KATALYST
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Katalyst Kaleidoscope

December 2017: Tax and Regulatory Highlights

A. Income-tax Highlights

1. US tax reform and its' relevance for Indian Companies and Promoter Families

The much talked about US tax reforms are making a measurable progress towards becoming law.. The House of Representatives passed the 'Tax Cuts and Jobs Act of 2017' on 16th November 2017. Subsequently, the US Senate passed the said tax reform bill, but with some variations. It is now, likely that House of Representatives and US Senate, will reconcile their tax bills and the reforms will get President's accord by end of 2017. Listed hereunder are some of the proposed reforms likely to have impact in the Indian context:

Companies/ businesses in US

- Reduction in Corporate tax rate from 35% to 20%.

- US tax framework is proposed to be moved from currently taxing 'world-wide' income of US entities to 'territorial' income of US entities. Currently, if any untaxed profits are repatriated into US, the corporations would be liable to pay taxes at the rate of 35% / federal corporate tax rates. It is proposed, that the foreign sourced dividends (with few exceptions) will not be taxed in US going forward. This will leave very little motivation for US corporations to not repatriate the foreign earnings and profits from foreign jurisdictions into US.

- To give effect to the above, a one-time tax is proposed to be levied on un-taxed foreign earnings and profits. If passed, the US Corporations will be required to pay the one-time repatriation toll-charge, over 8 installments, at reduced rate of 14% of cash and cash equivalents and 7% effective rate for remainder of the inclusion. The rates are however, slightly higher as proposed by US Senate version.

- Concessional; treatment or reduced tax effect on business income earned by partnership, S corporation or sole proprietorship.

Indian Promoters/ families

- The House version proposed to eliminate the existing Estate Duty after 2024, whereas the Senate version does not propose such elimination. This is likely to have material impact on pre-immigration planning by Indians moving abroad, with their estate in India.

Katalyst comment: Indian Groups having business presence in US are required to keep a close watch on the impact of the sweeping US tax reforms on cash-flows and business strategies. The corresponding impact of the proposed US tax reform is also likely to felt on the foreign direct investment into India from US. However, the extent of the impact will only be seen as the reforms get implemented.

2. ITAT opines on issue of shares at premium under Section 56(2)(viib) of the Act[1]

Section 56(2)(viib) of the Act envisages a situation where a Company issues shares at a premium i.e. issue price is higher than the prescribed fair value of each share. The said Section seeks to levy tax on such excessive premium as it exceeds the face value, as income from other sources, in the hands of the issuer Company.

In what is one of the first few judicial rulings on the said Section, the Kolkata ITAT[2] held that issue of 0.1% redeemable non-cumulative preference shares (face value of Rs 10 per share) at a premium of Rs 1,990 per share during the FY 12-13, is appropriate basis the valuation report provided by the assessee and acknowledges that assessee was entitled to issue shares at a huge premium. ITAT further opined that valuer has followed accepted method of valuation by considering the rate of return on preference shares issued by

[1] Income-tax Act, 1961
[2] In the case of Microfirm Capital Private Limited [TS-587-ITAT-2017 (Kol)]

other companies for relevant period and is based on proper benchmarking. ITAT also opined that tax officer is not only required, but is duty bound to evaluate/ investigate the valuation report under Section 56(2)(viib).

Katalyst comment: ITAT has perhaps laid down a guideline that valuation reports for the purpose of Section 56(2)(viib) are required to be descriptive enough to justify the premium and the tax officer is duty bound to investigate them.

3. Compensation received for breach of 'ROFR' – a non-taxable capital receipt

The Hon'ble High Court of Bombay[3] upheld ITAT's order that the fundamental right of assessee to start the bottling business was taken away as a result of breach of right of first refusal (ROFR) and such breach resulted in loss of income source itself and compensation for such loss, cannot be taxed as income. The Hon'ble High Court also opined that the compensation for breach of ROFR cannot be taxed as casual receipt or capital gains absent the transfer or extinguishment of any rights. The Hon'ble High Court brought-out the difference between an award for damages for breach of contract as against the party to the contract accepting satisfaction of the contract otherwise than in accordance with the original terms thereof.

Katalyst comment: This ruling brings out the distinction between ROFR and right to manufacture, in as much as that ROFR by itself, did not permit the assessee to manufacture goods but merely granted a preferential opportunity to prove itself as worthy of being granted such a right and therefore does not qualify as a capital asset.

4. HC permits[4] enquiry into accounting treatment by the tax officer even after approval of the Scheme by the Court under Section 391-394 of the Companies Act, 1956

The tax officer served a notice for re-opening of completed assessment for AY 2007-08 after completion of 4 years from the end of the relevant AY. The tax officer further contended that assessee should have followed 'pooling of interest' method instead of the 'purchase' method for accounting of the amalgamation; thus, there would not have been any question of creation of 'goodwill' and therefore, there was concealment of income. The assessee, challenged the re-opening beyond 4 years by way of a writ petition, on the ground that the Scheme of Amalgamation as approved by the High Court was available at the time of assessment and there is no new evidence/ fact to re-open the assessment. High Court stated that though the Scheme of amalgamation was accepted by the Court, a detailed enquiry about the appropriateness of method was not conducted, and hence the High Court up held reassessment notices.

Katalyst comment: This ruling is perhaps one of its kind and challenges the hitherto well-accepted position that accounting treatment approved by the Courts under Scheme of Amalgamation / Arrangement under Section 391-394 of Companies Act, 1956/ Section 230-232 of Companies Act, 2013 should not be open to enquires/ investigation by tax authorities. However, unlike earlier framework, the Companies Act, 2013 requires National Company Law Tribunal to seek a prior certificate from the Statutory Auditor of the Company to the effect that accounting treatment proposed under the Scheme is in compliance with the applicable provisions/ accounting standards.

5. CBDT issues a draft notification[5] on conversion of foreign bank branch in India into an Indian subsidiary

With an objective to insulate the banking activities conducted by the branch of foreign banks from the risks arising from inter-connectedness, the Reserve Bank of India had issued a framework requiring the foreign banks commencing operations in India after August 2010 to mandatorily convert their branch in India into a subsidiary. The necessary modifications were therefore made under the Foreign Direct Investment Policy and Income-tax Act, 1961.

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[3] In the case of Parle Soft Drinks [TS-554-HC-2017(BOM)]
[4] In the case of Johnson Products Private Limited [TS-586-HC-2017(DEL)]
[5] CBDT Press Release dated 17 November 2017

Section 115JG was introduced with effect from 1 April 2013, to provide for a tax-neutral conversion of a branch of a foreign bank in India into a subsidiary. However, the said section provided that the provisions of the Act relating to the treatment of tax attributes like unabsorbed depreciation, set-off or carry forward and set-off losses etc., will apply basis the notification to be issued under the said section by the CBDT.

Katalyst comment: The draft of the said notification will provide some clarity, hopefully through the upcoming Union Budget, as the Section 115JG requires each notification under the said section to be placed before the House of Parliament.

B. Corporate Law Highlights

1. Amalgamation of directly or indirectly owned subsidiaries is exempt from disclosure requirements under LODR[6]

Renaissance Jewellery Limited (RJL) is a listed company on The BSE and the National Stock Exchange Limited. RJL has a wholly owned subsidiary viz. N Kumar Diamond Exports Limited (NKDEL). NKDEL further holds 55% equity stake in its subsidiary, House Full International Limited (HFIL). The balance 45% equity in HFIL is held by RJL. Vide a Scheme of Amalgamation, it was proposed to merge NKDEL and HSIL, into RJL.

SEBI amended Regulation 37 of LODR, vide a Notification dated 15 February 2017, wherein Regulation 37(6) was introduced to provide that a merger of a wholly owned subsidiary with a listed company was exempted from the process of seeking SEBI's no-objection or observation letter from stock exchanges. However, in the present case, HFIL is not a wholly owned subsidiary of RJL.

SEBI, in the informal guidance issued to the Company has clarified that, even an indirect subsidiary is covered for the purpose of the said Regulation 37(6) and hence, the proposed Scheme is also exempted from the process of seeking SEBI's no objection letter or observation letter from stock exchanges.

Katalyst comment: This informal guidance brings in the necessary clarity in line with the SEBI's intent to exclude the mergers of wholly owned subsidiary with the listed company, out of the process of review by SEBI.

2. Can a registered partnership firm participate in amalgamating proceedings?

The National Company Law Tribunal, Ahmedabad bench, had occasion to consider the situation[7]; in the application, one of the intended transferors was a partnership firm and it was contended by the applicant that the partnership firm should also be considered as a "body corporate" and the scheme of amalgamation should apply to it also. The NCLT referred specifically to Section 394(4)(b) of the Companies Act, 1956 and mentioned that even in the old Act, a transferor company must be a company registered under the Companies Act, and a company includes a "body corporate"; however, there is no similar provision in Section 230 and 232 of the Companies Act 2013 and therefore, a body corporate cannot participate in a scheme of amalgamation, although a partnership was held to be a body corporate. Accordingly, it was held that a partnership firm cannot participate in the amalgamation proceedings.

Katalyst comment: It may be worth noting that under the Companies Act, 1956 the Mumbai High Court had approved a Scheme of Amalgamation[8] wherein a registered partnership firm was merged with a Company.

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[6] SEBI's informal guidance in case of Renaissance Jewellery Limited

[7] Kedia Ceramics NCLT decision dated 27 September 2017

[8] Kirtilal Kalidas Diamonds Exports P. Ltd [148 CompCase 607] BOM

3. **Income-tax proceedings cannot be continued pending completion of insolvency proceedings**[9]

The Hon'ble High Court of Delhi, re-iterated the principle that insolvency code overrides all other laws for the time being in force under Section 238 of the Code. Furthermore, once a moratorium is ordered under Section 14 of the Code while initiating the insolvency proceedings, pending completion of such moratorium/ insolvency proceedings, no income-tax proceedings can be initiated or pending income-tax proceedings shall also not be proceeded with, including recovery proceedings, if any.

Katalyst comment: This ruling re-emphasizes that pending completion of insolvency proceedings, no proceedings, whatsoever, can be initiated or on-going proceedings be continued, under any law. This perhaps makes the insolvency process leaner.

4. **Any dealings by Senior Management or Promoters of a listed company with a third-party, with respect to the shares of listed company require a prior approval from Board of Directors of the listed company as well as public shareholders**[10]

PNB Housing Finance Limited (PNBHFL) sought an informal guidance from SEBI on a proposal to make an ex-gratia amount to the senior management of PNBHFL, in respect of the returns made by the third-party shareholders on its investment in PNBHFL, when PNBHFL was an un-listed company. The third-party shareholder, held 49% stake in the PNBHFL and exited the investment at a good return, before even PNBHFL was listed on stock exchanges.

Said third party shareholder sought to reward the senior management of PNBHFL for the performance at current times, when PNBHFL is a listed entity. SEBI in its response, required compliance with Regulation 26 of LODR since the proposal to make the ex-gratia payment is made when the Company is listed on stock exchanges. Regulation 26 stipulates that, no employee, including KMPs or director or promoter of a listed entity shall enter into any arrangement for himself or on behalf of any other person, with any shareholder or any third party with regard to compensation or profit sharing in connection with dealings in the securities of such listed entity, unless prior approval for the same has been obtained from the Board of Directors as well as public shareholders by way of an ordinary resolution.

C. Securities' Law Highlights

1. **Foreign/ multilateral entities allowed as 'issuer' under International Financial Services Centre (IFSC) Guidelines, 2015**

SEBI, vide a Circular dated 14 November 2017, has amended the definition of an 'issuer' in context of the IFSCs. As it stands amended, an 'issuer', in addition to an Indian entity shall now include an entity incorporated in foreign jurisdiction, provided such entity is permitted to issue securities outside the Country of its incorporation or establishment or place of business as per the laws and regulations of its country of incorporation. Additionally, an 'issuer' shall also include any super national, multilateral or statutory organisation/ institution/ agency provided such entity is permitted to issue securities as per its constitution.

Katalyst comment: The said amendment will encourage broad based entities to participate in IFSC in India.

2. **SEBI clarifies**[11] **the scope of embargo on listing of any equity shares which are previously de-listed from any stock exchanges**

Regulation 30 of SEBI (Delisting of Equity Shares) Regulations, 2009 puts an embargo on the listing of equity shares which have been delisted for a term of 5 years. Arvind Limited (AL), sought a clarification from SEBI vide an informal guidance, with respect to proposed consolidation of its' engineering. AL is listed on The

[9] In case of Monnet Ispat Energy Limited [LSI-2123-HC-2017-(DEL)]
[10] SEBI's informal guidance in case of PNB Housing Finance Limited
[11] SEBI's informal guidance in the case of Arvind Limited

BSE/ NSE and has a subsidiary Company viz. Anup Engineering Limited (AEL), which was de-listed from Ahmedabad Stock Exchange in June 2015.

The Group's engineering business is presently housed in AL and partly in AEL. As a part of the proposed restructuring, AL sought to de-merge its engineering business into a newly incorporated wholly owned subsidiary (New Co), which would consequentially get listed on The BSE/ NSE. Additionally, the engineering business of the AEL was also sought to be consolidated into the said New Co by way of a merger or de-merger.

The contention of AL was that the embargo in the Regulation 30 of De-listing Regulations does not apply in this case as the issuer entity is different and NOT AEL. AL further relied on the contention that the shares sought to be issued are the new shares and not the previously de-listed equity shares (on which the said embargo applies). In its response, SEBI clarified that the embargo under Regulation 30 of the De-listing Regulations shall not apply in this case subject to the compliance with the SEBI's Circular of Scheme of Arrangement involving listed companies dated 10 March 2017.

Katalyst comment: While the said informal guidance provide some food for thought for the de-listed companies wanting to list again within the term of the embargo, one needs to note that the Scheme of Arrangement still needs to pass the review of SEBI under the Circular dated 10 March 2017 with respect to the Scheme of Arrangement involving listed companies.

D. Other Highlights

1. Indian Party is now allowed to file the Annual Performance Report (APR) with respect to a JV/ Wholly Owned subsidiary outside India, based on un-audited financials[12]

The Reserve Bank of India, issued the said Notification amending the Foreign Exchange Management (Transfer or Issue of any Foreign Security) Regulations, 2004 (commonly referred to as Outbound Investment Regulations). The said Notification amends the responsibility of Indian Party to furnish the APR based on the un-audited financials of the JV/ WoS, if the Statutory Auditor of the Company certifies that the laws of the host country ***do not*** mandate the auditing of the JV/ WoS.

As it stands prior to this amendment, the RBI allowed filing of APRs by an Indian Party, basis the Statutory Auditors' certificate that the un-audited financials reflect the true and fair view of the affairs of the JV/ WoS, *even when the laws in the host country required mandatory auditing of the books of accounts*. The amendment therefore makes it mandatory for the Indian Party to file the APRs with respect to JVs/ WoS, basis the audited financials, wherein the host country does mandatorily require the auditing of books of accounts. Therefore, the liberty to file an APR basis the un-audited financials, wherein the host Country requires the mandatory auditing, will not be available in future.

2. Levy of stamp duty on Scheme of arrangements/ amalgamation/ reconstruction in the State of Haryana[13]

For the first time, the State of Haryana has included the Order of a National Company Law Tribunal with respect to the reconstruction or amalgamation or merger/ demerger in the definition of 'conveyance' under Article 23 of Schedule 1-A of the Stamp Act. The stamp duty is proposed to be levied at 1.5% (subject to a maximum of INR 7.5 Crore) on an amount of market value of the property or the amount of such consideration as set forth in the instrument or order, whichever is higher. The key is note the following aspects:

- The stamp duty will be levied irrespective of whether the Scheme involves any issue or shares or not. For instance, a merger of wholly owned subsidiary into its Parent Company will also be subject to the

[12] RBI's Notification dated 14 November 2017

[13] Gazette Notification in State of Haryana dated 22 November 2017

levy.

- The text of the amendment suggests that the stamp duty will be leviable on 'property' whether or not leviable to stamp duty.

3. Can Independent Directors be held personally liable for Company's operational issues?

The Hon'ble Supreme Court in the case of Jaypee Infratech restrained the Independent Directors and their family members for transferring any personal assets until Rs 2,000 Crore is deposited by the Company with the Supreme Court to protect the interest of the homebuyers who have invested in the incomplete projects of the Group.

The judgement hold independent directors equally liable for the operational issues of the Company. While the judgement is being interpreted positively as well as negatively (i.e. positively to the extent that independent directors are not differentiated in terms of roles and responsibilities within the Companies Act, 2013) and they must achieve the purpose of governance sought to be achieved through their statutory deputation; on the other hand, it is also interpreted negatively to the extent that independent directors do not have sufficient knowledge of the operational aspects and cannot be held responsible for the operational aspects of the Company.

Do feel free to reach out to us for a detailed discussion on ketan.dalal@katalystadvisors.in