KATALYST
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Katalyst Kaleidoscope

May 2018: Tax and Regulatory Highlights

A. Income-tax Highlights

1. Clarity in respect of newly introduced LTCG tax on sale of listed equity shares

- With the removal of long term capital gains exemption under section 10(38) of the Income tax Act ("the Act"), Section 112A now provides for long term capital gain tax at the rate of 10% (subject to grandfathering of FMV as on Jan 31, 2018) on transfer of listed equity shares on which STT is paid. There are certain genuine off-market transactions which could not have been subject to STT at the time of acquisition and in this context, the CBDT has issued a draft notification, which provides that the requirement of payment of STT at the time of acquisition shall not apply in order to claim the benefit of concessional regime u/s 112A:

  The list of transactions is as follows:
  1. Acquisition approved by the Supreme Court, High Court, National Company Law Tribunal, SEBI or RBI;
  2. Acquisition by any non-resident in accordance with FDI guidelines;
  3. Acquisition by an investment fund [as referred to in sec. 115UB];
  4. Acquisition through preferential issue to which Chapter VII of the SEBI (Issue of Capital and Disclosure) Regulations does not apply;
  5. Acquisition through an issue of share by a company;
  6. Acquisition by scheduled banks, reconstruction or securitisation companies or public financial institutions during their ordinary course of business;
  7. Acquisition under ESOP;
  8. Acquisition under the SEBI (Substantial Acquisition of Shares and Takeovers) Regulations 2011;
  9. Acquisition from the Government;
  10. Acquisition by mode of transfer as per section 47/50B of the act if previous owner has acquired shares by any of the modes given in this list;
  11. Acquisition by an investment fund referred to Explanation 1(a) to section 115UB or a venture capital fund referred to in section 10(23BF) or a Qualified Institutional Buyer.

- However, the following transactions shall not be subject to the concessional regime under Section 112A and shall be taxable under section 112 of the Act i.e. at the rate of 20%:

  1. Acquisition of listed equity share of a company through a preferential issue if its shares are not frequently traded in a recognised stock exchange of India;
  2. Acquisition of existing listed equity share in a company not through a recognised stock exchange on mode otherwise than above;
  3. Acquisition of equity share of a company during the period when company is delisted on a recognised stock exchange.

2. Conversion of inventory into capital asset – draft rules for computation of FMV of inventory at the time of conversion

In order to tax the "profit" from conversion of inventory into capital asset (or its treatment as capital asset) as business income, the Finance Act, 2018 inserted section 28(via) in the Income-tax Act, 1961. For this purpose, it is proposed to insert a new rule 11UAB in the Income-tax Rules, 1962

("the Rules") for prescribing the manner of determination of fair market value of the inventory which has been converted into, or treated as, capital asset.

As per Draft Rule 11UAB, Fair Market Value of Inventory will be as follows:

i. If inventory is an immovable property being land or building or both, then value that is to be adopted as the Fair Market Value is the Stamp duty Value i.e. the value for the purpose of payment of stamp duty on the date on which the inventory is converted into, or treated, as a capital asset;
ii. If inventory is jewellery, archaeological collections, drawings, paintings, sculptures, any work of art, shares or securities then value will be as per sub rule (1) of rule 11UA of the Income Tax Rules,1962 i.e. fair market value as per the valuation report obtained through a registered valuer for jewellery, artistic works etc. and in case of unlisted equity shares, as computed in the manner prescribed.
iii. If inventory is a property other than those specified in the above two categories, then the value will be the price that property would ordinarily fetch on sale in the open market on the date on which the inventory is converted into, or treated, as a capital asset.

Katalyst Comments:

1. *The intent of Section 28(via) appears to bring to tax assessees who intend to discontinue business operations (e.g. a builder) and who would have intended (pre-amendment) that the stock-in-trade (e.g. a land) converted into a capital asset (and then sold) would not have any tax impact on the difference between cost and FMV on the date of conversion.*
2. *The third category of inventory can get very subjective and litigious in terms of valuation.*

3. Flipkart case – Product discount is not a Capital expenditure

The Bangalore ITAT allowed Flipkart India's[1] (assessee) appeal challenging disallowance of product discounts as capital expenditure, and rejected AO/CIT (A)'s conclusion that assessee's strategy of selling goods at lower than cost price leads to creation of intangibles and therefore profits foregone by selling goods at discount, should be regarded as 'capital expenditure'.

ITAT relied, inter alia, on Karnataka HC ruling in A. Khader Basha[2] to rule that "there is no provision in the Act by which the AO can ignore the sale price declared by an Assessee and proceed to enhance the sale price without material before him to show that the Assessee has in fact realized higher sale price"; it also held that "wherever the legislature wanted to tax income not earned, it had made specific provisions in the Act by way of deeming fiction like provisions of Sec.43CA(1), Sec.45(4) and Sec.50C(1) of the Act".

Katalyst Comments:

For any expense to be capitalized, such expense ought to be resulting into creation of capital asset of enduring nature. Such discount cannot be vaguely considered as capital expense towards creation of brand value and are more in nature of reduced revenue.

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[1] Flipkart India Private Limited [TS-209-ITAT-2018 (Bang)]
[2] A. Khader Basha v. Asstt. CIT [2015] 58 taxmann.com 332/232 Taxman 434

4. Payment for access of database not royalty – McKinsey case

The Delhi ITAT, in the case of McKinsey Knowledge Center India (P.) Ltd.[3] held that payment made merely for access to database, when the assessee did not receive any knowledge as to how database was maintained nor had any license for commercial exploitation of copyright in the database, cannot be regarded as royalty under Explanation 2 of section 9 (1) (vi) (dealing with the imparting of any information concerning technical, industrial, commercial or scientific knowledge, experience or skill).

The ITAT relied on the decision of the Delhi High Court in the case of Infrasoft Ltd.[4], wherein it was held that, in a case where assessee gets right to access "copyrighted material", the payment could not fall in the definition of term "Royalty", under India-Singapore DTAA. Hence, it is not royalty both under DTAA as well as the Act and no TDS should be deducted on the same.

B. Foreign Exchange Regulations

1. Changes in framework for Foreign Portfolio Investors (FPI) in debt

As listed down in the circular[5] dt. April 6, 2018, the RBI, in consultation with SEBI, introduced following changes in Framework vide its circular dated April 27,2018[6]

- **Revision of Investment Limits:** RBI vide its circular dated April 6, 2018 has revised the limits of FPI Investments in debt. It has increased the limits for investment in Government Securities (G-Secs) by 0.5% every year for the F.Y. 2018-19 and F.Y. 2019-20. All the existing sub-categories of corporate bonds are discontinued, and a single overall limit of 9% on outstanding stock of securities is fixed. Further, General sub-category of G-secs includes additional INR 4760 crore in limit due to an inclusion of coupon investment in the G-secs Limit. The limit of INR 6500 crore is transferred from long term sub-category of State Development Loans (SDLs) to G-sec.

- **Revision of Minimum residual maturity requirement:** RBI vide its Circular dated April 27, 2018 has reduced the minimum residual maturity from 3 years to 1 year. Revised minimum residual maturity for all the categories i.e. Central Government Securities (G-Secs), State Development Loans (SDL) and corporate bonds, is 1 year. Further, RBI by circular[7] dated May 1, 2018 has clarified that investment in securities of any above-mentioned category with residual maturity below 1 year shall not exceed 20% of the total investment in the respective category. If it exceeds 20%, then the FPI shall bring it down below 20% within 6 months from the date of the circular; and also ensure that no fresh investment is made in securities with residual maturity below 1 year.

[3] Mc Kinsey Knowledge Center India (P.) Ltd. v. ITO [2018] 92 taxmann.com 226 (ITAT - Delhi)
[4] Director of Income Tax v. Infrasoft Ltd. [2013] 39 taxmann.com 88 (Delhi)
[5] AP (DIR Series) Circular No. 22 dated April 6, 2018
[6] AP (DIR Series) Circular No. 24 dated April 27, 2018
[7] AP (DIR Series) Circular No. 26 dated May 1, 2018

- **Utilisation of FPI Limits of investment in G-secs:** These shall be monitored online and auction mechanism is discontinued.

- **Concentration Limit:** Investment in each of the category of debt shall be subject to the following concentration limits:
  a. Long-term FPIs: 15% of prevailing investment limit for that category,
  b. Other FPIs: 10% of prevailing investment limit for that category.

Further, certain relaxation is available, subject to an overall limit of the category as a one-time measure if an FPI have investment in excess of concentration limit.

- **Single/Group investors-wise limit in corporate bonds:** All Investment by any FPI (including related FPIs) shall not exceed 50% of any issue of a corporate bond. If exceeds 50% then it shall not make further investment until above stipulation is met. Further an FPI shall not have more than 20% of corporate bond exposure in single corporate entity (including related entities). If exposure exceeds 20%, FPI cannot make further investment until stipulation is met. A newly registered FPI shall adhere to this stipulation within 6 months from the commencement of investment.

- **Other Changes:** FPIs now permitted to invest in treasury bills issued by the Central Government. Also, FPI shall not invest in partly paid instruments.

2. Key changes in External Commercial Borrowings (ECB) Policy

In the light of various requests received towards rationalization of the ECB regime from various corporate entities across the country, the RBI, vide its circular[8] on External Commercial Borrowings (ECB) Policy, the key changes of which are as follows:

- **Rationalisation of all-in-cost for ECB under all tracks and Rupee denominated bonds (RDBs):** A uniform all-in-cost ceiling of 450 basis points over the benchmark rate. The benchmark rate will be 6-month USD LIBOR (or applicable benchmark for respective currency) for Track I and Track II, while it will be prevailing yield of the Government of India securities of corresponding maturity for Track III (Rupee ECBs) and RDBs.

- **Revisiting ECB Liability to Equity Ratio provisions:** It has been decided to increase the ECB Liability to Equity Ratio for ECB raised from direct foreign equity holder under the automatic route from 4:1 to 7:1. This ratio will not be applicable if total of all ECBs raised by an entity is up to USD 5 million or equivalent.

- **Expansion of Eligible Borrowers' list for the purpose of ECB:** Housing Finance Company, Port Trusts are permitted to avail ECBs under all tracks. Such entities shall have a Board approved risk management policy and shall keep their ECB exposure hedged 100 per cent at all times for ECBs raised under Track I. However, Companies engaged in the business of Maintenance, Repair and Overhaul and freight forwarding are permitted to raise ECBs denominated in INR only.

[8] A.P. (DIR Series) Circular No.25 dated April 27, 2018

- **Rationalisation of end-use provisions for ECBs:** A positive end-use list was prescribed for Track I and specified category of borrowers, while negative end-use list was prescribed for Track II and III. It has now been decided to have only a negative list for all tracks. Negative list for all tracks includes Investment in Real Estate with certain exceptions, investment in capital market and Equity investment and lending to entities for those activities. Additionally for Track I and Track III, end user negative list includes ECBs for the purpose of working capital, general corporate purpose and repayment of Rupee loans. However, on lending for the above-mentioned activities are covered in negative list for all tracks.

3. Scheme of Arrangement involving an NBFC

A petition was filed by three companies in respect of a Scheme of Arrangement ("Scheme")[9]. The Scheme envisaged demerger of undertakings from the transferor companies to the transferee companies. The Regional Director (RD) objected on the ground that the objects of the petitioner companies appeared to be that of Non – banking Financial Companies (NBFCs), but RBI approvals were not obtained. The petitioner companies submitted that the requirement of a prior approval from the RBI arises only when there is a takeover or acquisition of control of an NBFC. Out of the three petitioner companies, only one company was an NBFC (C-1). There was no takeover / acquisition or change in control of that NBFC-company. Further, C-1 would not issue any shares subsequent to the sanction of the Scheme that may, in any manner, alter its shareholding pattern.

The NCLT observed that, out of the three petitioner companies, only one was an NBFC and the said company was doing this business by obtaining proper licence and authority. Further, as per the directions, the authorised representative of the petitioner companies had filled his affidavit making a categorical statement that the NBFC business / Registration as an NBFC issued by RBI in favour of C1 would remain with that company, and the said business was not being transferred under the Scheme. In view of the above, the Scheme was approved.

Katalyst Comments:

Although the application did receive a sanction from the NCLT for the demerger as envisaged, this appears to be at variance from the RBI Master Circular dt. July 1, 2014 which indicates that prior approval of the RBI would be required by an NBFC before approaching the Tribunal under section 230-233 of the Companies Act,2013, seeking an order for mergers or amalgamations with other companies or NBFCs. This is regardless of the fact whether there is any change in the shareholding pattern or not.

C. Corporate Law Highlights

Key Changes in Companies Act and the rules framed thereunder have been highlighted as under:

[9] HB Stockholdings Limited and others, CP No. 243/2016 RT CP (CAA) No. 142/Chd/Hry/2017, dated 22.12.2017, NCLT Chandigarh

- The requirement of ratification of appointment of Auditor in every annual general meeting (AGM) till the conclusion of sixth AGM has been removed from the Companies (Audit and Auditor) Rules, 2014[10]

- MCA has amended the Companies (Appointment and Qualification of Directors) Rules, 2014. These rules now bring under their ambit relatives of an independent director which are directly or indirectly indebted to the company for INR 50 Lakhs as an additional disqualification criterion.

- MCA has amended the Companies (Prospectus and Allotment of Securities) Rules, 2014[11] and has removed the following from the erstwhile rules:
  Rule – 3: Information to be stated in the prospectus,
  Rule – 4: requirement of reports to be set out with prospectus,
  Rule – 5: other matters and report to be stated in the prospectus, and,
  Rule – 6: period for which certain information is to be provided in certain cases.

D. Securities' Laws Highlights:

1. **SEBI (Listing Obligation and Disclosure Requirements) (Amendment) Regulations, 2018:**

As per the recommendations of the Kotak Committee, certain amendments have been made to the **Listing Obligation and Disclosure Requirements** as prescribed by the SEBI, some of which have been captured as below:

Particulars	Amendments
Definition of Related Party (Reg. 2(1)(zb))	The scope of 'Related party' has been widened. Any person or entity belonging to the promoter or promoter group of the listed entity and holding 20% or more of shareholding in the listed entity has been included in related party.
Disqualification of Independent Directors (Reg. 16)	Following persons are now disqualified from being an independent director of listed entity: • Any member of the promoter group of that listed entity. • A person who is a non-independent director of another company on the board of which any non-independent director of the listed entity is an independent director.
Board of Directors (Reg. 17)	• Appointment of at least 1 independent woman director for Top 500 and Top 1000 listed entities w.e.f. April 1, 2019 and April 1, 2020 respectively; • Board of directors should comprise of at least 6 Directors in Top 1000 and Top 2000 listed entities w.e.f. April 1, 2019 and April 1, 2020 respectively;

[10] MCA notification no. G.S.R. 432 (E) dated May 7, 2018
[11] MCA notification dated May 7,2018

	• Quorum for Every Board Meeting shall be 1/3rd of the Board Strength or 3, whichever is higher and including at least one Independent director in Top 1000 and Top 2000 listed entities w.e.f. April 1, 2019 and April 1, 2020 respectively; • Requirement of shareholders' approval vide special resolution in every year in which annual remuneration payable to single non-executive directors exceeds 50% of total annual remuneration payable to all non-executive directors.
Ceiling of Directorship in Listed Entity (Reg. 17A)	This newly inserted regulation provides following ceiling limit of directorship in listed entities: • A person shall not be a director in more than 8 listed entities w.e.f. April 1, 2019 and 7 listed entities w.e.f. April 1, 2020; • A person shall not be an independent director in more than 7 listed entities; and • A whole-time director/ managing director in any listed entity shall not be independent director in more than 3 listed entities.
Secretarial Audit (Reg 24A)	This newly inserted regulation mandates secretarial audit for every listed entities and their unlisted material subsidiaries incorporated in India w.e.f. the year ended March 31, 2019.

Katalyst Comments:

- *Amendments in definition of "related party" and disqualification of independent directors are likely to reduce influence of Promoters on listed entities and should bring more transparency in the affairs of the company.*

- *As per the provisions of the Companies Act, a person is allowed to be director in maximum 20 companies simultaneously, out of which, directorships in maximum 10 public companies are allowed. To harmonize with this provision, regulation 17A has been inserted.*

- *Regulation 24A has been inserted to harmonize provisions of section 204 of the Companies Act where secretarial audit is mandatory for listed companies and certain other classes of companies.*

E. Indirect Taxes

1. Maharashtra Government constitutes Appellate Authority for Advance Ruling[12] for GST consisting of Chief Commissioner, CGST & CE, Mumbai Zone and Commissioner of State Tax, Maharashtra in terms of Section 99 of MGST Act, 2017.

[12] Notification No. MGST- 1018/C.R.38/Taxation-1 dated May 10, 2018

2. Services provided by outgoing tenant by way of surrendering the tenancy rights[13] against consideration in the form of a portion of tenancy premium('pagadi') is liable to GST.

3. Intra-state e-way bill[14] to roll out in Maharashtra from May 25, 2018.

4. **Summary of key rulings by the Authority of Advance Ruling ('AAR'):**

#	Issue	Ruling	Comments
1.	Whether supply of sunglasses from retail outlet/duty-free shops at International airport to outbound international passenger against the international boarding pass is liable to GST[15] - [Delhi AAR(GST)].	AAR has held that supply of goods from the duty-free outlet to international passengers going abroad is taking place beyond Customs Frontiers of India; however, outlet is located in India. Hence, applicant is not taking goods outside India and supply can't be called 'export' or 'zero-rated supply'.	This would amount to the objective of duty-free concept being defeated.
2.	GST implications in case of overseas trading/high sea sale[16] - [Kerala AAR(GST)].	AAR has held that import of goods means bringing goods into India from a place outside India. Goods were not imported into India in case of applicant and therefore, IGST would not be applicable.	The AAR has clarified that in case of high sea sale, if goods are not physically imported in India, IGST is not applicable.
3.	Whether recovery of food expenses for canteen services provided by employer to employee is liable to GST[17] [Kerala AAR(GST)].	AAR has held that activities of supply of food shall be treated as supply of service as per Schedule II of Section 7 of the CGST Act, 2017 and recovery of cost from employee is consideration for supply. Further, it is also held that whether supply of food is for profit or not, it is liable to GST.	The valuation aspects and treatment of other services provided by the company to its employee e.g. renting, boarding & lodging etc. need to be clarified by the Government.

[13] Circular no. 44/18/2018-CGST dated May 2, 2018
[14] MGST notification no. 15D/2018-State Tax dated May 7, 2018
[15] Delhi AAR-[TS-156-AAR-2018-NT]- Rod Retail Pvt. Ltd.
[16] Kerala AAR- [TS-111-AAR-2018-NT]- Synthite Industries Ltd.
[17] Kerala AAR-[TS-110-AAR-2018-NT]- Caltech Polymers Pvt. Ltd.

5. Maharashtra AARs:

- It is held that supply of solar power generating system under two different agreements for supply of equipment and supply of service would be taxable as single 'works contract'[18]. Whether a particular supply is to be considered as a composite supply or a works contract would depend on the essence of the agreement and not on its treatment by parties involved.

- The supply under Turnkey Engineering, Procurement and Construction ('EPC') contract for setting up of a solar power plant wherein both goods and services are supplied constitutes a 'works contract'[19] at it involves the element of permanency.

- It has been held that if 'Liquidated damages('LD')' are deducted from the amount payable to a contractor, once delay in deliverables (providing of materials & services etc.) by the contractor is established; (in case of operation and maintenance activity and construction of new power plants or renovation of old plants) GST is payable on such LD. The recovery of LD is taxable as 'Other services' under Notification No. 11/2017-Central Tax / State Tax (Rate) dated June 28, 2017 and chargeable to GST at 18%.

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[18] Maharashtra AAR-[TS-165-AAR-2018-NT]- Fermi Solar Farms Pvt. Ltd
[19] Maharashtra AAR-[TS-155-AAR-2018-NT]- Giriraj Renewables Pvt. Ltd.