KATALYST ADVISORS

Katalyst Kaleidoscope

November 2023: Tax and Regulatory Insights

SUMMARY OF CONTENTS

A. Income tax highlights

1. Chennai ITAT: Disallowance of payment towards Non-Compete Fees and customer contracts[1]

An appeal was filed by the assessee before the Income Tax Appellate Tribunal, Chennai (ITAT) in connection with disallowance of payments for non-compete and payments for customer and other contracts for purchase of business by the assessee from GE India Private Limited (GE); the Assessing Officer (AO) and the CIT (A) treated these payments as capital expenditure and disallowed them. The taxpayer argued that the non-compete fees and payments for customer and other contracts for purchase of business were independent and should be treated as revenue expenditure.

The ITAT held that the non-compete fees paid and payment related to contract by the taxpayer should be considered as part of the initial investment for acquiring the business of GE India Pvt Ltd; it concluded that the non-compete agreement was an integral part of the entire purchase transaction and gave the taxpayer the right to conduct its business without competition, thereby protecting the overall business and enhancing the value of the assets. This decision was based on a combined reading of the purchase agreement and the non-compete clause.

Katalyst comments:
The issue of capital versus revenue expenditure has become even more contentious post the judgement of the Supreme Court in the context of Telecom license fee (CIT versus Bharti Hexacom dated October 16, 2023 – please see October 2023 Katalyst Kaleidoscope).

It also needs to be borne in mind that any payment toward non-compete, in any case, needs to be commercially justifiable, based on facts and legal construct. Additionally, whilst deductibility or otherwise in the hands of the payer is not necessarily determinative for taxation in the hands of the recipient, it does have a persuasive impact in the larger context.

2. Ahmedabad ITAT: Application of deemed dividend to non-shareholder situation[2]

Appeal filed by the Revenue against the order of the Commissioner of Income Tax (Appeals), [CIT (A)], relating to assessment year 2009-10. The AO had held that the assessee i.e., Kiran Ship Breaking Company ("KSBC") had received various amounts from Shree Electromelts Ltd ("SEL") during the year. Further, one of the directors of SEL, Shri Ram Krishan Jain, held more than 10% shares in the company and 50% shares in KSBC. Given that KSBC was neither a registered nor a beneficial shareholder of SEL, the Appellate Tribunal upheld the favorable decision of the CIT(A) and dismissed the appeal filed by the Revenue and held that Section 2(22)(e) of the Income Tax Act, 1961 regarding deemed divided was not applicable.

[1]Eaton Power Quality P. Ltd. Vs DCIT Pondicherry Circle, 156 taxmann.com 14, October 20, 2023 (CH. Tribunal)
[2] ACIT Vs Kiran Ship Breaking Company (ITAT Ahmedabad), ITA No. 2219/Ahd/2015 dated October 27, 2023

3. Delhi ITAT: Revenue failed to establish Mauritian Co. as 'conduit', TRC sufficient for capital gains exemption[3]

The Delhi ITAT allowed the appeal of a Mauritius-based investment holding company for capital gains exemption under the India-Mauritius Double Taxation Avoidance Agreement (DTAA) for the sale of shares. The Revenue argued that the company was set up as a conduit for tax avoidance, but the ITAT found insufficient evidence to support this claim; the ITAT emphasized that the tax residency certificate issued by Mauritius determines tax residency and entitlement to treaty benefits. The Revenue did not invoke the General Anti-Avoidance Rule (GAAR) or the Limitation of Benefit clause, suggesting that they accepted the exemption under the treaty but raised the theory of tax avoidance to deny the claim.

As a result, the ITAT deleted the addition of the capital gains and allowed the Assessee's appeal; this decision highlights the importance of providing substantial evidence and demonstrates the significance of tax residency certificates in determining entitlement to treaty benefits.

Katalyst comments:
The unfortunate controversy in relation to Mauritius continues, inspite of the fact that investments made prior to April 1, 2017 are grandfathered in the India-Mauritius treaty; it would be in the interest of Ease of Doing business and of sending right signals to international investors that CBDT issues a circular reiterating that pre March 2017 investments should not be gone into, especially keeping in mind that the India Mauritius capital gains exemption was clearly intended to attract foreign investors. In this context, seeking to establish substance through a combination of various issues is not even required in the first place, given the clear language of the treaty, and indeed, the CBDT Circular 789 dated April 13, 2000 to the effect that entities incorporated in Mauritius should be entitled to the benefit of capital gains exemption in terms of the India Mauritius treaty.

4. ITAT Surat: Exemption under Section 54F for combined residential units[4]

The assessee had long-term capital gains of Rs. approx. 7.2 crores and claimed deduction for the entire amount under section 54F of the Income Tax Act, 1961 and assessee invested the entire amount in the purchase of four residential flats and which were used as one unit with common kitchen and entrance. The Assessing Officer (A.O.) denied the exemption, on the basis that the assessee does not comply with the basic requirement of Section 54F.

The CIT(A) allowed the deduction to the assessee under Section 54F in respect of the four residential units and the Revenue appealed the CIT(A)'s order before the Income Tax Appellate Tribunal (ITAT), Surat Bench.

[3]Veg 'N' Table vs DCIT, Circle – International Tax -3(1) (1), Delhi [TS-657-ITAT-2023(DEL)] dt November 7, 2023
[4]Acit vs Manish Sumatilal Shah [ITA No. 382 /SRT/ 2023 dt October 4, 2023

The ITAT observed that the assessee had acquired four flats on the same floor of a complex and converted them into one residential house through architectural changes; the four flats were adjoining with common walls and shared one entrance and kitchen. The ITAT concluded that, for all practical purposes, the four flats constituted one residential house, exclusively used for the residence of the assessee and his family therefore, the ITAT held that the CIT(A) was justified in allowing the deduction under Section 54F of the Act and ITAT dismissed the appeal filed by the Revenue.

B. Corporate Law Highlights

1. NCLT Chennai: Excess of assets over the liabilities after considering issue of shares to be credited to Capital Reserve [5]

In the current case, the National Company Law Tribunal, Chennai Bench (NCLT Chennai), has approved a Scheme of Amalgamation. The Petitioner Company, in its scheme, stated that any excess of assets over liabilities, considering the issue of share capital, would be transferred to an amalgamation reserve. This reserve was to be treated as revenue reserve for all purposes. However, the NCLT Chennai determined that treating the amalgamation reserve as a 'revenue reserve' was incorrect. It could not be used for various purposes, including the declaration of dividends and bonus shares. The NCLT Chennai further directed the company to treat the amalgamation reserve as a capital reserve and not as a revenue reserve.

Katalyst comments:
The above order reiterates the importance of the appropriateness of accounting treatment in the context of schemes of arrangement.

2. NCLT Delhi: Reclassification of Reserves[6]

The NCLT Delhi in the context of Scheme of Amalgamation, was dealing with a situation, whereby the entire amount standing to the credit of general reserves was intended to be classified and credited to Retained Earnings, thereby making it available for the payment of dividends to the shareholders of the Petitioner Company.

The objection of the RD in the context of potentially large outflow that would later involve, and hence, the creditors should have been involved in the Scheme.

The NCLT approved the Scheme on the basis of detailed reasoning including that dividend requires shareholders consent anyway and any payment other than dividend shall also require shareholder approval. Additionally, the NCLT dispensed with the meeting of creditors on the

[5]Kamadgiri Industries Limited [CP/118/CAA/2018 in TCA (HC)/141/CAA/2017 dt August 31, 2023
[6]Nestle India Ltd., CP (CAA)-90(ND)/2022, dated September 9, 2023

grounds that the Scheme constituted an arrangement between the Company and its shareholders and was not a compromise between the Company and its creditors.

3. Companies (Prospectus and Allotment of Securities) Rules 2014: Mandatory Dematerialization for Private Companies[7]

MCA vide its notification dated October 27, 2023 has amended the Companies (Prospectus and Allotment of Securities), 2014 and inserted a new rule which provides that every private company shall issue securities in dematerialized form and facilitate dematerialization of all its securities and notification further states that every private company that intends to make an offer for the issuance of securities, buyback of securities, issuance of bonus shares, or rights offers must ensure that the entire holding of securities of its promoters, directors, and key managerial personnel has been dematerialized in compliance with the provisions of the Depositories Act, 1996. This compliance should be completed within eighteen months from the conclusion of the financial year 22-23; these provisions do not apply to "small companies" and Government Companies.

Katalyst comments:

The amendment regarding dematerialization of shares of private companies seems to be driven by the Government's concern that back dating and manipulation can happen in the absence of dematerialization.

"Small Companies" are excluded; the term has been defined to mean a company, other than a public company, whose paid-up capital does not exceed rupees four crore and turnover does not exceed rupees forty crore.

4. MCA: Companies to designate CS / KMP / Director for furnishing information w.r.t. beneficial interest[8]

The Ministry of Corporate Affairs (MCA) has issued a notification mandating that companies shall appoint an individual responsible for furnishing information on beneficial interest in the company's shares to the Registrar of Companies or authorized officers. This designated individual may be a company secretary (CS), key managerial personnel (KMP) other than the CS, or every director in the absence of a CS or KMP. The particulars of the designated individual shall be included in the company's annual return, and any modifications to these particulars shall be reported to the Registrar through the prescribed Form GNL-2.

[7]The Companies (Prospectus and Allotment of Securities) on Second Amendment Rules, 2023 vide notification no G.S.R. 802(E) dated October 27, 2023.

[8] The Companies (Management and Administration) Second Amendment Rules, 2023 vide notification no G.S.R. 801(E) dated October 27, 2023.

Katalyst comments:
The notification underlines the Government thinking of very prescriptive legislation and the increasing responsibility being put on identified company officials.

5. MCA: implementation date for allowing listing on Foreign Stock Exchanges notifed[9]

The Ministry of Corporate Affairs (MCA) has designated October 30, 2023, as the effective date for the enforcement of Section 5 of the Companies (Amendment) Act, 2020. Section 5 of the Amendment Act permits specific public companies to list on authorized stock exchanges in permissible foreign jurisdictions or any other jurisdictions as may be prescribed; the public limited companies will be allowed foreign direct listing only in defined permissible jurisdiction. Final rules are yet to be notified.

Katalyst comments:
The attraction to list abroad is particularly strong in the context of tech companies where the valuation on exchanges such as NASDAQ could be higher, given the greater sophistication of those markets; of course, there would be presumably greater disclosure requirements also. In the context of several Indian unicorns, it would be interesting to see how the actual impact of this amendment unfolds.

6. HC Delhi: Rights of creditors including revenue after approval of Resolution Plan [10]

Tata Steel Limited (TSL) had filed a writ petition challenging the revenue's jurisdiction to enforce tax and penalty demands; TSL maintained that dues payable for the periods preceding the date when the Resolution Plan (RP) is approved can only be paid as per the terms contained in the RP. The Delhi High Court (HC) held that a successful applicant whose RP has been approved should not be put in a position where it is called upon to liquidate dues of creditors, including statutory creditors, which were not embedded in the RP. A successful applicant is, in law, provided with a "clean slate". The revenue argues otherwise.

The Delhi High Court held that once the RP is approved, claims for periods before the approval cannot be recovered. The HC emphasized that Section 31 of the Insolvency and Bankruptcy Code (IBC) provides that, "In cases where no provision is made for claims lodged on behalf of the creditors, or there is a failure to lodge a claim with the Resolution Professional, all such claims stand extinguished". Accordingly, the HC held that once the RP is approved, it shall be binding even on the Revenue.

[9]MCA notification dated October 30, 2023, Notification no [F.No. 1 /3 /2020-CL.I]
[10]Tata Steel Ltd. vs. Dy. Commissioner of Income Tax [LSI-1023-HC-2023(DEL)] dated October 31, 2023

7. ROC Delhi adjudication order u/s 42 of the Companies Act: legality of amounts raised under Community Stock Option Plan[11]

The matter related to a company called Solargridx Ventures Pvt. Ltd. ("the Company") which raised money from as many as 565 subscribers through something called a Community Stock Option Plan ('CSOP'). The plan was constructed for granting to eligible community members the rights to receive payouts pursuant to the plan; each CSOP holder was said to be an evangelist of the company's services and products and accordingly, the company had agreed to reward them through payouts, through the medium of CSOP.

A show cause notice was issued to the company in the context of alleged non-compliance of Section 42 of the Companies Act which, interalia, restricts the ability to make a private placement offer to not more than 200 persons and has also various other conditions, including restriction on use of advertisements or marketing media for such issues. One of the key issues in this context was whether the CSOP issued were "securities".

The adjudication order held the company liable for violation of various provisions of Section 42, especially the following:

- Violation of Section 42(2) which caps a private placement offer to a maximum of 200 people, whereas the company had exceeded that limit.

- Violation of Section 42(7) by holding that the use of the company's website/platform amounts to use of public advertisement

The basis of the above was that what the CSOP issued were "securities" as defined u/s 2(81) of the Companies Act read with Section 2(h) of the SCRA Act, 1956, wherein the word "securities" has been defined to include "derivatives" and the CSOPs were held to be "derivatives".

C. SEBI/RBI/other highlights

1. Supreme Court judgment on priority of Electricity Supplier's Claim in Corporate Insolvency[12]

The facts in this case that the appellant Paschimanchal Vidyut Vitran Nigam Limited (PVVNL) was an electricity supplier and had entered into an agreement with Raman Ispat (corporate debtor) for supply of electricity by the former to the latter and the agreement provided that the outstanding electricity issues would constitute a charge on its assets. The corporate debtor was under liquidation in IBC and the question was the priority of PVVNL's position as a creditor

The appellant PVVNL submitted with Section 173 and 174 of the Electricity Act at an overriding effect on all laws, including the IBC, the latter being a general law dealing with corporate insolvency. Its contention was that the rights of the electricity suppliers were not subordinate

[11] Adjudicating Officer order dated September 22, 2013 in the case of Solargridx Ventures Pvt. Ltd
[12] Paschimanchal Vidyut Vitran Nigam Ltd., versus Raman Ispat (P) Ltd, 180 SCL 30 dated July 17, 2023

to and not subject to the priority of claims mechanism under IBC. This was contested by the liquidator for several reasons, including that the recovery of electricity dues could be recovered as arrears of revenue, but that does not create security interest in favour of the appellant. The Supreme Court also held that Section 52 gives an option to secured creditors to relinquish their security interest or to enforce it. In the latter option, their priority for recovery of dues is ranked high; however, if they seek to enforce their security, they can proceed to do so, but in the event of shortfall, they rank low in priority.

The Supreme Court held that a creation of a security need not necessarily be based on an express provision of the 2003 Act or plenary legislation, but can be created by properly framed regulations authorised under the parent statute. In these circumstances, the argument of PVVNL that, by virtue of Clause 4.3(f)(iv) of the Supply Code, read with the stipulations in the agreement between the parties, a charge was created on the assets of the corporate debtor, is merited. It also held that, in these circumstances, the conclusion that PVVNL is a secured creditor cannot be disputed. The liquidator had submitted that dues owned to the appellate were technically owned to the Government and u/s 53(1)(e) of the IBC, any amount due to the Government ranks lower in priority to their class of creditors; The Supreme Court held that the appellate has undoubtedly Government participation, but that does not render it to be Government. However, the liquidator cannot urge at this stage that PVVNL is a secured creditor. In this context, it was held that PVNNL's appeal cannot be entertained, but the liquidator is directed to decide the claim of PVNNL in the manner required by the law.

2. Supreme Court: Cheque bouncing and responsibility of directors under Negotiable Instruments Act[13]

Section 138 of the Negotiable Instruments Act outlines consequences for bouncing of cheques; in the context of companies involved in such cheque bouncing, Section 141 says that every person who, at the time the offence was committed "was in charge of, and was responsible to the company for the conduct of business of the company..." shall be deemed to be guilty. The context was that the appellants were directors of the company, but were neither Managing Director nor Whole Time Director and had not signed the cheques; in this context, the Supreme Court held that though the directors were managing the affairs of the company, they do not per se become in charge of the conduct of the business or the person responsible for the conduct of the business of the company. Accordingly, on facts, they were held not liable u/s 141.

[13]Ashok Shewakramani versus State of Andhra Pradesh, 180 SCL 66 dated August 3, 2023

3. Securities Appellate Tribunal overturns SEBI Order on Zee Entertainment CEO in Fund-Siphoning Case[14]

The Securities Appellate Tribunal (SAT) has overturned the Securities and Exchange Board of India's (SEBI) confirmatory order restraining Mr. Punit Goenka, MD and CEO of Zee Entertainment Enterprises Ltd. (ZEEL), from the position of Director or Key Managerial Personnel (KMP) in ZEEL. SAT stated that the diversion of funds has not been proven, and the appellant provided a sufficient explanation supported by genuine documents. The tribunal noted that SEBI's interim order, based on a preponderance of probabilities while rejecting genuine documents, was harsh and unwarranted. SAT emphasized that Mr. Goenka's position in the merged entity resulting from ZEEL's merger with Culver Max Entertainment Pvt. Ltd./Sony would have no impact on the investigation, and SEBI's contrary stand on evidence acceptance was deemed arbitrary.

SAT highlighted that SEBI may invoke the "substance over form" principle only after establishing, based on facts and circumstances, that the impugned transaction was fictitious. SAT found no evidence of round-tripping of funds. It was argued on behalf of Mr. Goenka that SEBI had inconsistently applicated the preponderance of probability principle, and emphasized his cooperation with the regulatory body, asserting that keeping him away from ZEEL's affairs was erroneous.

Katalyst comments:
Regardless of the SAT order, press reports indicate a commercial issue between Zee & Goenka regarding who should be leading the merged entity.

D. Goods and Service Tax Highlights

1. CBEC Circular[15] : Valuation criteria for corporate guarantee and taxability of personal guarantee issued

The circular refers to the guidelines issued by the Reserve Bank of India ('RBI') which provides that guarantee provided by the directors is not to be made for consideration and hence, the market value for such transactions should be zero and correspondingly, the value of the supply should be zero; however, the circular provides the scenarios prescribed by RBI which mandates providing of personal guarantee by directors, promoters for consideration. In such circumstances, the value of supply should be consideration provided to such director/promoter.

In case of Corporate Guarantee provided between related parties, the valuation should be actual value of the consideration provided to the related party OR 1% of the amount of the Guarantee offered, whichever is higher.

[14]Punit Goenka vs. SEBI [LSI-1002-SAT-2023(MUM)] dated October 30, 2023
[15]CBEC Circular No. 204/16/2023- GST dated October 27, 2023

Katalyst comments:
The circular has clarified the long pending issue of GST applicability on personal guarantee and valuation of personal and corporate guarantee both. However, this circular is effective prospectively and hence, past issues are still likely to be contentious.

2. Telangana AAR[16] : Sale of Developed Plots Considered 'Sale of Land' exempt from GST, while Work Contract Services Taxable at 18% GST

The issue before Telangana AAR was whether the sale of developed plots by applicant to various customers after development is taxable under the GST Acts or not. The Telangana AAR has held that sale of developed plots which involve levelling, laying down of drainage lines, water lines, electricity lines, etc, as per Circular No. 177/09/2022 is the 'sale of land' as per schedule III of the CGST Act and does not attract GST. However, the AAR has held Applicant/developer has supplied work contract services to land owners who have transferred the development rights to the Applicant and the same is taxable at 18% GST.

Katalyst comments:
The AAR clarified that the sale of developed plot is 'sale of land' and no GST is applicable. However, if the development rights are transferred for the purpose of development of land, works-contract services for the purpose of development of land is liable to GST.

3. Telangana High Court[17] : Colleges liable to pay GST on 'Affiliation' and 'Inspection' fees to Affiliating University

Telangana High Court has held that colleges affiliated to the Respondent University are liable to pay GST on the affiliation fees and inspection fees, from July 2017; the HC held that the Notification No.12/2017 dated June 28, 2017, enumerates specific services which stand exempted and inspection and affiliation fees both are not reflected therein, and thus, the relief sought for by the Petitioners would not be sustainable. The HC also held that Notification No.12 (as mentioned above) provides for exemption of services rendered by the educational institutions to three different categories, (i.e., students, faculty and staff) and does not deal with the services rendered by the university to the educational institutions, as 'affiliation' and 'inspection' is a service rendered by the university to the educational institutions for which the University had charged the respective educational institutions.

Accordingly, it was held by ITAT that said services are not covered under exemption notification and hence, liable to GST.

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[16]Circular No. 204/16/2023- GST dated October 27, 2023
[17]Circular No. 204/16/2023- GST dated October 27, 2023