KATALYST
ADVISORS LLP

Katalyst Kaleidoscope

December 2018: Tax and Regulatory Highlights

A. Income-tax Highlights

1. Conversion of private limited company into Limited Liability Partnership (LLP) considered to be "transfer" unless prescribed conditions are satisfied; however, no capital gains arise since conversion took place at "book value"

Mumbai Tribunal[1], while upholding the decision of the Commissioner of Income Tax (Appeals), has made the following observations:

a. Conversion of a company into an LLP is a "transfer" falling within the purview of section 45 of the Income-tax Act, 1961 (ITA), which is not taxable provided the conditions prescribed by section 47(xiiib) of the ITA are met. The Tribunal distinguished the Bombay High Court ruling in the case of Texspin Engg. & Mfg. Works[2] on facts, observing that conversion of partnership firm into a company (under Part IX of Companies Act, 1956, which was the case before the High Court) is different from conversion of company into LLP (under the LLP Act) since "conversion" under the LLP Act contemplates a transfer of, inter alia, all properties to an LLP.

b. However, where the conversion takes place at "book value" of the assets and liabilities, the machinery provisions fail while computing capital gains as such, since the cost of the undertaking being vested in the LLP and the transfer consideration thereof being the same i.e. book value. While arriving at this conclusion, the Tribunal has re-affirmed the view that full value of consideration for a transfer means the price bargained for by the parties to the transaction, not the market value.

c. The issue of withdrawal of exemption under section 47A does not arise where no exemption under section 47(xiiib) was claimed in the first place and therefore, transfer by virtue of such conversion would be taxable in the hands of the LLP, not as per the provisions of section 47A, but under section 170 as the successor entity, in absence of the predecessor company.

Katalyst Comments:

Conversion of a company into LLP has been held to be a taxable transfer, unless the prescribed conditions are satisfied, thereby adding to this already contentious issue.

2. Conversion of Compulsorily Convertible Preference Shares (CCPS) into equity shares does not amount to "transfer"

The Mumbai Tribunal[3] has held that conversion of CCPS into equity shares is not a "transfer" under section 2(47) of the ITA since it was not an exchange of shares but a conversion of one type of share into another, where the pre-conversion security ceased to exist. Relying on the

[1] ACIT vs Celerity Power LLP (ITA No. 3637 of 2015)
[2] CIT v. Texspin Engg. & Mfg. Works [2003] 263 ITR 345 (Bom)
[3] Periar Trading Company Pvt Ltd vs ITO (ITA No. 1944/Mum/2018)

CBDT circular[4] and the decision of the Tribunal in the case of Vijay Merchant[5], the Tribunal observed that capital gains are to be computed taking into consideration the cost of the original shares and thus, the conversion did not make any difference to the capital gains computation. The Tribunal also observed that if a contrary view was taken i.e. if such conversion was to be considered as transfer and subject to tax, it would result in double taxation, which is not the intent of the legislation.

Katalyst Comments:

The ruling brings clarity regarding the tax position on cases where preference shares were converted into equity shares prior to introduction of section 47(xb) of the ITA by Finance Act, 2017. However, it would have to be seen whether an analogy can be drawn from the above ruling for other conversions eg. warrants. Further, if the conversion of one instrument into another is not considered as "transfer", the period of holding of the converted instrument should also relate back to the date when the original instrument was acquired.

3. **Rights to enjoy lease income of retail spaces held as a camouflage to divert income under a revocable transfer[6]**

   The assessee, while constructing a hotel, was in need of funds, for which it entered into an agreement with its group company. Pursuant to the agreement, the group company gave an interest free deposit to the assessee in lieu of right to the rental income from specified retail spaces. Delhi High Court dismissed the writ petition filed and upheld the order of the Tribunal, observing that the agreement entered into was revocable and finite and the assessee continued to be the owner of the property. Further, the High Court noted that even after considering rental income in its computation pursuant to the agreement, the group company declared a loss whereas the assessee had profits. Therefore, it upheld the decision of the Tribunal that the agreement was in place only for evading taxes and therefore, rental income would be subject to tax in the hands of the assessee under section 60 of the ITA.

4. **Mauritius releases Statement of Practice for determining the Place of Effective Management**

   A new provision was introduced in the Mauritius Income Tax Act earlier this year, stating that a company incorporated in Mauritius shall be treated as a non-resident if its place of effective management (PoEM) is situated outside Mauritius. As a clarification in this regard, the Mauritius Revenue Authority has issued a Statement of Practice[7]. It states that in determination of PoEM, facts and circumstances relating to the business activities of the company (including use of information and communication technologies in the decision-making process) must be examined.

[4] F No. 12/1/64-IT(A) dated 12 May 1984
[5] ITO vs Vijay Merchant [1986] 19 ITD 510 (Mum)
[6] Ambience Developers & Infrastructure Pvt Ltd vs CIT (W.P.(C) 10572/2018 & CM Nos.41219-20/2018)
[7] SP 17/18 dated 28 November 2018

Further, it states that generally, a company incorporated in Mauritius will be deemed to have its PoEM in Mauritius, if:

a. the strategic decisions relating to the company's core income generating activities are taken in, or from, Mauritius; **and**
b. **any one** of the following conditions is met:
   (i) the majority of the Board of directors' meetings are held in Mauritius; or
   (ii) the executive management of the company is regularly exercised in Mauritius.

Therefore, if a company incorporated in Mauritius does not meet any of the above-mentioned conditions, it will be treated as non-resident for the Mauritius Income Tax purposes.

Katalyst comments:

With the local Mauritius tax laws being aligned to the concept of PoEM for determining the residential status, it seems that the Mauritius Revenue Authority is tackling the issue of companies incorporated in Mauritius primarily for the purpose of obtaining the benefits of Double Taxation Avoidance Agreement. However, whether such substantive provisions in the law and issue of Tax Residency Certificate based thereon would be sufficient for addressing the doubts of the Indian tax authorities regarding the residential status will have to be seen; however, this should not impact investments grandfathered pre-1 April 2017, in terms of the protocol dated 10 May 2016 to India-Mauritius DTAA.

B. Reserve Bank of India / Foreign Exchange Regulations

1. RBI modifies Hedging requirement with respect to the External Commercial Borrowing (ECB) Policy

In the first week of November 2018[8], the RBI had liberalised the rules governing the ECBs raised under Track I for infrastructure firms (eligible borrowers) by reducing the Minimum Average Maturity (MAM) to 3 years. The average maturity requirement for exemption from mandatory hedging provisions was also reduced to 5 years, thereby, requiring the aforesaid eligible borrowers with ECBs having MAM of 3-5 years to meet 100% mandatory hedging requirement.

Now, the RBI has liberalized[9] the hedging requirements by reducing the mandatory hedge coverage from 100% to 70% for ECBs raised under Track I of the ECB framework by the above-mentioned eligible borrowers for ECBs with MAM of 3-5 years. Further, it is also clarified that ECBs falling under the aforesaid revised provision but raised prior to the date of this circular will be required to mandatorily roll-over their existing hedges only to the extent of 70% of outstanding ECB exposure.

[8] A.P. (DIR Series) Circular No.11 dated 6 November 2018

[9] A.P. (DIR Series) Circular No.15 dated 26 November 2018 - External Commercial Borrowings (ECB) Policy – Review of Hedging Provision

Katalyst Comments:

Considering the current liquidity crunch in the credit markets, the RBI, vide the aforesaid relaxation, has given some more respite to infrastructure companies.

C. Securities' Laws Highlights

1. SEBI requires disclosure of Significant Beneficial Ownership in the shareholding pattern

As an extension of the Companies (Significant Beneficial Ownership) Rules, 2018 notified by the MCA, SEBI has issued a circular[10] providing a format for all listed entities to disclose, on a quarterly basis, details pertaining to significant beneficial owner. The format also requires details of the significant beneficial owner for every registered owner along with the number and % of shares held and the date of creating/ acquiring such beneficial interest. These changes will come into effect from the quarter ended 31 March 2019.

Katalyst Comments:

With additional disclosure requirements, the regulatory framework continues to prescribe additional compliances, requiring significant use of resources by the companies in these matters.

2. Operating Guidelines for Alternative Investment Funds (AIFs) in International Financial Services Centres (IFSCs)[11]

In addition to the already existing broad framework for setting up AIFs in IFSCs, SEBI has introduced operating guidelines for such AIFs. The guidelines cover registration, compliance requirements, restrictions, and conditions such as each AIF scheme having a minimum corpus of USD 3 mn, minimum investment value of USD 150,000, manager/ sponsor required to have continuing interest in AIF, etc.

3. Amendment to SEBI (Delisting of Equity Shares) Regulations, 2009 (Delisting Regulations)[12]

One of the key issues faced by the promoter/ acquirer of shares during the delisting process was that the price discovered through reverse book building price typically was at significant premium to prevailing market. The amendment to the Delisting Regulations give the acquirer the right of counter-offer pursuant to price discovery through reverse book building process. Previously, if the 'offer price', which was determined through reverse book building was not acceptable, the acquirer could only reject the offer price and, consequently, decline to acquire the equity shares from the public shareholders. Now, the acquirer can make a counter offer to the public shareholders within two days of the discovery of the 'offer price'; provided,

[10] SEBI/HO/CFD/CMD1/CIR/P/2018/0000000149 dated December 7, 2018
[11] SEBI/HO/IMD/DF1/CIR/P/143/2018 dated November 26, 2018
[12] SEBI/LAD-NRO/GN/2018/46 dated November 14, 2018

however, that the price in the counter offer is not less than the book value of the target company as certified by a merchant banker.

Other key changes have been summarised below:

- Definition of 'acquirer' now expressly includes a third-party acquirer making a delisting offer pursuant to regulation 5A (Delisting Offer) of SEBI (Substantial Acquisition of Shares and Takeover) Regulations, 2011 which permits a Delisting Offer along with a mandatory open offer.
- To demonstrate compliance with the requirement of delivering the letter(s) of offer to all the public shareholders, letter of offer can be dispatched by registered or speed post of India Post and a detailed account regarding the status of delivery of the letters of offer is provided (i.e., whether delivered or not).
- In case of a small company, the extant regulations required consent of 90% of total number of public shareholders. As per the amendment regulations, public shareholders, irrespective of their numbers, holding 90% or more of the public shareholding giving their consent in writing to the proposal for delisting should suffice.
- In relation to compulsory delisting, a time limit of 3 months from the date of delisting has been prescribed for giving an exit offer (at the value determined by the independent valuer) to the public shareholders and in case of a company whose fair value is positive, the equity shares held by the promoter / promoter group cannot be transferred (whether by way of sale, pledge or otherwise) nor can benefits such as dividends, bonus shares, split, etc., be granted to the promoter / promoter group till the exit option is provided to the public shareholders as certified by the stock exchanges. Additionally, the whole-time directors of the compulsorily delisted company are not eligible to become directors of any listed company until such time.

Katalyst Comments:

The amendments seem to be an attempt to facilitate the delisting process and make it more workable by allowing the acquirer to make a counter offer to the price discovered through book building process.

4. SEBI notifies revised conditions for re-classification of any person as promoter/ public[13]

SEBI has issued (Listing Obligations and Disclosure Requirements) (Sixth Amendment) Regulations, 2018 and it provides for, *inter alia*, the procedure for seeking relaxation from the strict enforcement of any LODR requirements, revised documentation requirement in case of transmission of securities in physical mode, etc. One of the key amendments is with reference to Regulation 31A which provides revised conditions for re-classification of any person as promoter or public.

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[13] SEBI/LAD-NRO/GN/2018/47 dated November 16, 2018

Re-classification of a promoter as public shall be permitted by the stock exchanges only upon fulfilment of stipulated conditions, including receipt of an application to that effect, from the listed entity, within 30 days from the date of approval by shareholders in general meeting. A promoter seeking re-classification is prohibited from - (i) holding more than 10% of the total voting rights in the listed entity, (ii) exercising control over its affairs, (iii) having any special rights, and (iv) acting as a key managerial person in the listed entity. It is also clarified that a listed entity shall be considered as 'listed entity with no promoters' if due to re-classification or otherwise, the entity does not have any promoter. It is also stated that if any public shareholder seeks to re-classify itself as Promoter, it shall be required to make an open offer

5. **Settlement Proceedings Regulations replaced**

SEBI (Settlement of Administrative and Civil Proceedings) Regulations, 2014 governed the settlement proceedings till now. Given the changes in the securities markets in the recent years, a committee was set up in 2017, with Justice A. R. Dave as the chairman, for review of the extant regulations. Based on the report of the Dave committee, SEBI has introduced[14] SEBI (Settlement Proceedings) Regulations, 2018, to be effective from 1 January 2019 and repealed the erstwhile regulations.

As per the new regulations, SEBI may not settle if the alleged default has (i) market wide impact, (ii) caused losses to large number of investors, or (iii) affected the integrity of the market. Further, SEBI may also not settle certain specified proceedings if the applicant is a willful defaulter, a fugitive economic offender or has defaulted in payment of any fees due or penalty imposed under securities laws. Some of the other key changes include widening the ambit of the term "securities laws", violation of which could be settled; High Powered Advisory Committee recommending settlement terms which may include monetary or non-monetary terms or a combination of both; SEBI may agree to confidentially settle if the applicant agrees to provide assistance in investigation, inspection, etc against any other person in respect of securities laws' violation.

Katalyst Comments:

The changes, based on the Dave committee report, seem to be a consequence of the frauds and other recent occurrences in Indian financial markets.

D. Corporate Law

1. **Fold up of holding company into subsidiary – update post Mumbai NCLT order rejecting the Scheme of Amalgamation and Arrangement between Gabs Investments Pvt Ltd and Ajanta Pharma Ltd**

In September 2018, Mumbai bench of the NCLT had rejected the Scheme of Amalgamation and Arrangement between Gabs Investments Pvt Ltd (holding shares in Ajanta Pharma) and

[14] SEBI/LAD-NRO/GN/ 2018/48 dated November 30, 2018

Ajanta Pharma Ltd on the grounds that the said scheme was conceived to avoid taxes and also to circumvent the provisions of SEBI takeover code (refer October 2018 issue of Katalyst Kaleidoscope for more details). While the matter is awaiting hearing with the NCLAT, two more schemes with a similar fact pattern came up for consideration before the NCLT.

In the Scheme of Amalgamation between PIPL Business Advisors and Investment Pvt Ltd, GSPL Advisory Services and Investment Pvt Ltd and NIIT Technologies[15], the New Delhi bench of the NCLT was posed with similar objections from the Income-tax authorities. NCLT New Delhi bench accorded its approval to the Scheme of Amalgamation by relying on the decision of Bombay High Court in the case of AVM Capital Services Pvt Ltd discussing the difference between tax evasion and tax planning, the latter being clearly permissible. It was also observed that the equity shares of the listed company shall be continued to be held by the existing promoters as held by them previously through the Transferor Companies, and the same being approved by SEBI, was not in circumvention of SEBI provisions.

In another case of Scheme of Amalgamation of Vora Soaps Ltd with Godrej Industries Ltd before the NCLT Mumbai bench[16], no objections were raised by the tax authorities regarding the merger of the Vora Soaps Ltd, also the holding company of Godrej Industries Ltd. The NCLT has, therefore, approved the said Scheme.

Interestingly, while these schemes have been approved subsequent to the NCLT Mumbai bench decision in the Ajanta Pharma case, there has been no reference or discussion regarding the same in either of the cases.

2. E-filing with National Company Law Tribunal (NCLT), New Delhi

Pursuant to a notice issued, NCLT, New Delhi has stated that it is ready to start e-filing and has requested all concerned to file application/ petition/ appeal, etc. only though the NCLT e-filing portal with effect from 1 November 2018. The e-filing receipt then needs to be enclosed while filing hard copy of 2 complete sets of the documents filed online.

Katalyst comments:

A step towards embracing technology and reducing inane paperwork is laudable, however, this should be followed by no requirement to file hard copies once the system is in place and tested.

E. Other Highlights

1. Stamp duty on Amalgamation schemes in Tamil Nadu

While the revamped Tamil Nadu Stamp Act, 2013 awaits presidential assent, the Inspector General of Registration issued a circular declaring that the Schemes of Arrangement

[15] CP CAA 385/ND/2017 connected with CA(CAA) 83(ND) of 2017
[16] CP(CAA) 2716/MB/2018 in CA(CAA) 137/MB/2018

sanctioned by High Court/ NCLT will be liable to stamp duty as "conveyance" under Article 23 of the Indian Stamp Act, 1899 as applicable in Tamil Nadu.

Katalyst comments:

Given that the Madras High Court had specifically held that[17] mergers and amalgamations shall not be liable to stamp duty in absence of a specific provision, technically, there should be no Stamp duty levy on mergers and amalgamations until the Tamil Nadu Stamp Act, 2013 obtains the Presidential assent. Therefore, such a circular, in the interim, is a surprising step and is bound to add to confusion and litigation. In any case, such levy of stamp duty, should only be applicable to properties in Tamil Nadu and not on the properties which are situated outside Tamil Nadu.

F. GST Highlights

1. High Court stays an order of National Anti-profiteering Authority (NAA) by questioning the methodology adopted to compute profitability

The order of NAA wherein profiteering was found under section 171 of the CGST Act has been stayed by the Delhi High Court[18] by way of questing the methodology to calculate the quantum of anti-profiteering by the NAA and also directing the petitioner to pay the amount of anti-profiteering accepted under earlier litigation.

In another case, Bombay High Court[19] admitted the writ and granted partial stay to McDonald against the order of NAA wherein NAA found the case of profiteering by restaurants operating under the brand name of 'McDonald's' and held that despite the reduction in GST rate from 18% to 5%, the base price was increased by 12.38% which was more than the ratio of denial of ITC of 9.11%.

2. Rulings by Authority of Advance Rulings (AAR) on applicability of GST on delayed payment of EMI, GST on supply of food to industry and GST on intermediary services to overseas clients

Maharashtra AAR[20] has held that interest collected by NBFC for delay in repayment of EMI constitutes a supply under section 7 of CGST Act as it is paid to NBFC for tolerating an act of delayed payment. No exemption of financial transaction is applicable to such interest, as it fails the test of being a 'loan', 'deposit' or 'advance'.

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[17] T. Krishnamachari & Co v The Joint Sub-Registrar, [2009] 2 MLJ 245 and Srinidhi Industries Ltd. v Sub-Registrar, (decision dated 18.11.2014 in WP 4128 of 2010)
[18] In the matter of Pyramid Infratech Pvt. Ltd. vs UOI [W.P.(C) 10999/2018]
[19] Hardcastle Restaurants Private Limited v/s Union of India and Ors. [TS-767-HC-2018(BOM)-NT]
[20] In the matter of Bajaj Finance Ltd. [TS-668-AAR-2018-NT]

Maharashtra AAR[21] has held that catering services provided under B2B model to industry/corporate and under B2C model to employees are classified as canteen services/restaurant services and liable to GST @5% in view of the notification 11/2017-CGST(Rate) dated June 28, 2017 as amended by Notification 46/2017-CGST(Rate) dated November 14, 2017.

Maharashtra AAR[22] has held that marketing, promotion and distribution services provided to overseas client cannot be treated as 'export of service' as the recipient of service is located outside India. These services should be classified as 'intermediary services' and place of supply for such services is the location of place of supplier i.e. India and liable to GST.

Maharashtra AAR[23] has held that office administration service, accounting support service, pay-roll services and maintenance services are classified as 'intermediary' service and if these services are provided to overseas clients, they are taxable in India as place of supply for 'intermediary service' is place of supplier of service i.e. India.

Katalyst comments:
Post last AAR issued by Maharashtra AAR on applicability of GST on BPO services which earlier classified as 'export of services', BPO sector is in a turmoil and various authorities represented before the Government on this issue.

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[21] In the matter of Ismail Ahamad Soofi [TS-677-AAR-2018-NT]
[22] In the matter of Sabre Travel Network India Pvt. Ltd [TS-762-AAR-2018-NT]
[23] In the matter of Vservglobal Pvt. Ltd. [TS-676-AAR-2018-NT]