KATALYST ADVISORS

Katalyst Kaleidoscope

August 2024: Tax and Regulatory Insights

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A. Income Tax Highlights

1. SC: No capital gains tax on land development agreement[1]

The Supreme Court dismissed a special leave petition of a Bombay High Court judgement; on the facts of the case before the Bombay High Court, the assessee had entered into a development agreement with another party to develop a piece of land, and the crux of the issue was whether this agreement constituted a 'transfer of land' that would make it liable for capital gains tax. The Assessing Officer questioned the nature of the agreement to develop the property at own cost and transfer 36% of the sale area to owners as consideration and constituted it as a transfer under tax regulations, which would trigger capital gains tax.

The High Court held that merely granting a licence to developer who entered into assessee's land only for the purpose of development cannot be treated as 'allowing possession of land' as contemplated under the Transfer of Property Act, 1882, and therefore, section 2(47)(v) of the Income Tax Act, 1961, would not apply in the present case.

Katalyst comment: *This decision underscores the interpretation of 'transfer of land' under the Transfer of Property Act and its implications for capital gains tax under the Income-tax Act; however, in each case the factual dimensions would be critical.*

2. Delhi ITAT: TRC and authenticity of transactions sufficient to claim DTAA benefit[2]

The appellant company held a valid tax residency certificate ('TRC') and a Global Business License – I in Mauritius. During the relevant fiscal year, the company transferred shares of Indian companies, realized long-term capital gains from these transactions and claimed that these capital gains were exempt from taxation in India under Article 13(4) of the India-Mauritius Tax Treaty, which provides that gains should be taxable in the country of the transferor, being Mauritius.

However, the assessing officer ('AO') denied the treaty benefits and added the capital gains to the total income; the appellant contended that the TRC should be deemed sufficient evidence for claiming treaty benefits. It argued that the revenue authorities were obligated to accept the company's status of residence and beneficial ownership as per the treaty and accordingly, the appellant asserted that the capital gains earned were not taxable in India. It pointed out that their investments in Indian entities were made in compliance with all relevant conditions and that the investments were held for over five years before the shares were sold, resulting in the capital gains in question; thus, the appellant argued that the transaction was not intended for tax avoidance purposes.

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[1]DCIT v. Darshana Anand Damle [459 ITR 60] (SC) dated July 19, 2024

[2]India Property (Mauritius) Company-II Vs ACIT Delhi [TS-514-ITAT-2024(DEL)] dated July 18, 2024

The Delhi ITAT ruled in favor of the appellant and held that treaty benefits for the capital gains under Article 13(4) of the Indo-Mauritius DTAA were available. The ITAT's decision was based on the validity of the TRC and the authenticity of the historical investments.

Katalyst comment:

i. *The issue of tax exemption for Mauritius companies availing the India-Mauritius treaty benefits has unfortunately been the topic of endless litigation, even though it is very clear that the treaty was meant to attract foreign investments into India, and the benefits should have been available on the basis of the TRC. This was reiterated by the CBDT Circular No.789 dated April 13, 2000, which was referred to in the Supreme Court judgement on the Azadi Bachao Andolan.*[3]

ii. *Given the grandfathering of the exemption in relation to the investments made before April 1, 2017 i.e. that investments made thereafter are anyway not exempt from capital gains, the issue is even more unfortunate; one would have thought that gracefully accepting this position should have logically been the approach of the Government.*

3. Mumbai ITAT: Payment to retiring partners is diversion of income by overriding title [4]

In the present case, the appellant was an LLP providing professional services and had made payments to its retired partners in accordance with its partnership deed; the basis for these payments was that the partners had rendered professional services during their tenure but could not enjoy the fruits of their work because it remained incomplete, and the concerned client could not be billed for the work already done at the time of retirement. The amount paid to the retired partners was deducted from the gross receipts of the LLP for the year under consideration. The Assessing Officer ('AO') made an addition to the LLP's income on account of these payments made to the retired partners.

The Tribunal observed that there is a difference between an amount that a person is obliged to apply out of income and an amount that cannot be considered part of income, because the income is diverted before it reaches the assessee. The Tribunal held that the payments to the retired partners should be considered as a diversion of income by overriding title, meaning that the income never actually reached the LLP as assessable income, and accordingly, it ruled in favor of the appellant.

[3] Union of India v. Azadi Bachao Andolan 263 ITR 706 (SC) dated October 7, 2003
[4] Deloitte Haskins and Sells LLP v National E Assessment Centre, ACIT dated June 21, 2024

Katalyst Comment: *This is an important decision reiterating the principle of diversion by overriding title; this concept has held fort for many years and the landmark Supreme Court judgement in this aspect is that of CIT Bombay v Shri Sitaldas Tirathdas* [5]

4. Kolkata ITAT: Long-term capital gains exempt on proceeds being invested in residential house despite technical transfer issues with Development Authority[6]

In this case, the appellant transferred her long-term investment in shares and, in return, received a plot of land of equal value. She sought an exemption for capital gains on sale of shares under Section 54F of the Income Tax Act, arguing that the proceeds were used to purchase and construct a house on the land so acquired. However, the Assessing Officer disallowed the exemption claim, stating that the land transfer required permission from the relevant development authority, which had not been granted by the time of assessment, and hence there was no valid transfer.

The appellant countered by providing evidence that she had entered into an agreement to purchase the residential plot before selling her shares and also, she made the payment for the land and construction within the time frame specified under Section 54F. She contended that although the agreement was finalized before the sale of shares, there were legal and technical issues due to conditions of the development authority in relation to land transfer. As a result, the house was built first, and the land was later transferred into her name.

The Tribunal, after considering the evidence, ruled in favor of the appellant and held that the appellant had successfully demonstrated that the land was ultimately transferred to her name and that the investment in the house was completed within the stipulated time frame. The tribunal concluded that the delay in obtaining the development authority's permission was merely a technicality and did not warrant denying the exemption under Section 54F.

Katalyst Comment: *This ruling has underscored that substantive compliance with the requirements of Section 54F is sufficient to grant the exemption, even in the face of procedural delays.*

5. Ahmedabad ITAT: Allowability of ESOP expenditure as deduction[7]

The assessee claimed deduction on employee stock option plans ('ESOP') granted by it as a business expenditure, being difference between the market price of shares as on the date of exercise of options and the market price of shares on the grant date.

While the Revenue disallowed the claim on the contention that no actual benefit is being passed onto the employees, the ITAT observed that the ESOP expenses had been claimed at the time of

[5] [41 ITR 367] dated November 24, 1960
[6] Basabdutta Dutta v ITO [ITA 868/KOL/2023] dated July 11, 2024
[7] Axis Bank Ltd. v ACIT [TS-535-ITAT-2024(Ahd)] dated July 24, 2024

exercise by the employees, and the actual amount of benefit is merely a quantification of liability, which is determined at a future date. Therefore, the discount on issuing ESOP is not a contingent liability but an ascertained liability, making it allowable under Section 37(1) as a business expenditure; the ITAT further noted that the assessee had reflected the ESOP expenditure as 'perquisites' in the hands of the employees and had deducted tax at source at the appropriate rate when granting the ESOP benefit to the employees. As a result, the ITAT ruled that the ESOP expenditure is allowable.

Katalyst Comment: *In the Biocon case[8], the Bangalore ITAT held that liability with respect to ESOP is incurred at end of each year, which is quantified at end of vesting period when employees become entitled to exercise options; the difference between grant price and exercise price on ESOP is an ascertained liability and not a contingent liability, and hence, deductible business expenditure.*

6. Delhi ITAT: Deeming provision of taxation of share premium is not applicable to subscriptions by holding company[9]

The assessee company issued optional convertible preference shares ('OCPS') to its holding company. The Assessing Officer ('AO') recalculated the fair market value ('FMV') of the OCPS and deemed the premium received as taxable under Section 56(2)(viib) of the Income-tax Act, 1961.

The ITAT on appeal held that the above section, which deals with taxing the premium received over FMV of shares, is not intended for transactions between holding and subsidiary companies. Further, the AO's method of calculating FMV using the net asset value ('NAV') method, was found inappropriate as it applies only to equity shares, not OCPS. The valuation by the assessee using the discounted cash flow ('DCF') method was upheld and the ITAT concluded that premium in the given case was not taxable.

Katalyst Comment: *This deeming provision of taxation of the premium on issuances of securities has been abolished by the Union Budget 2024, but this ruling would be relevant for shares issued in prior financial years.*

[8] Biocon Ltd v DCIT Bangalore 2013] 25 ITR(T) 602 (Bangalore - Trib.) (SB)/[2014] 144 ITD 21 (Bangalore - Trib.) (SB)/[2013] 155 TTJ 649 (Bangalore - Trib.) (SB) dated July 16, 2013

[9] Income-tax Officer v Solitaire BTN Solar (P.) Ltd. dated June 12, 2024

7. CBDT clarification in respect of Income Tax Clearance Certificate [10]

Section 230(1A) of the Income-tax Act, 1961, requires certain individuals domiciled in India to obtain an income tax clearance certificate ('ITCC') under specific circumstances. The section was amended vide the Finance Act (No. 2), 2024, to add a reference to the Black Money Act .

In this context, the CBDT has clarified that the ITCC may be required to be obtained by persons domiciled in India only in the following rare circumstances:

(i) where the person is involved in serious financial irregularities and his presence is necessary in investigation of cases under the Income-tax Act or the Wealth-tax Act and it is likely that a tax demand will be raised against him, or

(ii) where the person has direct tax arrears exceeding INR 10 lakhs outstanding against him which have not been stayed by any authority.

B. Corporate Law/SEBI/FEMA Highlights

1. Bombay HC: Jurisdiction and procedure of Regional Director in amalgamation cases under fast-track merger route[11]

The company filed for an application with the Regional Director ('RD') to merge four wholly owned subsidiaries with itself vide the fast-track merger route; however, the Regional Director rejected the amalgamation application solely on the grounds that, according to the balance sheets of the companies, they were not solvent. The companies challenged this order, arguing that it was passed without jurisdiction and was legally flawed; they contended that the RD had unlawfully rejected their application without the authority to do so.

The Bombay High Court concluded that under Section 233 of the Companies Act, 2013, the RD does not have the power to reject the application but may only file an application before the National Company Law Tribunal, raising objections and requesting the Tribunal to consider the scheme, if it believes the scheme is not in the public interest, against the interests of the company's creditors or does not satisfy the prescribed pre-requisites.

[10] CBDT Circular dated August 20,2024

[11] Asset Auto India Private Limited and 5 other vs Regional Director (Western Region) and 3 others [LSI-772-HC-2024-(BOM)] dated August 6, 2024

Katalyst Comments:

This judgment raise several important issues:

- *The prolonged delay from 2018, when the RD made its decision, to 2024, casts doubt on the effectiveness of the fast-track merger process.*
- *There is a need for clearer guidelines on the RD's powers to avoid delays and ensure a predictable process.*
- *This judgment may lead to more challenges against RD decisions, complicating the fast-track merger timeline; uncertainty and delays could deter companies from using the fast-track merger route.*
- *The absence of statutory time limits for NCLT referrals jeopardizes the fast-track nature of the process.*

It would be obvious that reforms are needed to clarify the RD's role and ensure the fast-track merger process remains efficient.

2. SEBI: Consultation paper on proposed amendments to the Securities and Exchange Board of India (Prohibition of Insider Trading) Regulations, 2015[12]

SEBI has proposed to enlarge the description of 'connected persons' to include more categories of people who might have access to Unpublished Price Sensitive Information (UPSI); the proposed definition will also include relatives, partners in firms, advisors, and those sharing households with connected persons.

The definition of 'relative' is also proposed to be aligned with the definition under the Income Tax Act, 1961; this is intended so persons closely associated with connected persons, who might gain access to UPSI, are also covered under the regulations.

The proposed definition of "relative" is as follows:

i. spouse; or
ii. sibling(s); or
iii. sibling(s) of spouse; or
iv. siblings of parents; or
v. any lineal ascendant or descendant of the individual or spouse; or
vi. spouse of the person referred to in sub-regulation (ii) to (v) above.

[12] SEBI Consultation Paper dated July 29, 2024

Katalyst Comment: *Whilst the intent may be laudable, the move to expand the net of UPSI to more and more categories will create significant complexities and may not be aligned with on-ground reality; for example, very often, those sharing households are often not on talking terms.*

3. SEBI: Consultation paper on offshore derivative instruments[13]

SEBI has released a consultation paper addressing how foreign investors use offshore Derivative Instruments ('ODI'), segregated portfolios, and related structures. It proposes to extend the disclosure requirements of foreign portfolio investments to ODIs and participatory notes, used by overseas investors for investing in Indian equity or equity derivatives without registering with SEBI.

The consultation paper proposes several key measures:

- Additional disclosure requirements should be directly applied to ODI subscribers, ensuring that they cannot avoid regulatory obligations by investing through ODIs.
- For FPIs with segregated portfolios, disclosure requirements should also be enforced at the segregated portfolio level, not just at the overall fund level.
- ODI issuers and their Designated Depository Participants (DDPs) will be tasked with monitoring the concentration of investments by ODI subscribers; daily reporting on investment positions will be mandatory.
- Similar monitoring will be extended to the size of investments, with positions aggregated across multiple ODI issuers and related FPIs.
- Stricter regulations on the use of derivatives by ODI issuers, ensuring that these instruments are used exclusively for hedging equity shares on a one-to-one basis.

4. SEBI Consultation Paper regarding faster rights issue with flexibility of allotment to select investors[14]

The trigger for the Consultation Paper is that the amounts raised through rights issue is less than the amount raised through other available modes (QIPs and preferential allotments) during 3 years ending March 2024; the conclusion seems to be that rights issue is not the preferred mode of fund raising and it is in this context, SEBI undertook a review of the existing rights issue process, and has accordingly issued the consultation paper.

[13] SEBI Consultation Paper dated August 6, 2024
[14] SEBI Consultation Paper dated August 20, 2024

The summary of the proposals recommended in the Consultation paper is as follows:

- Doing away with the current requirement of filing Draft Letter of Offer (DLoF) with SEBI for issuance of observation;
- Rationalising the content of Letter of Offer (LoF) by reducing the current disclosures to contain some of the relevant information regarding the Rights Issue such as object of the issue, price, record date, entitlement ratio, etc.
- Reviewing the role of intermediaries involved in the Rights Issue Process;
- Reducing the timelines involved in Rights Issue Process;
- Enabling Allotment to Selective Investors in Rights Issue;
- Laying down adequate checks and balances.

In elaboration of the above, some of the aspects brought out in the Consultation paper are as follows:

1. It is propose to discontinue the requirement of appointing Merchant Banker by an issuer for rights issue and it is proposed to assign activities presently carried out by the Merchant banker to the issuer, Registrars to issue and Stock Exchanges.

2. The current regulation restricts the promoters to renounce their rights in case the issue has not achieved minimum subscription; it is proposed to relax the restriction and allowing promoter to renounce their rights in favour of selective investors provided certain upfront disclosures have been made.

5. SEBI: Materiality of related party transactions [15]

SEBI had passed an Ad Interim Ex Parte Order dated April 29, 2024 ('Interim order') addressing certain prima facie issues raised in complaints received against Linde India Ltd. ('LIL/Company'). The complaints predominantly concerned various transactions and agreements the Company had entered into with Praxair India Pvt. Ltd. ('PIPL') and Linde South Asia Services Pvt. Ltd. ('LSASPL'), which are related parties of the Company.

The facts of the matter are quite involved, and are broadly as follows:

- LIL (formerly BOC India Ltd.) has been listed on the National Stock Exchange of India Ltd. ('NSE') and BSE Ltd. ('BSE') since June 1999. LIL is engaged in the business of Gases and related products and Project Engineering division.

[15] SEBI Order in the matter of Linde India Ltd dated July 24, 2024

- In 2018, there was a global merger between Linde AG and Praxair Inc. This resulted in the formation of Linde Plc., which is a NASDAQ – listed entity. Praxair Inc. had an unlisted subsidiary in India – PIPL, which was also predominantly engaged in the production and supply of various gases. Pursuant to the merger, Linde Plc had two subsidiaries operating in India – (i) LIL which was a listed entity wherein it held 75% of the beneficial ownership and (ii) PIPL which was a 100% step down subsidiary.

- LIL and PIPL, subsequently, entered into a JV&SHA, whereby both LIL and PIPL were to hold a 50% stake in LSALPL, a company engaged in providing administrative and support services to both LIP and PIPL.

- Consequent to the announcement by the Company about entering into the JV&SHA, SEBI started receiving investor complaints alleging that the business allocation between LIL and PIPL, which was part of the JV&SHA, was not in the interest of the public shareholders of LIL. Based on these complaints, SEBI started an investigation.

In this context, the interim order had considered two broad issues which are as follows:

- Failure of LIL in obtaining shareholder approvals for material related party transactions ('RPTs') undertaken with PIPL.

- Irregularities alleged in respect of a business agreement entered by LIL with PIPL wherein certain products and geographic areas were allocated between the companies.

The contention of the company was primarily as follows, in relation to the two issues:

i. In relation to material RPT issue, the stand was that the definition of RPT transaction under LODR refers to the computation of transactions aggregate 'under a single contract' and hence, only if the threshold is breached under common contract should it be considered as material.

ii. In relation to the second aspect i.e. allocation of business between LIL and PIPL, the company's stand was that business allocation is distinct from "transfer of resources, services or obligations" and business allocation does not amount to such transfer.

After a detailed reasoning, SEBI's whole time member has passed an order rejecting both these contentions and has directed the company as follows:

- LIL to test the materiality of future RPTs on the basis of aggregate value of transactions irrespective of the number of contracts involved.

- If the aggregate value of RPTs exceeds materiality threshold under LODR Regulation 23(1), then shareholders' approval should be obtained.

- NAC to appoint registered valuer to carry out valuation of the business foregone and receive including by way of geographical allocation as referred to in the facts above.

Katalyst comment:

i. *While it remains to be seen as to where this matter ultimately ends, it is getting increasingly clear that RPTs is being interpreted very broadly by the regulators and in a much more all-encompassing fashion than was originally thought.*

ii. *Shareholder activism on this aspect is also becoming quite stringent.*

iii. *The role of the Audit Committee and Board of Directors is becoming very onerous even generally and specifically with reference to RPTs. In fact, the SEBI order mentions towards the end that "the role/culpability of the Directors/Officers of LIL, if any, for issues covered under this Order, will also be addressed separately".*

6. FEMA (Non-Debt Instruments) Rules, 2019: Simplifying Cross-Border Investments and Enhancing FDI Framework [16]

As per the recent amendment to FEMA (Non-debt Instruments) Rules, 2019, with the aim to streamline foreign investments in Indian entities, it is now permitted for an Indian company to issue shares against swap of equity shares of an overseas company. Effectively, a foreign company can now be acquired by an Indian entity for non-cash consideration by issuing its own shares to such foreign company.

Additionally, the amendments clarify the treatment of downstream investments by entities owned by Overseas Citizens of India (OCI), aligning it with the treatment of investments by Non-Resident Indians (NRIs).

Other notable amendments to the abovementioned rules include:
- Treatment of downstream investments by entities owned by overseas citizens of Inda aligned with treatment of investments by NRIs;
- Standardizing the definition of 'control' for consistency across laws;
- Harmonizing the definition of 'startup company' with existing government notifications.

Katalyst comment: *The changes now allow direct share swaps between Indian and foreign companies, which were previously restricted, simplifying cross-border transactions and reducing associated complexities.*

[16] FEMA (NDI) Rules, 2024 dated August 16, 2024

C. Goods and Service Tax Highlights

1. Gauhati High Court: Purchasing dealer cannot be penalised if selling dealer has failed to deposit tax[17]

The Gauhati High Court has set aside a show cause notice ('SCN') and held that the purchasing dealer cannot be penalized for the act of the selling dealer in case the selling dealer had failed to deposit the tax collected by it; the case relies upon the decision of the Delhi High Court in the case of Quest Merchandising India Private Limited[18] and the impugned SCNs and orders were set aside. However, the High Court has agreed that the department is free to act in those cases where the purchase transactions are not bonafide in accordance with the law.

Katalyst comment: *In the case of Subhash Singh*[19]***,*** *the Uttarakhand High Court had allowed input tax credit to the purchaser where the seller has failed to deposit the tax with GST authorities.*

2. Telangana High Court: Fixed establishment re-registered under the foreign laws does not imply separate entity and no GST is payable[20]

The assessee being a sub-contractor provides work contract services in Maldives for construction under an agreement with National Buildings Constructions Corporation Ltd. (NBCCL). The AAAR has upheld the ruling of the AAR stating that GST applies to work contract services provided in Maldives by the assessee to NBCCL. In this regard, the Telangana High Court has set aside the order of AAAR and held that both the assessee and NBCCL established operations in the Maldives to fulfill the India-Maldives agreement, and these establishments qualify as 'fixed establishments' u/s 2(7) of the IGST Act.

The High Court also clarified that the 'place of supply' in relation to an immovable property for carrying out construction work shall be the place where the immovable property is located and hence, as the services and both the recipient and supplier are outside India, GST is not applicable in the instant case. Further, the High Court directed to reimburse the GST and interest paid by the assessee.

Katalyst comment: *A welcome judgement by the Telangana HC; the entity re-registered in Maldives due to foreign laws cannot be considered as separate legal entity. Section 13(4) of the IGST Act provides that place of supply in relation to immovable property is the location of immovable property which is outside India and hence, GST liability as per section 5 of the IGST Act does not arise.*

[17] National Plasto Moulding vs. State of Assam [TS-469-HC(GAUH)-2024-GST] dated August 9, 2024
[18] Quest Merchandising India Private Limited [2017 SCC OnLine Del 11286] dated October 26,2017
[19] Subhash Singh vs. Deputy Commissioner, SGST [TS-270-HC(UTT)-2024-GST] dated May 10,2024
[20] Sri Avantika Contractors (I) Ltd vs Appellate Authority for Advance Ruling & ors. [TS-476-HC(TEL)-2024-GST] dated August 9, 2024

3. Karnataka HC: No reverse charge on services rendered by overseas branch to Indian head office[21]

The show cause notice ('SCN') issued by the State GST Authority alleges that LTIMindtree's overseas branches have rendered services to Indian head office and the same is liable to be taxed under reverse charge mechanism in GST regime. In this regard, it was argued before the Karnataka High Court that services are received outside India, location of service provider is outside India and location of service recipient is also outside India. Further, it is also argued that there is no jurisdiction under GST law for India to tax the transaction and the place of supply is an issue that can decided only by an officer competent to do so, but certainly not by the officer who issued the SCN. Thereafter, the Karnataka High court stays the SCN issued by the State GST authority.

Katalyst comment: *In a matter similar to LTIMindtree, Infosys was issued a pre-show cause notice by the Karnataka GST authority for service received from branch office located outside India for the period from July 2017 to March 2022. The company submitted that it is not liable to make payment of GST under the reverse charge mechanism in lieu of the Circular No. 210/04/2024 dated June 26, 2024. The State GST authority subsequently withdrew the SCN.*

[21] LTIMindtree vs. Union of India [TS-450-HC(KAR)-2024-GST dated August 1, 2024