.R (E), dated the 30th March, 2019

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