KATALYST ADVISORS

Katalyst Kaleidoscope

February 2022: Tax and Regulatory Insights

SUMMARY OF CONTENTS

A. Income tax highlights

1. Key Principles emerging in relation to issuance of shares at premium u/s 56(2)(viib) of the Income-tax Act, 1961 ("Act")

Background: Section 56(2)(viib) of the Act seeks to tax any unjustified share premium at the time of equity infusion in an Indian company by resident individuals. In this context, valuation of equity shares needs to be justified a valuation report (from a SEBI registered merchant banker) justifying valuation of a company (in which equity is sought to be infused at premium) as per the **Discounted Cash Flow Method ("DCF")** or **Net Asset Value ("NAV"),** at the option of the taxpayer. This provision has been subject to significant litigation mainly on the grounds of justifiability of valuation by the assessee.

Certain key principles emerging out of recent precedents are summarized as under:

i. Rejection of valuation by the tax authorities arrived at using by using the DCF method by the taxpayer (instead of the NAV method) cannot be justified, especially if the basic assumptions made by the valuer are not found unreasonable[1]

ii. If the share premium is justified on the basis of the DCF method or the NAV method for the purposes of section 56(2)(viib) of the Act, no separate addition can be made u/s 68 of the Act, which provides for unexplained cash credits and is generally invoked for taxing black money. [2]

iii. While section 56(2)(viib) of the Act applies to issuance of either equity shares or preference shares at a premium, there is no methodology for valuation of preference shares. In such a case, if the valuation of preference shares (if issued at a premium) is carried out using the DCF method on the basis of scientific principles and sound basic assumptions, then it is not open for the tax authorities to challenge such valuation. [3]

iv. For the purposes of valuation u/s 56(2)(viib) of the Act, a reference balance sheet on the valuation date (i.e., date of issuance of shares) is required to be drawn up, and such balance-sheet shall be audited by the auditor of the company issuing such shares (unless such balance sheet cannot be drawn up, in which case, previously audited balance sheet is applicable). If the reference balance sheet is drawn up as on the valuation date (i.e.,

[1] Credtalpha Alternative Investment Advisors Pvt Ltd [TS-32-ITAT-2022(Mum)]
[2] M/s. Fortigo Network Logistics Pvt. Ltd. [TS-55-ITAT-2022(Bang)]
[3] M/s. Fortigo Network Logistics Pvt. Ltd. [TS-55-ITAT-2022(Bang)]

date of issuance of shares), but is audited subsequent to the valuation date, it would be sufficient compliance for the purposes of valuation u/s 56(2)(viib) [4].

v. If a valuation report under FEMA is required (say, for downstream investments by Foreign Owned and Controlled Companies), which is based on Internationally Accepted Pricing Methodology (which may, in addition to NAV/ DCF methods, also includes other methods such as comparable company multiple method, comparable transaction multiple method, etc.), a separate valuation report under section 56(2)(viib) of the Act would also be required justifying the share premium only using the NAV/ DCF methodology. [5]

2. Bangalore ITAT: Depreciation is allowable on goodwill acquired upon amalgamation, following SC Ruling in case Smifs Securities[6]

In case of a Scheme of Amalgamation between a holding company and its subsidiary, the transferee company had recorded goodwill in its books, and had claimed tax depreciation on the same.

The Bangalore Tribunal, agreeing with the arguments professed by the transferee company, allowed the depreciation claim on goodwill (especially since the same was based on the valuation report obtained for the purposes of the Scheme of Amalgamation) relying on the decision of the Supreme Court in the case of Smifs Securities. It further held that the question of apportionment of goodwill in the ratio of the number of days between the transferor company and the transferee company does not arise given that the "goodwill" arose for the first time in the books of the transferee company upon the amalgamation becoming effective.

Katalyst Comments:

While "goodwill" per se is not eligible for depreciation post enactment of Finance Act, 2021, if there are other intangible assets (such as brands, customer lists, etc.) other than goodwill, and which are recognised on the basis of a proper valuation report, then such other intangible assets should be eligible for depreciation.

[4] Electra Paper and Board Pvt. Ltd [TS-58-ITAT-2022(CHANDI)]
[5] Medicon Leather Pvt. Ltd v. ACIT [TS-1146-ITAT-2021(Bang)]
[6] M/s. Altimetrik India Pvt. Ltd. [TS-65-ITAT-2022(Bang)]

3. Mumbai ITAT: Provisions of section 50C on transfer of property are invocable only in the year of "transfer", as defined[7]

In case where the tax-payer had undertaken a "transfer" as defined u/s 2(47)(v) of the Act, then the reckoner value of property (which is deemed as consideration for the purposes of section 50C of the Act, if such reckoner value is higher than the 110% of the consideration), during the year of such "transfer" would be adopted, and not the reckoner value in the year of execution of the actual conveyance deed.

"Transfer", as defined u/s 2(47)(v) of the Act, inter alia, imports section 53A of the Transfer of Property Act, 1882 and requires that: i) an Agreement to Sell has been entered into; ii) such Agreement to Sell is for consideration; and, iii) possession of the property has been transferred to the acquirer. Therefore, even if the sale deed or conveyance deed is subsequent to the above-mentioned scenario, then the "transfer" would be deemed to be effectuated for the purposes of computation of capital gains.

4. Question of "Business Income" versus "Capital Gains" in the context of Acquisition of Controlling Interest over group companies[8]

Recently, the Bombay High Court quashed reassessment proceedings against the taxpayer (i.e., Tata Sons Limited) wherein the tax authorities had sought to re-assess profits on sale of investments (presumably, claimed as capital gains by Tata Sons Limited) as business income.

The key issue, which was already adjudicated upon in the earlier assessment order, was that the "activity" of Tata Sons Limited of making investments in group companies in order to acquire/ retain control of the companies promoted by it cannot be equated to a "carrying out a business" and therefore, gains arising out of the same cannot be treated as "business income".

Katalyst Comments:

There could be strategic or commercial or regulatory reasons (for example, requirement of SPVs in case of infrastructure companies), where the holding company conducts business activity through such investee companies. However, holding of such investments cannot be equated as "business income" of the holding company per se, even though such business activity of the holding is required to be carried out through an investee company of such

[7] Standard Chartered Bank Crescenzo [TS-51-ITAT-2022(Mum)]
[8] Tata Sons Limited [TS-64-HC-2022(BOM)]

holding company. In fact, the CBDT, vide Circular No. 6/2016 dated 29 February 2016, had clarified specifically that the taxpayer has an option to choose income arising from sale of listed shares and securities as capital gains, if such listed shares/ securities are held for more than 12 months.

B. Corporate Law Highlights

1. NCLAT allows dispensation of shareholders and creditors meeting in case of merger of WOS with Parent company[9]

Recently, NCLAT allowed dispensation to hold, inter alia, meeting of unsecured creditors the contentions of the applicant companies to a Scheme of Arrangement between a wholly owned subsidiary with its holding company on the grounds that - i) Positive net-worth of both companies; ii) unsecured creditors are paid off in the ordinary course of business; and iii) the scheme is not pre-judicial to the interest of unsecured creditors and their liability is neither extinguished nor reduced.

Earlier, the NCLT had rejected the said dispensation on the basis that the Transferee Company already had existing unsecured creditors, and whether such existing creditors would be willing to welcome additional unsecured creditors of the Transferor Company, should be expressly decided by the creditors of Transferee Company.

2. MCA directs applicability of certain provisions of Companies Act, 2013 to LLPs

MCA vide its Notification dated 11 February 2022 has directed applicability of certain provisions of the Companies Act, 2013 to LLPs, except where the context otherwise requires, with specified modifications to suit LLPs, w.e.f. February 12, 2022.

Some sections of the Companies Act, 2013 which will now be applicable to LLPs, inter alia include:

- Section 90 – Maintaining register of significant beneficial owners;
- Section 164 – Disqualification for appointment of directors;
- Section 165 – Limit on number of LLPs where a person can become a designated partner;
- Section 206 – Inspection of books and papers, etc.

[9] In the matter of Ericsson India Private Limited & Anr. NCLAT, Company Appeal No. 148 of 2021 dated 18 January 2022

C. SEBI/ FEMA Law

1. SEBI Circular: Change in threshold limit for obtaining NOC from secured creditors in Schemes of Arrangement by Listed Entities[10]

In January 2022, SEBI has provided clarification stating that NOC from secured creditors should be obtained prior to SEBI / Stock exchange giving approval to the Scheme of Arrangement, and not at the time of submission of requisite approvals from stock exchanges / SEBI.

SEBI has amended this requirement, and accordingly, NOC from at least 75% of the secured creditors in value is required prior to SEBI / Stock Exchange approval (earlier the requirement from SEBI was to obtain NOC from 100% secured creditors).

Katalyst Comments

While the requirement in cumbersome enough to begin with (given that, at a later stage, NCLT would anyway require listed entities to convene meetings of secured creditors wherein such secured creditors can give their consent), reduction of threshold from whom such NOC is to be obtained is a partial relief.

2. SEBI Press Release: Update regarding requirement for separation of role of Chairperson and MD / CEO[11]

The SEBI Board, in its meeting held in March 2018, had considered and approved the proposals including the one relating to separation of role of Chairperson and MD/CEO of listed companies. Accordingly, SEBI (LODR) were amended in May 2018 mandating top 500 listed companies (w.e.f. 01 April 2020) to ensure that the Chairperson of the Board shall be:

a. Non-executive Director; and
b. not related to MD / CEO

The deadline for compliance was extended by two years in January 2020. However, considering the unsatisfactory level of compliance by listed companies, the SEBI Board has decided that this provision may not be retained as a "mandatory" requirement and instead it should be made applicable to all listed entities on "voluntary" basis.

[10] SEBI Circular SEBI/HO/CFD/DIL2/CIR/P/2022/11 dated February 01, 2022
[11] SEBI Press Release No. PR No. 5/2022 dated 15 February, 2022

3. SEBI puts framework in place for conversion of private listed InvITs[12]

SEBI vide its circular dated February 09, 2022 has laid down framework for conversion of private listed InvITs into public InvITs.

The circular provides that a Private Listed InvIT may convert into a Public InvIT on making a public issue of units through a fresh issue and/or an offer for sale in terms of the InvIT Regulations. SEBI has also clarified that post issuance and listing of such units through public issue in accordance with this circular, the Private Listed InvIT shall stand transformed and shall be considered a Public InvIT and it shall be required to comply with all provisions of the InvIT Regulations prescribed for Public InvITs.

4. SEBI releases consultation paper to propose rules and disclosure norms for pricing of IPO[13]

In view of increasing number of IPO filings made by loss-making companies (primarily in the tech space), SEBI plans to ask "new age technology companies" to justify the pricing of their shares for IPOs to ensure transparency in valuations. SEBI has proposed such norms since some of the recent IPOs by such new age technology companies have eroded billions of dollars in investor wealth post listing.

Currently, companies only disclose earnings per share (EPS), price to earnings (P/E), return on net worth (RoNW), and net asset value (NAV), as well as comparisons of these accounting ratios with their peers, i.e., companies of similar size in the same industry. However, SEBI is of the view that such traditional parameters cannot be applied to new-age tech companies, and hence the "Basis of Issue Price" section should be supplemented with disclosure of Key Performance Indicators and certain additional parameters such as valuation of past transactions / fund raising.

5. Increase in Limits for Foreign Portfolio Investor ("FPI") investing in corporate bonds/ G-Secs under the Voluntary Retention Route ("VRR")[14]

The RBI has recently increased the limit of investments by FPIs under the VRR Route (i.e., lock-in of funds for a period of minimum 3 years in India) for investments in corporate bonds, G-Secs, T-Bills, etc. from INR 150,000 Crore to INR 250,000 Cr. This increased limit should result in increased participation of debt instruments issued by the government/ corporates.

[12] SEBI Circular No. SEBI/HO/DDHS/DDHS_Div3/P/CIR/2022/15 dated February 09, 2022
[13] SEBI Circular No. SEBI/HO/DDHS/DDHS_Div3/P/CIR/2022/15 dated February 09, 2022
[14] A.P. (DIR Series) Circular No. 22 dated February 10, 2022

D. Goods and Service Tax highlights

1. Transfer of Unit from one state to another state is liable as supply of goods and benefit of transfer of ITC is not available[15]

Reversing a judgment of the AAR, the Andhra Pradesh Appellate Authority of Advance Ruling ('AAAR') recently held that transfer of unit of business from one state to another is not equated to "transfer of business as a going concern", if such transfer is between a person having same PAN, but different GST Registration. Therefore, the same would be under the purview of "supply". Further, it is also clarified that there is no provision under GST law to transfer the ITC from one unit to the other in such a case (while it is so for transfers between two separate persons) and therefore, unutilsed ITC of one state cannot be transferred to the other state.

2. Sale of "developed plot" is liable to GST as it is different from 'sale of land' per se which is exempt[16]

Recently, the Gujarat AAAR held that the activity of sale of developed plots with infrastructure such as drainage line, water line, electricity line, land leveling etc. in accordance with an approved plan would be covered under the clause "construction of civil structure or a part thereof, intended for sale to a buyer", and therefore, be liable to GST since the activity of sale of developed plot of land is not equitable to sale of land per se (which is not subject to GST).

.

3. Recoveries from employees towards notice pay and parental insurance do not amount to supply[17]

The Maharashtra AAR recently held that recoveries of notice pay from employee as per the employment contract between employee and employer is in the nature of penalty or liquidated damages for not serving notice period and therefore, cannot be equated to "supply of service", and therefore, not subject to GST.

Further, with respect to recovery of parental insurance from employees, it was held that since the employer was not engaged in the business of providing supply of insurance services and it was not covered within the purview of supply.

[15] Shilpa Medicare Ltd [TS-1258-AAAR(AP)-2020-GST]
[16] In the matter of Shree Dipesh Anilkumar Naik [TS-760-AAAR(GUJ)-2021-GST]
[17] In the matter of Syngenta India Ltd. [TS-12-AAR(MAH)-2022-GST]

******

Our Offices:

Mumbai
71/75 Mittal Tower,
7th Floor, C Wing,
Nariman Point,
Mumbai - 400021
Tel: +91 22 4917 1616

Pune
#406-408,
Global Square, Near Bund-Garden,
Yerwada, Pune- 411006
Tel: +91 20 4840 7700