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Katalyst Kaleidoscope

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A. Income tax highlights

1. Key Principles emerging in relation to Rights Issue vis-à-vis deemed income provisions:

Background: Section 56(2)(vii) (predecessor of section 56(2)(x) of the Income-tax Act, 1961 ("Act)] of the Act seeks to tax receipt of certain 'properties' including shares and securities, if such shares and securities are received for an inadequate consideration (i.e., deemed gift tax in the hands of recipient).

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

i. In the present case, a shareholder was allotted shares as a result of rights issue, and such rights issue was at the face value, and lesser than the fair market value of the shares so allotted. The question was whether the difference between the fair market value of shares so allotted and face value should be taxed in the hands of the shareholder. In this context, the Mumbai ITAT observed that if the shares are allotted in proportion to the rights entitlement, then the said receipt of shares pursuant to rights issue, section 56(2)(vii) should not apply.[1]

ii. Therefore, as a principle, if the shares are issued disproportionately (i.e., in excess of the rights entitlement), then the risk of deemed income tax in the hands of the recipient on the difference between the fair market value of such shares allotted and the face value cannot be eliminated. Therefore, any additional shares allotted pursuant to renunciation of rights in favour of unrelated persons at a price lower than the fair market value could attract deemed income provisions in the hands of the recipient shareholder. [2]

Katalyst Comments:

This decision re-establishes the principle that any proportionate allotment of shares cannot result in deemed income in the hands of the shareholders, since the rights issue will inevitably be at a price below the fair market value; however, one should be cognizant of the tax risk in case of a disproportionate allotment.

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[1] ITO vs. Rajeev Ratanlal Tulshyan 136 taxmann.com 42 (Mumbai – Trib.)

[2] Shri Jigar Jashwantlal Shah vs. ACIT, ITA No. 1541/Ahd/2017

2. Mumbai ITAT: Interest paid on perpetual debt instruments issued for the purpose of business should be allowable expenditure[3]

Background: Perpetual debt instrument is a quasi-equity instrument, which is, legally, a debt instrument, but is repayable by the issuer at its own volition, and not after a fixed tenure. Therefore, being a quasi-equity instrument, interest on the same is not debited to the P&L account as "interest expenditure"; however, the nature of instrument, being a debt instrument does not change.

Consequently, Mumbai ITAT observed that an interest expenditure incurred on such perpetual debt instruments would be tax deductible, if such perpetual debt instruments were issued for business purposes.

3. Mumbai ITAT: Requirement of 'beneficial ownership' to be ascertained in Article 13 in India – Mauritius treaty in order to question the beneficial ownership of the assessee in respect of shares[4]

In case of capital gains accruing to a Mauritius company on sale of shares of an Indian company (acquired prior to 1 April 2017), which are effectively, not subject to capital gains tax in India, the Mumbai ITAT observed that the beneficial ownership based on specific and cogent facts, such as real/ effective owners, administrative/ strategic control, source of investments, trail of transactions (including directions) for acquisition and sale of shares, should be ascertain first, before denying the treaty benefit under the India – Mauritius DTAA.

Katalyst Comments:

The unfortunate controversy regarding India – Mauritius treaty continues. The fact is that the treaty was designed to attract investments in India, and was drafted at a point in time when India's foreign reserves were precariously low. Further, the treaty has been amended to withdraw capital gains exemptions post 1 April 2017 investments. CBDT should issue a circular to clearly provide that pre 1 April 2017 investments will not be litigated.

[3] The Tata Power Co. Ltd [TS-327-ITAT-2022(Mum)]
[4] Blackstone FP Capital Partners Mauritius V Limited [TS-381-ITAT-2022(Mum)]

4. Telangana High Court: Entertains writ petition by assessee against approval by GAAR panel under section 144BA(6)

The Telangana High Court recently admitted a writ petition against an order made by the GAAR panel in a subject matter involving a particular transaction for which, the income-tax authorities purportedly sought apply the provisions of GAAR.

Without delving on the details/ merits of the transactions, but relying specifically on the decision of the Supreme Court ruling in the case Walfort Share & Stock Brokers[5] (i.e., tax planning is a tax payer's prerogative), the High Court admitted the writ petition against the order of the GAAR panel.

Katalyst Comments:

This is the first reported judgment post GAAR approving panel being operationalized and brings out the dimension that GAAR cannot be invoked indiscriminately, especially where a legitimate tax planning route was adopted to achieve a larger commercial objective. It would be interesting to see the detailed facts and key principles emerging out of this first-of-its-kind decision

B. Corporate Law Highlights

1. MCA committee recommends revamp of Company Law

Recently, on 21 March 2022, the Company Law Committee ('CLC') submitted its third report to the Hon'ble Union Minister of Corporate Affairs. Accordingly, the CLC Report has recommended various changes to the Companies Act, 2013 to recognize various concepts, expedite corporate processes, improve compliance requirements, etc. Some of the recommendations are listed below:

- Proposal to recognize issuance and holding of fractional shares
- Proposal to recognize issuance Restricted Stock Units and Stock Appreciation Rights to employees
- Distressed companies should be allowed to issue shares at a discount
- Proposal to give legal status to Special Purpose Acquisition Companies, and exempt them from the requirement applicable to companies regarding business operations
- Inclusion of new concept 'Forensic Audit' under Companies Act, 2013

[5] 2010 326 ITR 1 (SC)

- Certain companies to be allowed to realign their financial year after ceasing to be associated with a foreign entity
- Maintaining Statutory Registers through a common electronic platform
- Twin test approval requirement for merger
- Central Government to be empowered to prescribe rules for classes of companies mandatorily required to serve certain documents in electronic mode only
- Mandatory cooling off period before auditors become directors
- Government to prescribe a separate list prohibiting non-audit services
- Mandatory joint audit of certain companies
- Clarification on inclusion of free reserves in calculation of buy-back

Katalyst Comments:

One of the key mandates of the committee was Ease of Doing Business. Viewing from that perspective, one would have expected more from the report, especially on substantive aspects.

2. Share transfer forms to provide clarity on foreign investment approvals

The Central government has amended the rules associated with share transfer forms as required to transfer shares of companies under the Companies Act 2013. Based on the amendment, the buyer is required to confirm in the form of a declaration in the share transfer form, that no approval is required under the Foreign Exchange Management (Non-debt Instruments) Rules, 2019 (the "NDI Rules"), or where such approval is required under the NDI Rules, it has been obtained, and to ensure that the said transfer is in compliance with the NDI Rules

3. Mumbai NCLT: Dispensation of creditors' meeting granted since there was no compromise or arrangement with any creditors[6]

While dispensing with the creditor's meeting in the first motion application in relation to a Scheme of Arrangement, the NCLT observed that, as far as the rights of Creditors are concerned, they will not be affected by the proposed Scheme of Arrangement, since post-Scheme the assets of the Applicant Company would be sufficient to discharge their liabilities.

Further, the Scheme was an arrangement between the Applicant Companies and their respective shareholders as contemplated under Section 230(1)(b) of the Companies Act, and

[6] S H Pitkar Orthotools P. Ltd. & Ors., dated 20 April 2022, C.A.(CAA)/51/MB/2022, NCLT, Mumbai

there was no compromise or arrangement with any creditors. Accordingly, the requirement for conducting meeting of the creditors of the Applicant Companies was dispensed with.

Katalyst Comments:

This is a welcome order. As it is, the long time period in NCLT proceedings is a challenge for Ease of Doing Business. The provisions need to be administered keeping this aspect in mind.

4. Chandigarh NCLT: Allows merger of loss-making company with profit-making company citing 'synergy' benefits, and overrules income-tax department's objections over tax loss

The Chandigarh Bench of NCLT recently approved Scheme of Amalgamation of Panasonic India Private Limited (Transferor Company – loss making) with Panasonic Life Solutions India Private Limited (Transferee Company – profit making).

The income-tax authorities alleged that the main objective of Scheme of Amalgamation was to take benefit of accumulated losses which are available for set-off in future periods. Income-tax authorities further stated that there would be loss of revenue on account of possible non-payment of capital gains realizable by the shareholders of Transferee Company in the future, as these shareholders are residents of Singapore and Netherlands, who enjoy benefits under the provisions of respective DTAAs.

Applicant companies submitted that the commercial rationale for the merger was to reduce marketing and operating cost, gain economies in procurement, increase value to customers, etc. They further submitted that the amalgamation was in compliance with section 2(1B) of the Income-tax Act. Regarding the allegations of revenue loss relating to capital gains in the hands of shareholders, the Applicant Companies submitted that the non-resident shareholders of the Transferor Company would anyway have had no obligation to pay capital gain taxes subject to relief under India's Tax Treaty with the Netherlands and Singapore on the transfer of shares of the Transferor Company if the transaction had not taken place.

In conclusion, NCLT did not find enough merit in the objections raised by the income-tax authorities and held that the Scheme was for the purpose of business consolidation, and the tax benefits are merely a consequential fallout of the implementation of the Scheme.

C. FEMA Law

1. Amendment in FEMA Non-Debt Instrument Rules to incorporate / amend the provisions in line with the revised FDI Policy

The Government had revised the Foreign Direct Investment (FDI) Policy, which was to take effect from the date of Foreign Exchange Management Act (FEMA) Notification. Accordingly, the Ministry of Finance has amended the FEMA Non-Debt Instruments Rules to incorporate / amend the following provisions of the Rules in line with Revised FDI Policy:

- For computation of foreign investment, declaration about beneficial interest held by a person resident outside India made under any applicable law, in addition to the Companies Act shall be considered.
- 'Indian Company' does not include a society, trust or any entity, which is excluded as an eligible investee entity under the FDI Policy.
- Along with ESOPs / Sweat Equity, the term 'Share Based Employee Benefits' has been defined and referred to in the FDI policy.
- Where a scheme of compromise / arrangement / merger / amalgamation / demerger of Indian companies, or transfer of undertaking / division of Indian company, has been approved by the competent authority, the transferee company or the new company, as the case may be, may issue equity instruments to the existing shareholders of the transferor company resident outside India, subject to sectoral cap / permitted activities / conditions.
- The term for conversion of a 'Convertible Note', issued by a start-up company, into equity shares shall be within a period not exceeding 10 years (previously 5 years) from the date of issue.

D. SEBI

1. SEBI Informal Guidance: Applicability of open offer obligation in case where shares are transferred through a Scheme of Arrangement[7]

Dhampur Sugar Mills Limited (DSML), a public listed entity, proposed to apply to NCLT to approve a Scheme of Arrangement under sections 230-232 of the Companies Act, 2013. The Scheme involved demerger of certain undertakings of DSML to DBOL, its wholly owned subsidiary. As a consideration for demerger, DBOL would issue shares to shareholders of DSML

[7] SEBI Informal Guidance: SEBI Letter 2021/29815/1 dated 25 October 2021

in such manner that the shareholding pattern of DSML and DBOL would be identical. Subsequent to the above, as an integral part of the Scheme, the Promoter Group of both companies were contemplating inter-se transfer of shares held in DSML and DBOL, such that the total Promoter shareholding pre and post scheme would remain the same.

SEBI issued an informal guidance and stated that the transaction forming part of the proposed scheme under section 230-232 of the Companies Act would be exempted under Regulation 10(1)(d)(ii) of the Takeover Regulations from open offer obligation, provided the aforesaid scheme is approved by NCLT, and subject to compliance with any other law.

2. SEBI Informal Guidance: Applicability of Deemed Public Offer Regulations upon gift of shares[8]

The shareholders of Fabindia Limited were intending to gift up to 15,00,000 shares or 1.01% of the share capital of the company to various artisans across India, without any consideration, for economic upliftment of such artisans and small farmer community at large. The shares would be gifted by the shareholders to the intended beneficiaries before filing DRHP with SEBI, for undertaking the IPO.

SEBI issued an informal guidance that gifting of shares by the existing shareholders of a company, which does not involve payment of any consideration by the transferees may not constitute a deemed public offer, unless there is an existence of a design / arrangement between the company and the existing shareholders to circumvent the applicable provisions of law.

3. SEBI Informal Guidance: SEBI holds investors of AIFs having UPSI in breach of insider trading norms for investment decisions of AIFs[9]

Under the Insider Trading Regulations, persons having UPSI are not permitted to trade (directly or indirectly) in the underlying listed securities. In this context, Yes Bank sought a clarification from SEBI on whether its employees (and their immediate relatives) could invest in units of an AIF, which AIF in-turn invests in securities of such listed companies whose UPSI is with Yes Bank's employees.

SEBI has held that investors in alternative investment funds (AIFs) will be liable for breach of insider trading norms if: (a) such investors possess unpublished price sensitive information (UPSI) in relation to any entity; and (b) the AIF trades in the securities of such entity. SEBI's

[8] SEBI Informal Guidance: SEBI Letter 2021/39809/1, dated 29 December 2021
[9] SEBI Informal Guidance: SEBI Letter 2022/11110/1 dated 16 March 2022

guidance is likely to hamstring the operations of an AIF/ pooled investment vehicle in many ways – since AIFs are operated by an independent investment manager (IM) and the investors exercise no control/ visibility on the trades executed by the AIF.

4. SEBI proposes introduction of 'pre-filing' of offer document for companies contemplating IPOs[10]

SEBI recently through a consultation paper has proposed introducing an alternative mechanism for regulatory review by permitting 'pre-filing' of offer document for companies contemplating IPOs. Under the proposal, an issuer should make 'pre-filing' of offer document with SEBI and stock exchanges without making it available for public for an initial scrutiny period only. The document should contain all disclosures as required currently under the ICDR Regulations. In the consultation paper, SEBI has suggested the entire process – starting from 'pre-filing' of the DRHP till the stage of filing the RHP with ROC, SEBI and stock exchanges.

5. BSE Circular: Prior approval of shareholders for preferential allotment of shares pursuant to issuance of convertible debt instrument/ loan[11]

BSE has clarified that the terms of issuance of convertible debt instrument or loan should have been approved prior to the issue of such instrument/ loan by way of a special resolution passed by the company, in case of preferential allotment of shares under ICDR Regulations, read with proviso to section 62(3) of the Companies Act, 2013.

E. Goods and Service Tax highlights

1. Apex court strikes down levy of GST under the reverse charge mechanism on 'ocean freight' as it violates 'Composite Supply' principle[12]

The Apex court in the recent landmark judgment has dealt with many issues which inter alia include Constitutional Architecture of IGST, validity of notifications issued to levy GST under reverse charge mechanism ('RCM') on ocean freight on importer, Charging Section 5(1) of the IGST Act.

[10] SEBI Consultation Paper on pre-filing of Offer Document in case of Initial Public Offerings dated May 11, 2022

[11] BSE Circular dated 7 April 2022

[12] Union of India vs Mohit Minerals Pvt Ltd [TS-246-SC-2022-GST]

The Apex court has struck down the levy of GST imposed under the RCM on the 'service' aspect of the transaction of ocean freight payment by the Indian importer and held that such levy is in violation of the principle of 'composite supply' enshrined under Section 2(30) read with Section 8 of the CGST Act. Since the Indian importer is liable to pay IGST on the 'composite supply', comprising of supply of goods and supply of services of transportation, insurance, etc. in a CIF contract (ruling did not discuss on other types contracts such as FIB contract), a separate levy on the Indian importer for the 'supply of services' by the shipping line is in violation of Section 8 of the CGST Act.

The Apex court has also clarified that that the Government while exercising its rule-making power under the provisions of the CGST Act and IGST Act is bound by the recommendations of the GST Council. However, that does not mean that all the recommendations of the GST Council made by virtue of the power Article 279A (4) are binding on the legislature's power to enact primary legislations.

2. 1/3rd deduction of Land is optional & deduction of actual value of land can be claimed[13]

GST is not applicable on the value of land, in case of a joint development agreement**,** but only on the portion of consideration representing the balance. In this context, the Gujarat High Court held that if the actual value of land is higher than 1/3rd of the total value of consideration, then GST would not be applicable on the actual value, rather than the deemed deduction of 1/3rd prescribed by Notification No. 11/2017 dated 28 June 2017.

3. Goods cannot be detained and no tax and penalty to be levied for typographical error in e-way bill[14]

With respect to the typographical error relating to discrepancy in date of invoice (on invoice-3 February 2021 and on e-way bill 2 February 2021) on e-way bill, the Kerala High Court has held that the error is clerical and bona fide in nature and goods should not be detained and no tax and penalty should be levied since such error would have no bearing on the overall tax liability.

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[13] Munjaal Manishbhai Bhatt vs. UOI [TS-214-HC(GUJ)-2022-GST]

[14] Greenlights Power Solutions vs State Tax Officer [TS-199-HC(KER)-2022-GST]

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