Katalyst Kaleidoscope

January 2018: Tax and Regulatory Highlights

A. Income-tax Highlights

1. **ITAT allows depreciation claim on Goodwill acquired under Slump-sale:** Pune ITAT in the case of Johnson Matthey Chemicals[1], allowed depreciation on goodwill pursuant to acquisition of business by way of slump-sale, relies upon Supreme Court ruling in Smifs Securities[2]; ITAT confirmed the position that the slump price paid to acquire a business has to be bifurcated between tangible and intangible assets for purposes of allowing depreciation. If the allocation is done in a systematic manner by an independent valuer and there is no fallacy, the tax officer is bound by the allocation. ITAT also remarked that "ultimately after the slump price has been attributed first to the value of tangible assets, then the balance is to be attributed to intangible assets and once the same is done and whether it is under the umbrella of know-how, trademarks, patents or goodwill, it makes no difference since all these are covered under the umbrella of intangible assets, which are eligible for claim of depreciation u/s. 32(1)(ii) of the Act."

2. **Date of accepting offer relevant for determining Capital Gains under Share swap arrangement:** Mumbai ITAT in the case of Mukesh Gandhi[3] opined that the date on which assessee accepted the exchange/swap offer should be considered as transfer date for determining capital gains under share swap arrangement.

3. **Consideration received for surrender of rights/share in the firm, not taxable u/s 56(2)(vi) as income from other sources:** Pune ITAT in the case of Vasumati Sanghavi[4] held that the rights surrendered by the partners was an adequate consideration for receiving the amounts from the firm and hence, such an amount received would not be taxable u/s 56(2)(vi). ITAT also relied upon Bombay HC ruling in the case of Mr. Riyaz Sheikh[5] to hold that such receipts are not to be taxed under the head 'income from capital gains' or 'income from other sources'.

4. **Minimum Alternate Tax (MAT) relief for companies subject to insolvency proceedings:** With a view to minimize the genuine hardship faced by companies against whom an application for corporate insolvency resolution process has been admitted by the Adjudicating Authority under Insolvency and Bankruptcy Code, 2016, the CBDT has issued a Press Release dated 6th January, 2018 stating that, in case of such companies, with effect from Assessment Year 2018-19 the amount of total loss brought forward (including unabsorbed depreciation) shall be allowed to be reduced from the book profit for the purposes of levy of MAT under section 115JB of the Act.

B. Corporate Law Highlights

1. **The Companies (Amendment) Act, 2017 (Amendment Act):** The Companies (Amendment) Bill, 2017 was passed by Lok Sabha on 27th July 2017 and thereafter by Rajya Sabha on 19th December 2017. The Amendment Act received the President's assent on 3rd January 2018. By this Amendment Act, in total 93 amendments been carried out in

[1] Johnson Matthey Chemicals India Pvt Ltd [TS-604-ITAT-2017(PUN)]
[2] CIT Vs. Smifs Securities Ltd. (2012) 348 ITR 302 (SC)
[3] Mukesh Ramanlal Gandhi (ITA No. 2712/Mum/2015) [TS-588-ITAT-2017(Mum)]
[4] Vasumati Prafullachand Sanghavi [TS-599-ITAT-2017(PUN)]
[5] Mr. Riyaz Sheikh [TS-5831-HC-2013(BOMBAY)-O]

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Companies Act, 2013 to provide relief to stakeholders and to provide more clarity on some of the provisions of Companies Act, 2013.

Listed hereunder are some of the key changes brought about by the Amendment Act:

- **Definition of "Subsidiary Company":** Under the existing law, "Subsidiary Company" is defined based on control over more than one-half of the total share capital which comprises the aggregate of the paid up equity capital as well as convertible preference share capital. The Amendment Act provides for exercise or control over more than half of the total voting power (instead of total share capital) as criterion for classification as a subsidiary.

  Katalyst comment: Under the existing law a company may be treated as a subsidiary of the other company merely based on the ownership of optionally convertible preference shares which in fact are in the nature of loans and contain conversion option only for commercial considerations such as security, etc. The amended definition seeks to address such complexities.

- **Section 185 - Loans to Directors:** The existing law prohibits a company from granting a loan to (i) its director or his relatives or to (ii) any firm where such director or his relative is a partner, (iii) a private company where the director is shareholder or director, (iv) a corporate where the director has 25% and more voting rights or management control. The amended section provides a carve out which will allow a company to extend loans and security to such entities but on approval by a special resolution (ie approval by 75% of shareholders present and voting). The other condition is that the loan funds can be used by the borrower only for its principal business activity. However, loans given directly to a director or his relatives will continue to be prohibited.

  Katalyst comment: Under the existing law a company could not give any type of loan even to its subsidiary company where there is a common director, which created several practical difficulties for the companies significantly dependent on the holding / group companies for its funding requirements. The amended section is likely to address such complexities.

- **Section 188 – Related Party Transactions:** The existing law prohibits a related party from voting on a related party transaction and all related party transactions need requisite approval from non-interested shareholders. The Amendment Act introduced a proviso which seeks to exempt the blanket ban on a member voting on related party transactions, in the case of a company where 90% or more shareholders or members, in number, are relatives of promoters, or are related parties.

  Katalyst comment: This carve out seeks to overcome a practical issue in case where the related party owns almost all the shares but is excluded from the vote. Such change will provide a greater flexibility to closely held companies, which are reliant on its shareholders for funding.

  Additionally, 'related party' definition has been expanded to include any other body corporate, Indian or foreign, apart from companies. Such body corporate

could include a LLP, registered society, trust etc. The new definition means that foreign entities that have at least 20% of total voting power, or control over the company will also have to comply with related party transaction requirements.

- **Section 149 – Independent Directors:** The existing law has blanket bar on a person from acting as an independent director of a company if such person has a pecuniary relationship with that company. The Amendment Act clarifies that pecuniary relationships upto 10% of the total income of the independent director are now permitted.

- **Section 186 – Loans and Investment by Company:** A proviso has been provided to state that, where a company provides loan, guarantee, security to (a) a joint venture company, (b) wholly owned subsidiary, or (c) invests in a wholly owned subsidiary, prior approval of shareholders by way of a special resolution is no longer required. This amendment makes it easier for holding companies to give loans and financial assistance to their subsidiaries and joint ventures.

- **Section 197 – Managerial Remuneration:** The requirement of approval of the Central Government (CG) for Managerial Remuneration above the prescribed limits is replaced by approval through special resolution by shareholders in general meeting. Therefore, no CG approval is now required for public companies for payment of remuneration exceeding the prescribed limits.

- **Section 53 – Prohibition on issue of shares at a discount:** The existing law provides for issuance of shares at a value not below face value. The Amendment Act that provides carve out from applicability of section 53 to shares issued upon conversion of debt to equity in pursuance of any statutory resolution plan or debt restructuring in accordance with guidelines / directions / regulations specified by RBI.

- **Section 42 – Issue of shares on a Private Placement basis:** The process of private placement of securities has been simplified. It has been provided that private placement offer and application shall not carry any right of renunciation.

C. Foreign Direct Investment (FDI) Highlights

1. The Union Cabinet, chaired by the Prime Minister, has approved certain amendments in the FDI Policy. The key amendments proposed, as laid down in the press release published by the Press Information Bureau on 10th January 2018, are summarized below:

   - **Single Brand Retail Trading (SBRT):** Extant FDI policy on SBRT allows 49% FDI under the automatic route, and FDI beyond 49% and up to 100% through the Government approval route. It is now decided to permit 100% FDI under the automatic route and the Government approval would no longer be required.

     For foreign investment beyond 51%, the extant FDI Policy requires that sourcing of 30% of the value of goods purchased to be done from India. It is now decided to allow, for initial period of 5 years, incremental sourcing (i.e. increase in value of global sourcing from India for that single brand in a particular financial year over the preceding financial year) from India for global operations by single brand

retail entities / its group entities towards the mandatory 30% local sourcing commitment. After completion of this 5 year period, the SBRT entity shall be required to meet the 30% sourcing norms directly towards its India's operation, on an annual basis.

- **Real Estate Broking Service:** It is decided to clarify that real-estate broking service does not amount to real estate business and is therefore, eligible for 100% FDI under automatic route.

- **Investing Companies / Core Investment Companies:** Under extant FDI policy, foreign investment in an Indian Company only engaged in investment activity (including Core Investment Companies) is allowed upto 100% through the Government approval route. It is now decided to allow foreign investment upto 100% under automatic route provided such company is regulated by a financial sector regulator. If such entities are either, wholly or partially unregulated or in case of doubt, foreign investment will be allowed under the Government approval route.

- **Pharmaceuticals:** The definition of medical devices to be amended in the FDI policy and its reference to Drugs and Cosmetics Act to be removed.

- **Power Exchanges:** Extant policy provides for 49% FDI under the automatic route in Power Exchanges. However, FII/FPI purchases were restricted to secondary market only. It is now decided to allow FIIs/FPIs to invest in Power Exchanges through primary market as well.

- **Civil Aviation:** Extant FDI policy does not allow foreign airlines to invest in Air India. It is now decided to allow foreign airlines to invest up to 49% under the Government approval route in Air India subject to the condition that substantial ownership and effective control continue to vest with Indian National.

- **Auditors of Indian Investee Companies receiving Foreign Investment:** The extant FDI policy does not have any provisions in respect of specification of auditors that can be appointed by the Indian investee companies receiving foreign investments. It is now decided to provide in the FDI policy that wherever the foreign investor wishes to specify a particular auditor/audit firm having international network for the Indian investee company, then audit of such investee companies should be carried out as joint audit wherein one of the auditors should not be part of the same network.

  Katalyst comment: This is for the first time a reference is made in the FDI policy regarding the appointment of auditors and seems to reflect as intent to protect interest as well as create more opportunities for domestic audit firms. Also, presently there is no clarity as to whether such requirement shall also apply to investment / shareholders' agreement which have already been entered into and the Government / RBI should clarify the same.

– Others changes:
In case of sectors under automatic route, it is now decided that issue of shares against non-cash considerations like pre-incorporation expenses, import of machinery etc. shall be permitted under automatic route (earlier it was allowed through the Government approval route).

For investment in the automatic route sector from Countries of Concern, the administrative ministry has been changed from the Ministry of Home Affairs to the Department of Industrial Policy & Promotion.

The aforesaid amendments are yet to be incorporated in FDI Policy / FEMA regulations and one would need to await the exact language of the amendments to further assess the points discussed above.

D. Securities' Law Highlights

1. SEBI issued a circular on 22nd December 2017 which provides a standard format for making applications for obtaining exemption under the SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011. The circular also prescribes guidelines which would need to be adhered to for being exempt from making an open offer and for settlement of shares into a trust.

2. SEBI issued a circular[6] on 3rd January 2018 to clarify and relax conditions applicable for schemes of arrangement involving listed entities provided in its existing circular dated 10th March 2017[7] (Existing Circular):

   – **Exemption from application of circular:** The Existing Circular is not applicable to schemes of merger of wholly owned subsidiaries ("WOS") with their parent companies. The exemption have now been extended and additionally made inapplicable to schemes of mergers of divisions of the WOS with the parent companies (ie Demerger from WOS to its parent company).

   – **Exceptions to promoter lock-in requirements:** The promoter of an unlisted entity into which a listed company or its division is merging, is required to lock-in shares in the manner specified in the Existing Circular. This requirement is now relaxed in respect of: (i) any pledge of shares with any scheduled commercial banks / public financial institutions, as collateral security for loans, and (ii) inter-se transfer of shares among promoters, as long as the lock-in period continues after the transfer (in accordance with the conditions specified under regulation 40 of the ICDR Regulations).

   – **Independent chartered accountant and merchant banker:** It is now clarified that the valuation report as well as the fairness opinion shall be provided by an *independent* chartered accountant, and *independent* SEBI registered merchant banker respectively. The circular further qualifies 'independence' as including the absence of any material conflict of interest among themselves or with the company, including that caused by common directorships / partnerships.

[6] CFD/ DIL3/ CIR/ 2018/ 2 dated 3 January, 2018
[7] CFD/ DIL3/ CIR/2017/ 21 dated 10 March, 2017

- **Clarification on 25% pre-scheme shareholding:** In respect of schemes of arrangement involving unlisted entities, the Existing Circular required that the public shareholders (of the listed entity) and the qualified institutional buyers (of the unlisted entity) should hold not less than 25% in the combined entity. It is now clarified that such 25% threshold is to be calculated on a fully diluted basis.

- **Relaxation of timeline for listing of shares:** Timeline for listing as well as trading of shares issued pursuant to a scheme has been relaxed. It is provided that steps for listing are completed as well as trading of shares commences within 60 days (which was earlier 30 days for listing process and 45 days for trading commencement) of receipt of the order of the NCLT, simultaneously on all the Stock Exchanges where the equity shares of the listed entity (or transferor entity) are/were listed.

- **No formalities post sanction of the scheme by the NCLT:** The Existing Circular required the listed entity to submit certain documents to the stock exchanges, post sanction of the Scheme. Such requirement has now been removed.

E. Other Highlights

Maharashtra Shops and Establishments (Regulation of Employment and Conditions of Service) Act, 2017 ('Amended MSEA Act') has been made w.e.f 19th December 2017: As a result, the erstwhile Maharashtra Shops and Establishments Act, 1948 ('Earlier MSEA Act') stands repealed. The provisions of the Amendment MSEA Act shall apply to the establishments which employ ten or more workers, in contrast to the Earlier MSEA Act which applied to all establishments, irrespective of number of employees employed. This comes as a significant compliance relief to smaller entities and multi-nationals who intend to or have just set up its presence in India. Also, the registration can now be obtained for ten years at a stretch. Additionally, the definition of 'employee' is replaced with 'worker' and the Individuals engaged through an agency and persons in positions of confidential, managerial or supervisory nature, are excluded. Also, certain new requirements such as provision of a crèche facility, canteen, etc. have been introduced.

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