KATALYST ADVISORS

Katalyst Kaleidoscope

June 2024: Tax and Regulatory Insights

SUMMARY OF CONTENTS

A. Income Tax Highlights

1. Telangana HC: dismisses the assessee's writ on GAAR invokation in high stakes capital gains case[1]

The facts of the case were that the assessee had sold the shares of Ramky Estate and Farms Limited (REFL) to Advisory Services Pvt. Ltd (ADR); before this sale, REFL had issued bonus shares to its shareholders at a 5:1 ratio, reducing each share's face value to one-sixth. This sale resulted in a short-term capital loss for the petitioner under the Income Tax Act, 1961 (the Act) which the assessee offset against long-term gains from selling shares in Ramky Enviro Engineers Limited (REEL); the same was disputed by the Tax authorities stating that transaction qualified as an Impermissible Avoidance Arrangement under the provisions of GAAR.

The assessee argued that since the transaction fell under SAAR provisions, GAAR provisions could not be applied, claiming the relevant section only referred to units, not shares. The court found this argument flawed and inconsistent because the petitioner had previously stated that Section 94(8), which restricts bonus stripping, didn't apply to shares at that time. The court noted that the stance that that SAAR should generally supersede GAAR mainly pertains to international agreements, not domestic cases. Referring to the case of McDowell & Co. Ltd. v. CTO[2], the court observed that the multiple transactions in the case were designed with the sole intention of avoiding tax as brought out by the Tax Authorities. Taking into consideration the CBDT's view in its circular dated January 27, 2017[3], it held that since bonus stripping of shares was not covered by SAAR during the dispute year, the provisions of GAAR should be applied.

Katalyst Comments:

If a transaction is undertaken for no apparent commercial rationale, but seems to be tax driven, then the Courts would be inclined to invoke GAAR. The Telangana High Court was dealing with a scenario where a Specific Anti-Avoidance Rule (SAAR) existed before the General Anti-Avoidance Rule (GAAR) was legislated. In any case, if there is a SAAR provision enacted after GAAR, and for some reason, the SAAR provision does not apply, then GAAR should not be invoked; but clearly, the law on this is evolving.

[1]Ayodhya Rami Reddy Alla vs Principal Commissioner of Income Tax (Telangana High Court) [2024] dated June 7, 2024
[2]Mc Dowell & Company Limited vs The Commercial Tax Officer (Supreme Court) [1985] dated April 17, 1985
[3]CBDT Circular No. 7 of 2017 – Clarifications on implementation of GAAR provisions under the Income Tax Act, 1961 dated, January 27, 2017

2. Himachal Pradesh HC: No excessive share premium on loan conversion to equity; choice of Valuation method with assessee, not AO[4]

The facts of the case were that the assessee had issued 2.25 crore equity shares with a face value of Rs.10 each at a premium of Rs.90 per share to M/s Shri Bajrang Power & Ispat Ltd; certain unsecured loans were taken by the assessee which were converted into share capital as per an agreement between the two parties. The shares had been valued as per Discounted Cash Flow Method ("DCF Method") as prescribed under Rule 11UA of the Income Tax Rules and a certificate was also obtained from a Chartered Accountant thereunder.

The Assessing Officer rejected the assessee's valuation report and added Rs. 202.50 Crores under the relevant provisions of the Income Tax Act, 1961 considering alleged excessive share premium. The officer used the NAV Method to compute the fair market value of the shares. On appeal, the Chandigarh ITAT stating that above provisions did not apply as no consideration was received for the shares and the officer could not substitute the NAV Method for the DCF Method as exercised by the assessee. The ITAT, relying on a previous order of Mumbai ITAT[5], confirmed and upheld the view of the CIT(A) subsequent to which the appeal was filed with the High Court. The High Court upheld the reasoning of both the CIT(A) and Chandigarh ITAT and stated that there was no substantial question of law for consideration by the High Court.

3. Delhi HC: Compensation received from 'Flipkart' for loss in value of ESOP due to disinvestment not taxable as perquisite[6]

The facts of the case are that the assessee, a former employee of Flipkart Internet Private Limited (FIPL), was granted 1,27,552 stock options under an Employee Stock Option Plan by Flipkart Pvt. Ltd., Singapore, the parent company. Due to the divestment of a wholly owned subsidiary by the parent company, the value of these options fell; as compensation, the assessee was offered USD 43.67 per option, with tax to be withheld on this compensation considering it as a perquisite. The assessee filed an application against this seeking a 'Nil' deduction certificate which was rejected by the AO.

The issue under consideration was whether the said compensation can be considered as a perquisite under section 17(2)(vi) or not; the High Court held that the key aspect of the inclusive definition of a perquisite is the value of any specified security received by an employee from the employer, whether directly or indirectly. As per Section 17(2)(vi), Explanation (c) this value can only be calculated once the option is exercised; therefore, for

[4]Pr. Commissioner of Income Tax-1 vs M/s I.A. Hydro Energy (P) Limited (Himachal Pradesh High Court) [2024] dated, May 31, 2024
[5]Deputy Commissioner of Income Tax, Mumbai vs M/S Credtalpha Alternative Investment Advisors (Pvt.) Ltd (Mumbai ITAT) [2022] dated, January 19, 2022
[6] Sanjay Baweja vs Deputy Commissioner of Income Tax (Delhi High Court) [2024] dated, May 30, 2024

income to be considered a "perquisite," it must arise from the exercise of these options by the employee. The High Court held that the amount could not be considered a perquisite under Section 17(2)(vi) because the petitioner did not exercise the stock options and the payment was a one-time voluntary compensation from FPS to all option holders; however, it remains silent on whether section 56(2)(x) of the Income Tax Act, 1961, which covers receipts without consideration or for inadequate consideration, will get attracted or not.

4. **Mumbai ITAT: Notional interest income credited to the profit and loss account in compliance of Indian Accounting Standards cannot be considered as real income in absence of contractual obligation of repayment.[7]**

The assessee, a public limited company, gave an interest-free loan to its wholly owned subsidiary, Kesar Multimodal Logistic Limited. Although no interest was due, the assessee recorded "notional interest" of approx. Rs. 2.76 crore in its Profit and Loss account in compliance with the Indian Accounting Standards. Since this notional interest was merely a book entry pursuant to the requirements of the Indian Accounting Standards and did not actually accrue, the assessee excluded it from net profit when computing total income for tax purposes.

The ITAT held that the notional interest income was not liable for taxation under Real Income Principle; it placed reliance on the case of M/s. Shriram Properties Limited[8] and stated that the notional income credited to the profit and loss account could not be said to have accrued to the assessee, when there was no contractual obligation to pay the same.

Katalyst Comments:

The ITAT ruling puts emphasis on the meaning of 'real income' to be chargeable to tax. Notional interest recorded in accordance with the requirements of the accounting standards should not be construed to be real income when the said income does not materialize; this aspect of notional versus real income becomes more pertinent under IndAS.

5. **Bombay HC: Capital gains on transfer of shares of company should be computed after reducing amount withdrawn from escrow account[9]**

The assessee, a promoter of WMI Cranes Limited, along with another promoter, sold 100% of the company's shares to KFC for Rs.155 crore via a Share Purchase Agreement (SPA) of which

[7]Assistant Commissioner of Income Tax vs Kesar Terminals and Infrastructure Ltd. (Mumbai ITAT) [2024] dated March 8, 2024
[8]M/s. Shriram Properties Limited vs Principal Commissioner of Income Tax (Chennai ITAT) [2023] dated March 20, 2023
[9]Gopal Vazirani vs Principal Commissioner of Income Tax (Bombay High Court) [2024] dated, March 14, 2024

Rs. 30 crore was placed in escrow, and Rs.125 crore was received upon deal closure; the escrow account was to remain for two years. The petitioner filed his return of income for the year of closure wherein the long-term capital gains were calculated taking into the account the sale consideration including the escrow amount. However, post-assessment, certain pre-sale liabilities arose, leading to a withdrawal of the amount from the escrow account, which the promoters never received.

Consequently, the assessee filed a revision application under Section 264 of the Income Tax Act, 1961, which was rejected because the return of income was filed voluntarily, and an annulment would not have affected the self-assessed tax paid. The High Court, citing a Supreme Court order, held that real income (capital gain) should be calculated using the actual sale consideration, i.e., after deducting the escrow amount. Further, the Court stated that Section 264 of the Act has been introduced to factor in such situation because if income does not result at all, there cannot be a tax. The matter was remanded to the PCIT to pass a fresh order considering the facts of the case and issue a refund of the excess amount to the assessee along with interest.

Katalyst Comments:

As held in the case above, since no income can be said to have resulted, it cannot be considered to be real income for the purpose of tax, even though a book entry is required to be made in accordance with the accounting standards. Further it emphasizes that the revenue must to compute the correct income and grant the refund of taxes erroneously paid by an assessee, if returned income shows a higher tax liability than what is actually chargeable under the Act.

B. Corporate Law Highlights

1. NCLAT: Upholds NCLT order holding Compulsorily Convertible Debentures as 'equity instruments', not financial debt[10]

M/s Navayuga Infotech Private Limited (Corporate Debtor) entered Corporate Insolvency Resolution Process (CIRP) on 16.09.2022. The Appellant, Shubham Corporation Private Limited, had provided unsecured loans with accrued interest and submitted a claim; although small payments were made, the full interest remained unpaid. The Debtor, unable to pay further installments, offered 0% interest Compulsory Convertible Debentures (CCDs) under a Debenture Subscription Agreement (DSA) on 02.03.2020, which the Appellant accepted.

The issue was whether these CCDs should be treated as debt or equity under Insolvency and Bankruptcy Code, 2016 (IBC). According to the DSA, the CCDs would convert into equity shares

[10]Shubham Corporation Pvt. Ltd. vs. Kotoju Vasudeva Rao (NCLAT) [2024] dated May 22, 2024

after 10 years unless converted earlier; the Appellant argued that CCDs, like debentures, acknowledge debt and remain liabilities until converted to shares. Interest is not essential for a financial debt under IBC, and the claim was rightfully admitted as financial debt. However, the Supreme Court, referencing M/s IFCI Limited vs Sutanu Sinha[11], ruled that it would not alter the commercial contract; the DSA did not include any repayment obligation or options other than conversion to shares. Therefore, since the agreement mandated conversion to equity shares, it was deemed an equity instrument and could not be admitted as a financial debt.

2. NCLAT: NCLT-order altering 'Appointed Date' of demerger scheme set aside[12]

A Scheme was filed with the NCLT seeking to demerge the demerged undertaking from Orient Carbon & Chemicals Limited to OCCL Limited; the NCLAT placed reliance on ruling in the case Sterlite Port (Supra)[13] and passed the order approving the scheme and modified the terms of the scheme by altering the Appointed Date to the date of pronouncement of the order. The decision was also vetted by the relevant statutory authorities and approved by the shareholders and creditors.

The NCLAT stated that if the proposed scheme is reasonable and not against public policy, the NCLT does not have any jurisdiction to overrule the commercial judgment of those who approved it. Further, the modification deviated from the agreed terms of the scheme and disregards circular no. 09/2019 issued by MCA, which clarifies that the provisions of section 232(6) of the Companies Act, 2013 allows the company to decide an appointed from which the scheme should come into force and acts as an enabling position. The NCLAT observed that there was no reason to change the appointed date specified in the merger scheme. The reliance on the Sterlite Port case was incorrect because, in that case, the definition of "Appointed Date" gave authority to the NCLT to set a different date, but the NCLAT ultimately upheld the date set by the Scheme. Therefore, the original appointed date should have been maintained.

3. SC: Supreme Court Holds that Statutory set off or Insolvency set off Is not applicable to CIRP under IBC[14]

Bharti Airtel Limited and Bharti Hexacom Limited entered into a significant agreement involving eight spectrum trading agreements with Aircel Limited and Dishnet Wireless Limited in 2016. In 2018, Aircel Ltd. and Dishnet Wireless Ltd, entered Corporate Insolvency Resolution Process (CIRP) under the Insolvency and Bankruptcy Code, 2016. Subsequently, Airtel entities

[11]M/s. ICFI Limited v. Sutanu Sinha & Others (Supreme Court) [2023] dated, November 8, 2023
[12]Oriental Carbon & Chemicals Ltd. vs. OCCL Ltd (NCLAT) [2024] dated, May 30, 2024
[13]Sterlite Ports Limited vs Regional Director Southern Region (NCLAT) [2023] dated December 21, 2023
[14]Bharti Airtel Ltd. v. Vijaykumar V. Iyer & Ors. (Supreme Court) [2024] dated January 3, 2024

paid Aircel entities Rs. 341.80 crores, offsetting Rs. 145.20 crores against operational, SMS, and interconnect usage charges owed by Aircel. Airtel claimed Rs. 203.46 crores, with the Resolution Professional (RP) acknowledging Rs. 112 crores; however, Airtel also owed Rs. 64.11 crores in interconnect charges to Aircel. A legal dispute arose when the RP unilaterally adjusted Rs. 112.87 crores from Airtel's payable amount to Aircel, citing bank guarantee discharge. While the NCLT approved this set-off, the NCLAT reversed the decision.

The Supreme Court held that the creditors cannot claim set-off during the CIRP Process under IBC; the statutory set-off under the Civil Procedure Code, 1908 and insolvency set-off under the IBBI (Liquidation Process) Regulations, 2016 did not apply to CIRP. However, two exceptions were noted; one that contractual set-off is allowed if it is valid before or on the CIRP commencement date, and the second that equitable set-off is allowed if the claim and counterclaim are connected through related transactions. The Supreme Court found Airtel Entities' arguments misleading and rejected the claim that IBC provisions support insolvency set-off. However, it recognized the need for limited exceptions for pre-existing contractual arrangements to ensure the CIRP process focuses on fair resolution and reorganization of distressed entities.

Katalyst Comments:

The main issue highlighted was whether the Resolution Professional's decision to allow set-off was consistent with legal principles and exceptions, given the specific circumstances of the CIRP's initiation.

C. SEBI / RBI / Other Highlights

1. Proposed IFSCA (Listing) Regulations, 2024[15]

The International Financial Services Centres Authority (IFSCA) has proposed amendments to the IFSCA (Listing) Regulations to update the rules for issuing and listing financial products on Recognised Stock Exchanges in India's international financial services centres (IFSC). The consultation paper suggests different listing rules for various offerings to facilitate capital raising in the IFSC, aligning with global standards from the International Organization of Securities Commissions (IOSCO) and best practices from other jurisdictions.

The consultation paper outlines a detailed framework as under:

- For companies going public for the first time:
    i. meeting specific financial benchmarks

[15]Consultation Paper on Proposed International Financial Services Centres Authority (Listing) Regulations, 2024 dated, May 3, 2024

ii. lead managers are required to ensure proper disclosures are made to investors and the company is required file a offer document specifying certain parameters
iii. Maintain a 180 day lock up period restricting shareholders from selling their shares
iv. Underwriting firms have the option to utilize a "green shoe option" to sell additional shares in case of high investor interest

- Separate regulations to raise capital in the following manner:
  i. By selling shares to Qualified Institutional Placements
  ii. By forming Special Purpose Acquisition Companies to acquire a private company and following a set of rules and regulations on formation of a SPAC and on acquisition of a target company
  iii. By listing of Depository Receipts if they fulfill certain conditions and on issue of a public offer.
  iv. By listing Environmental, Social and Governance (ESG) Labelled Debt Securities

- The other issues dealt with in the Draft Regulation are:
  i. Listing of other financial products
  ii. Listing obligations and disclosure requirements; Permission to trade securities without the involvement of the issuer
  iii. Miscellaneous: It includes listing agreement, refusal of admission to list, suspension, voluntary delisting, compulsory delisting, submission of information, power to exempt/relax strict enforcement of the regulations etc

2. Amendments in Securities and Exchange Board of India (Issue of Capital and Disclosure Requirement) Regulations, 2018 regarding minimum promoters' contribution, waiver of security deposit etc[16]

The Securities and Exchange Board of India (SEBI) has issued SEBI (Issue of Capital and Disclosure Requirements) (Amendment) Regulations, 2024 to amend the SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2018 (SEBI (ICDR) Regulations).

Among the various amendments made, the key ones are as under:

- **Minimum Promoters Contribution**

  The provisions regarding "Minimum Promoters Contribution" have been revised. Previously, shortfalls in promoters holding at least 20% of the post-IPO share capital could be met by certain entities contributing less than 10%, or promoters could

[16]SEBI (Issue Of Capital And Disclosure Requirements) (Amendment) Regulations, 2024

subscribe to additional equity shares or convertible securities; the amendments now include two additional alternatives:

i. Any non-individual public shareholders holding at least 5% of the post-issue capital.
ii. Any entity (individual or non-individual) within the promoter group, excluding the promoters.

These changes remove a barrier to listing for companies whose promoters hold less than 20% of the post-IPO capital, without institutional investors attracting the liabilities of being classified as promoters.

- **Waiver of Security Deposit**

The SEBI ICDR Regulations previously mandated that issuers in case of IPOs, rights issues, FPOs, and initial public offerings and rights issues of Indian depository receipts deposit a refundable amount equal to 1% of the issue size with the stock exchanges. The ICDR Amendment has removed this requirement, thereby simplifying procedures and reducing compliance obligations.

- **Reduction of minimum extension of the offer period for IPOs, further public offers (FPOs), and initial public offerings and rights issues of Indian depository receipts**

Before the ICDR amendment, issuers could extend the offer period disclosed in the offer documents by at least three additional working days in cases of force majeure, banking strikes, or similar circumstances. This was to address potential disadvantages to early investors assuming a certain closing date. Under the ICDR Amendment, issuers can now extend the offer period by only one working day instead of three, in such situations.

3. Recommendations of the Expert Committee for facilitating ease of doing business under SEBI (Merchant Bankers) Regulations, 1992, SEBI (Bankers to an Issue) Regulations, 1994 and SEBI Buyback Regulations, 2018[17]

An Expert Committee chaired by Shri S.K. Mohanty, ex-Whole Time Member, SEBI was set up to inter-alia review the Merchant Bankers Regulations, Bankers to an Issue and Buyback Regulations from the point of view of facilitating ease of doing business and SEBI had invited suggestions from the public and regulated entities to simplify, ease and reduce the cost of compliance under various SEBI regulations.

[17]SEBI Consultation Paper on the recommendations of The Expert Committee For Facilitating Ease Of Doing Business Under SEBI (Merchant Bankers) Regulations, 1992, SEBI (Bankers To An Issue) Regulations, 1994 And SEBI Buyback Regulations, 2018 dated, May 21, 2024

Pursuant to the deliberations, the Expert Committee has submitted a report containing recommendations with respect to the aforesaid regulations; a summary of the relevant recommendations pertaining to Buyback Regulations are highlighted as under:

- **Issuance of Shares or other specified securities during the Buyback Period**

  As per existing provisions, Regulation 24(i)(b) of the Buyback Regulations prohibits a company from issuing any shares or other securities, including by way of bonus, until the buyback period expires. Since commitments with relation to ESOPS or convertible instruments to employees or shareholders can exist prior to the buyback period, such conversion should be permitted if it occurs within the buyback period.

- **Manner of computation of Entitlement ratio**

  Currently, regulations do not specify the manner to calculate the entitlement ratio. In general practice, if any promoter or promoter group member declares upfront that they will not participate in the buyback, their shares are excluded from the entitlement ratio calculation.

  The committee has recommended that if any promoter or promoter group member declares upfront they will not participate in the buyback, their shares should be taken under consideration for the entitlement computation. This will increase the entitlement for the remaining shareholders.

4. Amendment to the Foreign Exchange Management (Non-Debt Instruments) Rules, 2019[18]

The Ministry of Finance, through the Department of Economic Affairs, has issued a significant amendment to the Foreign Exchange Management (Non-debt Instruments) Rules, 2019. The amendment focuses on the space sector, changing investment rules for satellite manufacturing, satellite data products, launch vehicles, spaceports, and component manufacturing; it aims to liberalize foreign investment in the space industry, aligning with global trends and India's space ambitions. Under the new rules, sectors like satellite manufacturing and operation, satellite data products, and ground segments can have up to 100% foreign direct investment (FDI).

However, automatic approval is limited to certain thresholds, requiring Government approval beyond them. For instance, up to 74% FDI is allowed automatically for satellite manufacturing, operations, satellite data products, Ground Segment, and User Segment. FDI exceeding 74% in these areas requires government approval. For launch vehicles, related systems, sub-systems, and spaceports, up to 49% FDI is permitted under the automatic route; above this threshold,

[18] FEMA (Non-debt Instruments) (Third Amendment) Rules, 2024 dated, April 16, 2024

government approval is necessary. However, 100% FDI in satellite components and systems manufacturing is allowed under the automatic route. Further, Investee entities must also comply with sectoral guidelines from the Department of Space.

D. Goods and Service Tax Highlights

1. Orissa HC: GST demand on income from shares is unsustainable

The Orissa High Court quashes the order imposing demand of GST on income from shares; the High court has referred to the CBIC's Circular No.196/08/2023-GST dated July 17, 2023, wherein it was clarified that securities are considered neither as goods nor as services under the CGST Act and securities include 'shares'. Further, the High court also relied upon the decision of Karnataka High Court's in M/s. Yonex India Private Limited v. Union of India & Ors, where it was held that income from shares is not taxable. Therefore, based on the circular and HC ruling of Karnataka High Court, the Orissa HC has held that demand of authority based on assessment of audit report of petitioner, cannot be sustained.

2. Gujarat AAAR: ITC is not available on supply of air-conditioning, cooling and ventilation System[19]

The Gujarat AAAR has upheld the AAR and ruled that ITC of supply of air-conditioning, cooling and ventilation system is not available as per section 17(5)(c) of the CGST Act as the same being works contract service used for construction of immovable property; the AAAR relied upon the CBEC order no. 58/1/2002 dated January 15, 2002, which provides that supply of air conditioning, cooling system & ventilation system falls under the category of works contract service supplied for construction of an immovable property. Further, the AAAR also relied on the Apex Court's judgment in Globus Stores P. Limited[20], where it was held that air-conditioning plant is an immovable property. In view of the CBEC's order, SC ruling and GST provision of section 17 (5) (c) of the CGST Act, the AAAR has held that ITC of supply of air-conditioning & cooling and ventilation system.

[19]Wago Private Limited vs Gujarat Authority for Advance Ruling (AAAAR) [2024] dated June 5, 2024
[20]Commissioner of Central Excise, Indore vs Globus Stores Private Limited and Ors (Supreme Court) [2011] dated April 13, 2011

Katalyst comments:

Similar ruling was given by the Gujarat AAR in the matter of The Varachha Co. Op. Bank Ltd[21]; wherein ITC for Central Air Conditioning Plant, Lift, Electrical Fittings, Fire Safety Extinguishers and Roof Solar Plan was disallowed being immovable properties, as section 17(5) (c) of the CGST Act provides that no ITC of the tax paid for works contract service would be available when supplied for construction of an immovable property.

3. Kerala HC: Upholds the constitutional validity of section 16 (2)(c), and section 16(4) and allows 30 days window to claim ITC not taken at the time of initial roll-out of GST[22]

The Kerala High Court has recognised the challenges faced during the initial GST rollout and suggested that the taxpayer(s) who could not avail the benefits of the circulars[23] (outlining the steps to be taken in case of difference in ITC availed in Form GSTR-3B and GSTR-2A and further clarifications with respect to the aforesaid steps) within the prescribed time limit, may approach the appropriate GST authority within a period of 30 days from the date of the judgement to avail the benefit of the aforesaid circulars subject to review by the GST authority. Further, the HC has held that the amended deadline of 30 November to claim ITC will apply retrospectively with effect from July 2017 and the HC also upheld the constitutional validity of sections 16(2)(c) and 16(4) of the CGST Act.

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[21]The Varachha Co-op bank Limited vs Authority for Advance ruling (Gujarat AAAR) [2023] dated August 30, 2021
[22]M/s M. Trade Links vs Union of India & Ors (Kerala High Court) [2024] dated June 4, 2024
[23]Circular No. 183/15/2022- GST dated December 27, 2022 and Circular No. 193/05/2023- GST dated July 17, 2023