KATALYST
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Katalyst Kaleidoscope

January 2019: Tax and Regulatory Highlights

A. Income Tax Highlights

1. Mumbai ITAT rules on the non-applicability of section 56(2)(vii) of Income Tax Act, 1961 ('the Act') on rights issue of shares[1]

Mumbai ITAT has held that a shareholder cannot be taxed under section 56(2)(vii) of the Act, in case the shares are allotted to the shareholder on a proportionate basis, even if such shares are allotted at lower than the Fair Market Value ('FMV') computed as per Rule 11UA of the Income-tax Rules, 1962 ("Rules").

The issue of applicability of the said section in the context of right issue of shares was also ruled upon by the Mumbai ITAT in the case of Sudhir Menon HUF (162 TTJ 425). The ITAT had observed that in case of disproportionate allotment of right shares to an existing shareholder of a company at less than FMV as part of a genuine business transaction should not be subject to section 56(2)(vii)(c) of the Act, where the allotment is not higher than the proportion of existing shareholding.

While the issue before the ITAT was in the context of right shares, the ITAT has also made a remark that the provisions of said section cannot be invoked in case of bonus shares as the percentage holding remains the same. Thus, in case of disproportionate allotment of shares, whether by way of bonus issue or rights issue, taxability could arise under section 56(2)(viia) of the Act.

CBDT Circular[2] states that section 56(2)(vii) of the Act, was inserted as a counter evasion mechanism to prevent money laundering of unaccounted income.

In the given case, the issue of additional shares was bona-fide and necessitated by a covenant of the company's USA Subsidiary's loan agreement, carried out through banking channels and in the absence of any allegation regarding money laundering, no addition under section 56(2)(vii) of the Act could be made. The ITAT also held that section 56(2)(vii) of the Act was inapplicable in the current facts because it applied w.e.f. 1st October 2009, whereas the contract between the company and the shareholder for issue by the company of shares was completed before such date. It was only the formal routine act of issuance of the share certificate by the company which took place after 1st October, 2009.

Katalyst Comments:

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[1] ACIT vs Subodh Menon (ITA No. 676/Mum/2015)
[2] Circular 1/2011 dated 6th April, 2011

While Section 56(2)(vii) of the Act has ceased to be in effect, the new avatar is section 56(2)(x) of the Act which is much broader in its coverage and applicability. Therefore, the principles laid down in this ruling will be useful while determining implications under section 56(2)(x) of the Act.

This ruling is significant since it has clarified that section 56(2)(vii) of the Act was brought in as a counter-evasion measure, it cannot apply to bona-fide business transactions. This goes a long way in clarifying the exact purport of section 56(2)(vii) of the Act which should be instrumental in precluding tax authorities from invoking section 56(2)(vii) of the Act in case of bona-fide business transactions including receipt of shares pursuant to a commercially agreed price as a result of negotiation between contracting parties which could be lower than the FMV computed as per Rule 11UA of the Rules.

2. CBDT issues a clarificatory circular for non-applicability of section 56(2)(viia) of the Act in the context of fresh issue of shares; withdrawn subsequently

The CBDT had issued a clarificatory circular[3] regarding applicability of section 56(2)(viia) of the Act, in relation to receipt of freshly issued shares by a company in which public are not substantially interest by another closely held company or a firm.

Section 56(2)(viia) of the Act deals with taxability of the receipt of shares of a closely held company by another closely held company or a firm from any person(s) for a consideration lower than the fair market value (FMV) computed as per Rule 11UA of the Rules. The difference between the fair market value and the consideration is taxed in the hands of the recipients of shares.

It was represented before the board that the term 'receives' used in the section 56(2)(viia) of the Act creates a doubt on its applicability in the context of fresh issue of shares including issuance by way of issue of bonus shares, rights shares and preferential allotment of shares or transactions of similar nature by the specified company.

Considering the legislative intent, it was clarified in the aforesaid circular that the applicability of section 56(2)(viia) of the Act would arise only in case of 'transfer' of shares of a closely held company for no or inadequate consideration. The intention was never to apply this anti-abuse provision to the fresh issue of shares by the specified company.

[3] Circular No. 10/2018 dated 31st December, 2018

However, the said circular was subsequently withdrawn[4] by the CDBT within 4 days citing the reason that the interpretation of the term "receives" is sub-judice in certain higher judicial forums. It was clarified by the CBDT that the matter is required to be examined afresh, so that a comprehensive circular on the matter can be issued. It was further clarified that above circular shall be considered as never been issued and a fresh circular will be issued in due course. Further, in a subsequent Circular[5], CBDT further clarified that keeping in view the plain reading of the section as well as the legislative intent, section 56(2), being an anti-abuse provision in nature, should also extend to fresh issuance of shares since the same could be subject to abuse and therefore, would be contrary to the express provisions and the legislative intent of the section 56(2)(viia) or *similar provisions* contained in section 56(2) of the Act.

Katalyst Comments:

It is the need of the hour that CBDT revisit the scope and intent of the section. The indiscriminate manner of invocation of this section by the tax officers has had a regressive effect.

Section 56(2)(viia) of the Act ceased to be in effect from 1st April, 2017; the new avatar is section 56(2)(x) of the Act which is much broader in its coverage and applicability. The latest Circular issued by CBDT on the subject matter also effectively clarified that the scope of section 56(2)(x) would also extend to issuance of shares, if such issuance route is used to abuse the provisions of the Act.

In so far as the above issue is concerned, issue of shares in case of genuine transactions should not attract the anti-avoidance provisions.

3. Shareholder's Claim For 'Capital Loss' In Capital Reduction allowed by Bangalore ITAT[6]

The assessee held equity shares in its subsidiary company which went through a capital reduction process and the assessee was paid certain consideration which was less than the cost of acquisition of the shares. Consequently, the taxpayer incurred a loss and claimed the same as 'capital loss' arising from the transfer of Shares.

The Income Tax Assessing Officer contended that since the shareholding pattern of the subsidiary company remained unaffected (as each shareholder's shares were reduced in the same proportion of their pre-capital reduction shareholding), the taxpayer did not relinquish its

[4] Circular No. 2/2019 dated 4th January, 2019
[5] Circular No. 3/ 2019 dated 21st January, 2019
[6] Jupiter Capital Private Limited vs ACIT (dated 29th November, 2018)

voting power or extinguish its rights in the shares, and thus, no transfer (as envisaged under section 2(47) of the Act) had taken place. Basis this, the Assessing Officer disallowed the taxpayer's claim for capital loss.

The Bangalore ITAT allowed the claim for 'capital loss' on account of reduction in share capital of the company. The Tribunal held that reduction of share capital results into extinguishment of rights which is provided for in the inclusive definition of "*transfer*" under section 2(47) of the Act. The Tribunal relied on the judgment of the Supreme Court of India in Kartikeya Sarabhai v. CIT, wherein it was held that reduction in the face value of the share amounts to extinguishment of rights and can also be considered as a transfer and any profit or gain which arises from the transfer of a capital asset is liable to be taxed under section 45 of the Act.

4. GE Energy Ruling – Employees create Dependent Agency PE in India[7]

Pursuant to a survey conducted at the premises [Liaison Office ('LO')] of GE Energy entities, revenue had held that the LO constituted assessee's fixed place PE and that expatriates deputed in India constituted agency PE. HC noted that GE India was located in the space leased by LO which was at constant disposal of the LO and referred to ITAT's finding that the core of the sales activity was done from the premises of LO.

HC stated that as GE had not contested that the premises were indeed used for activities of some form and thus it was reasonable to assume those activities occurred through the premises. HC quashed GE's interpretation that business activities in India must include the authority to conclude / negotiate contracts for such activities to be substantial and core in nature. Upon examination of E-mail communications and chain mails with clients, HC noted that GE India was not working and for a particular enterprise but for multiple enterprises of GE group in their core activities, noted that technical officials having varying degree of authority involved themselves in contract negotiation, modification of technical specifications and the negotiations for it, to fulfill local needs and even local regulatory requirements and the complexities of price negotiation. Thus, the HC upheld constitution of dependent agency PE for 24 GE group entities.

HC also clarified that the fact that the transactions between agent and multiple related enterprises are at Arm's Length Price, is irrelevant for establishing a dependent agency PE.

Katalyst Comments:

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[7] GE Energy Parts Inc vs CIT (Delhi High Court) Jupiter Capital Private Limited vs ACIT (dated 29th November, 2018)

The issue of determination of PE in India and attribution of profit to such a PE has been a matter of litigation before various courts / tribunals. In some cases, it has been held that LO does not constitute a PE in India usually an LO carries on activities being in the nature of preparatory and/or auxiliary. On the other hand, some decisions rules that LO constitutes PE in India because it was carrying on commercial activities which were core activities of the assessee.

Foreign entities intending to open an LO in India should regularly assess the possible PE exposure.

5. **Government eases process for startups to seek tax exemption on angel funds**[8]

The Department of Industrial Policy and Promotion (DIPP) issued a recent notification intending to ease the availing of angel tax exemption. Startup Companies have been receiving notices under section 56(2)(viib) of the Act where the Revenue Authorities have asked the startups to justify the premium received on issuance of shares to domestic investors and whether, therefore, such premium is justifiable keeping in mind the fair market value of shares of such company) and therefore, asked the startups to pay taxes on angel funding on such premium component.

To avail the tax exemption:

- A startup should be recognized by the DIPP and its aggregate amount of paid up share capital and share premium after issuance of shares does not exceed Rs 10 crore, according to a notification; and

- The investor should have a returned income of Rs 50 lakh or more in the preceding financial year; or either its net worth or the invested amount should be more than Rs 2 crore as on the last date of the preceding financial year.

As per the notification, startups and investors wishing to claim exemption from angel tax will have to apply to DIPP and the Central Board of Direct Taxes (CBDT), which will grant approval and issue the certificate within a period of 45 days.

Katalyst Comments:

[8] Partial Modification to Gazette Notification No. G.S.R. 364(E) dated 11th April, 2018

This is a half-step by the government. The concept of potentially taxing the premium on issue of shares by companies is inherently flawed and arises due to certain out-liar cases. Such cases should be taxed separately in other section such as section 68 of the Act (cash credit) and GAAR and not provisions like these which amount to throwing the baby out with the bath water.

In any case, considering the dynamic nature of the market and the necessity of having cash by startups, the time period of 45 days is too long for them to keep things in a limbo.

The high eligibility criteria set for investors in a start-up is also exclusive to elite community of angel investors, effectively shunting out the first stream of funding in a start-up, which is friends, family, batchmates, retired individuals etc.

B. Reserve Bank of India / Foreign Exchange Regulations

1. RBI eases External Commercial Borrowings ('ECB') norms[9]

The RBI has liberalized the ECB policy, allowing all eligible entities to raise foreign funding under the automatic route and removing sectoral curbs. All eligible borrowers can now raise ECBs up to $750 million or equivalent per financial year under the automatic route replacing the existing sector wise limits.

Now, the ECB tracks will be divided into two categories basis the currency in which the ECB is raised, instead of 3 tracks earlier. The two categories are as under:

- Foreign Currency Denominated ECB (Merging of Tracks I and Track II as provided in the erstwhile regime); and
- Rupee Denominated ECB (Merging of Track III and Rupee Denominated Bonds as provided in the erstwhile regime)

The eligible borrowers are as under:

- All the entities which are eligible to receive FDI are eligible borrowers. Thereby, LLP's eligible to raise FDI, service/trading sector entities, etc. will now be eligible; and
- Port trusts, units in SEZ, SIDBI, EXIM bank, registered entities engaged in micro finance activities viz. registered societies/trusts/cooperatives and NGO's are also permitted.

The end uses prescribed are as under:

[9] A.P. (DIR Series) Circular No. 17

- In addition to the end-use restrictions provided in the notification, ECB raised is allowed to be used for working capital, general corporate purposes and repayment of rupee loans provided it is raised from foreign equity holder;
- Also, purchase of land for self-use is permitted.

The eligible lenders prescribed to be a lender who either should be a resident of Financial Action Task Force (FATF) or International organisation of Securities commissions (IOSC) compliant country.

Minimum Average Maturity (MAM) period: It will be 3 years for all ECB's irrespective of the amount except for:

- ECBs upto $50 million in the manufacturing sector – 1 year

- ECBs from foreign equity holder and utilised for specific purposes – 5 years

Katalyst Comments:

This move seems to be an attempt to pump up the foreign exchange inflows. Ramifications on the Indian lenders will have to be seen and this change will automatically step up competition in the banking sector. However, one key bottleneck in relation to full liberalization of the ECB norms is the use of dollar loans (from a non-foreign equity holder) for repayment of Rupee loans, for general corporate purposes and for working capital loans.

2. Review of policy on FDI in e-commerce

FDI up to 100% is allowed under the automatic route in entities engaged in the marketplace model of ecommerce (marketplace entities), subject to compliance with certain conditions. However, FDI in entities engaged in the inventory-based model of e-commerce continues to be prohibited as on date.

The DIPP has issued Press Note[10] to amend the existing FDI policy so as to plug in some the gaps in existing conditions applicable to marketplace entities. Below are the key changes made:

- Ownership and control over inventory:

[10] Press Note No 2 of 2018 dated 26 December 2018

Presently, marketplace entities are restricted from: (a) exercising actual ownership over the inventory, and (b) permitting total sales value on its marketplace from one seller or such seller's group companies in excess of 25% of such marketplace's total sales value in a financial year.

The above requirement of 25% restriction cap on total sales value has been removed and replaced with the new condition that if more than 25% of a seller's inventory is purchased from the Marketplace Entity or its group companies then such Marketplace Entity will be deemed to have control over the inventory sold by such seller.

- Equity holding in any seller entities:

  Now, sellers will not be permitted to sell their products on platforms run by a Marketplace Entity if such Marketplace Entity or its group companies have equity participation in the sellers.

- Other changes:

  - Marketplace Entities cannot require the sellers to sell their products exclusively on their platforms.
  - Fair and non-discriminatory services (such as warehousing, support services, etc.) to all the sellers.
  - Requirement to the financials (alongwith a certificate confirming compliance with these conditions) to the RBI for each financial year by 30 September.

The new guidelines will come into effect from 1st February, 2019.

Katalyst Comments:

The guidelines that will come to effect from February are stricter in nature, causing established players in India to go back to the drawing board.

E-commerce companies, have been luring customers with deep discounts and exclusive offerings. The bar on such firms 'influencing' pricing and mandating vendors to sell exclusively on their platforms may have a major impact on customer behavior. Most customers shop online for deep discounts and exclusive offerings, which may not be available on other online platforms, or in offline stores. This will, in turn, have an impact on the revenue and growth of e-commerce companies in India. The profitability target of these companies may now take a big hit.

E-commerce companies claim they have not been consulted before the policy was updated. E-commerce companies are likely to seek an extension of the February 1 deadline to comply with recent changes in the FDI rules for e-commerce as it entails overhauling their business model.

C. Securities' Laws & Corporate Law Highlights

1. Amendments to Securities and Exchange Board of India (Foreign Portfolio Investors) Regulations, 2014 – Clarification on clubbing of investment limits of Foreign Portfolio Investors ('FPIs')

SEBI has issued a clarification[11] on clubbing of investments of FPIs and non-resident Indian/overseas citizens of India routes, to bring in a single regime for foreign investors and regulate NRI and person of Indian origin fund inflows.

The clarification states that, multiple entities having common ownership, directly or indirectly, of more than 50 per cent will be treated as part of the same investor group and their investment limits would be clubbed, as per the notification.

2. SEBI Panel pitches for Direct Listing of Indian Companies Overseas

A panel set up by SEBI has proposed to allow direct listing of Indian companies on overseas bourses and of foreign firms on Indian exchanges. Currently, Indian companies can list their shares through depository receipts abroad, while foreign companies need to go through the Indian Depository Receipt route for listing of equities.

The panel recommended that Indian companies should be allowed to list in 10 countries without first listing in India, according to the report dated 4th December, 2018 published on SEBI's website. The 10 countries and their exchanges are:

- U.S.: NASDAQ, NYSE
- China: Shanghai Stock Exchange, Shenzhen Stock Exchange
- Japan: Tokyo Stock Exchange, Osaka Securities Exchange
- South Korea: Korea Exchange Inc.
- U.K.: London Stock Exchange
- Hong Kong: Hong Kong Stock Exchange
- France: Euronext Paris
- Germany: Frankfurt Stock Exchange

[11] SEBI/HO/IMD/FPIC/CIR/P/2018/150 dated 13th December, 2018

- Canada: Toronto Stock Exchange
- Switzerland: SIX Swiss Exchange

The SEBI panel has suggested changes in the regulatory framework such as the SEBI Act, Companies Act, Tax Laws and Foreign Exchange Management Act for the overseas listing of Indian Companies. It also suggested a minimum capital threshold for listing overseas, besides recommending 10 overseas jurisdictions, with strong anti-money laundering policies, and being members of the International Organization of Securities Commissions (IOSCO) and Financial Action Task Force (FATF), to ensure that the new rules are not misused.

3. SEBI to reintroduce non-voting shares for listed companies

Non-voting (NV) shares, which offer higher dividends but no voting rights, may be reintroduced for listed companies after nine years. SEBI has set up a committee, which is looking at whether NV shares could be reintroduced.

Differential Voting Right (DVR) shares are a way for companies to raise equity capital without dilution of promoter shareholding. DVR shareholders typically get higher returns in lieu of 'differential voting rights. This is also a mechanism to prevent hostile takeovers.

Section 43 (a)(ii) of the Companies Act, 2013 states that a company may issue equity shares with differential voting rights provided it is in accordance with Rule 4 of the Companies (Share Capital and Debentures) Rules, 2014. Initially, in order to issue equity share capital with differential voting rights Section 43(a)(ii) and its corresponding stringent Rules were mandatorily applicable to both private and public companies, but from June 5, 2015, the Ministry of Corporate Affairs has *vide* its notification[12] exempted private companies from the applicability of Section 43 and Rules, and private companies are now free to structure their share capital in a manner they deem best in the interests of the company.

Currently, SEBI does not allow issuance of shares with differential voting rights. Under the earlier regime, companies such as Tata Motors issued DVRs.

Katalyst Comments:

This potential liberalization will open up various fundraising and deal structuring options for Indian companies

[12] G.S.R 464 (E), Exemptions to private companies notification, Ministry of Corporate Affairs, June 5, 2015.

D. GST Highlights

1. Kerala High Court - No detention of goods for discrepancy in e-way bill if GST paid as per invoice

Kerala High Court[13] has held that if IGST have been correctly paid in accordance with the value as shown in the original bill, goods cannot be detained for discrepancy in the e-way bill.

2. Appellate Authority for Advance Ruling ('AAAR')[14] - Services by employees at corporate office to other units, liable to GST

Karnataka AAAR has upheld the decision of Authority for advance rulings ('AAR') and held that activities performed by employees at its corporate office in relation to employment such as accounting, other administrative and IT system maintenance for units located in other states shall be treated as 'supply' and liable to GST and also held that employer-employee relationship is to be viewed separately for every registered unit of the business entity.

3. Highlights of 32nd GST council meeting[15] held on January 10, 2019:

- **Turnover limit for supplier of goods:**
  Increase in threshold limit for registration for supplier of goods from INR 2 million to INR 4 million. The States would need to decide individual registration limit within 1 week. No change in threshold limit for service providers.

- **Composition scheme:**
  The composition scheme has been extended to the service providers. The suppliers of service (or mixed supplies) having turnover up to INR 5 million in previous year has an option to pay tax under composition scheme @6%.

  Increase in ceiling for composition scheme from INR 10 million to INR 15 million w.e.f. April 1, 2019. Special category States would need to decide about the composition limit in their respective States in a week's time.

  Assessees opting for composition scheme will be required to file only annual return w.e.f. April 1, 2019 and tax payment to continue on quarterly basis

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[13] In the matter of Rai Prexim India Pvt. Ltd. Vs State of Kerala [TS-771-HC-2018(KER)-NT]
[14] In the matter of Columbia Asia Hospitals Pvt. Ltd. [TS-814-AAAR-2018-NT]
[15] Notifications giving the effect of the changes are likely to be issued later and need to be validated

4. Tax mechanism for EPC[16] contract notified

If services by way of construction or engineering or installation or other financial services are provided for setting up of bio gas plant/ solar power-based devices, solar power generating system (SGPS), wind mills, waste to energy plants etc., conjointly with supply of renewable energy devices & parts for their manufacture [bio gas plant/ solar power-based devices, solar power generating system (SGPS), wind mills, waste to energy plants etc.], 70% of the gross value should be deemed to be value of supply of goods liable to GST @ 5% and balance 30% should be deemed to be value of services, liable to GST @ 18%.

5. Certain services covered under the purview of RCM w.e.f. January 1, 2019[17].

- Security services (supply of security personnel) provided to a registered person, except Government Departments which have taken registration for tax deducted at source (TDS) and entities registered under composition scheme
- Services provided by business facilitator (BF) to a banking company
- Services provided by an agent of business correspondent (BC) to business correspondent (BC)

6. Changes in rates of GST

Particulars	Earlier rate %	Revised rate %
Goods:[18]		
Pulleys, transmission shafts and cranks, gear boxes etc., falling under HS Code 8483	28	18
Power banks of lithium iron batteries	28	18
Digital cameras, video game consoles etc. under HS code 9504	28	18
Parts and accessories for carriages for disabled persons	28	5
Walking stick	12	5
Services: [19]		
Cinema tickets above INR 100	28	18

[16] Notification no. 24/2018-Central tax (Rate) dated December 31, 2018 read with notification no. 27/2018-Central tax (Rate) dated December 31, 2018
[17] Notification no. 29/2018-Central tax (Rate) dated December 31, 2018
[18] Notification no. 24/2018-Central tax (Rate) dated December 31, 2018
[19] Notification no. 27/2018-Central tax (Rate) dated December 31, 2018

Third party insurance of 'goods carriage'	18	12

7. **Key amendments in GSR Rules[20]:**

- A registered person who has not filed returns for two consecutive period is not allowed to generate e-way bill (effective from a date to be notified)
- The requirement of affixing signature or digital signature on invoice or bill of supply or consolidated document or any other document issued by an insurer or a banking company including NBFCs or ticket issued by the transport company has been done away with, if the respective document is issued in accordance with the provisions of Information Technology Act, 2000.

8. **Other amendments:**

- Due date of furnishing annual return in form GSTR-9 and reconciliation statement in form GSTR-9C has been extended to June 30, 2019[21]
- It has been proposed in the 31st GST council meeting held on December 22, 2018, to create a Centralised AAAR to deal with conflicting decisions by two or more state AAARs.

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[20] Notification no. 74/2018-Central tax dated December 31, 2018
[21] Order no. 3/2018-Central Tax dated 31 December, 2018