EY Tax and Regulatory Alert

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Contents

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Indirect Tax

This Section of Tax alert summarizes the Indirect tax updates for the month of March 2018

Judicial Precedents

1. M/S VE Commercial Vehicles Ltd, M/S Man Trucks India Private limited, M/S V.E. Commercial Vehicles ltd
   Vs
   CCE & ST, Indore
   [2018-VIL-143-CESTAT-DEL-CE]

Background and facts of the case

- In the present case both M/s V.E. Commercial Vehicles Limited (VECVL) and M/s Man Trucks India Pvt. Limited (MFTPL) are engaged in the manufacture of heavy commercial vehicles for transport of goods and chassis of such motor vehicle falling under Central Excise Tariff Heading 8704 and 8706 respectively of the Central Excise Tariff. Both VECVL as well as MFTPL classified the various models of vehicles manufactured by them under Central Excise Tariff Heading 87042390 as "tipper trucks" and their chassis under CETH 870660042.

- However, the department was of the view that the motor vehicles as well as the chassis manufactured by the appellants are not trucks designed for **highway use, but were "dumpers" designed for off highway use**. Such vehicles were classified, as per Revenue, under 870410 as well as chassis under 87060043. The rate of excise duty on dumpers, tipper trucks and chassis were not different. However, there was difference in the rate of duty for chassis leviable under National Calamity Contingent Duty (NCCD) leviable under Section 136 of the Finance Act, 2001. In respect of complete vehicles – dumpers as well as tipper – NCCD was exempted under Notification No. 21/2005-CE dt. 13.05.2005, whereas NCCD was payable on dumper chassis.

- Department issued a show cause notice which resulted in the demand of NCCD on the quantity of chassis cleared by the two manufacturers during the disputed period. Penalties were also imposed on the assesse.

- Case of department is mainly based on two points. Firstly they have made reference to the various catalogue / product literature / technical specifications on the website regarding various features of the motor vehicles. On the basis of such literature it has been concluded that the vehicles manufactured have been described wrongly as dipper but they are dumpers. Secondly Reference has been made to HSN explanatory notes pertaining to the heading 8704.

- Appellants supported their case by stating below points-

  - The motor vehicle manufactured by the appellant are tipper trucks designed for road / on-highway used and cannot be called dumper meant for off-highway use.

  - The CETH 8704 10 claimed by the Department is not applicable to the vehicles manufactured since CETH 8704 10 will apply only to vehicles designed for off-highway use.

  - By submitting a copy of the product leaflets for the vehicles manufactured by VECVL and drawing our attention to the various specifications. Specific attention were provided to two facts that such vehicles are designed with very high pick up and capable of maximum speeds of 72 to 85 km. per hour which are possible only on road/ highway and type of tyres used in such vehicles are those which are capable of running on roads.

  - By submitting a catalogue for (Carmics dumper) which is not manufactured by the appellant but is representative of what a dumper is specific consideration was given to fact that such vehicle are capable of achieving only maximum speed 20 miles per hour and are fitted with off-road tyres.

- In the second issue involved there was an appeal filed by MFTPL for decision. During the period June 2008 till February, 2011 MFTPL manufactured and exported chassis fitted with engine, cabin and parts of vehicles. It was noticed by the Department that the duty payable at the relevant time on such vehicles was 10% plus Rs. 10,000/- per vehicle but the MFTPL was found only to have paid the duty @ 10% resulting in short payment of duty.

- In light of the HSN explanatory notes and the various tariff headings and sub-headings, department is of the view that the motor vehicles manufactured by the appellants do not fall in the category of dumpers designed for off-highway use under 870410. They are classifiable, as claimed by the appellant under 87042390 as tipper trucks likewise the classification of chassis also will fall under 87060042 and not under 87060043 as claimed by the Department.

- Accordingly the demand was set aside for demand of differential duty of NCCD made by the adjudicating authority in the impugned orders.

- In relation to second issue which involved short payment of duty by the appellants. Considering differential duty to be paid by the appellant will be available to them as rebate since the goods have been exported. Basis this order has been set aside

2. M/S Honda Cars India Ltd
Vs
CCE, LTU, Delhi
[2018-VIL-147-CESTAT-DEL-CE]

Background and facts of the case

- In the present case assessee/appellant is engaged in the manufacture of motor cars of various models. They were manufacturing and clearing the said cars from their Noida Unit and Alwar Unit on payment of applicable central excise duty. They were discharging such duty on 'transaction value' in terms of Section 4(1)(a) of the Central Excise Act, 1944.

- Consequent to the decision of the Hon'ble Supreme Court in Fiat India Pvt. Ltd. – 2012 (283) ELT 161 (SC) - *2012-VIL-01-SC-CE*, the Department sought certain details regarding manufacturing cost of different models of cars and the transaction value, on which duty has been paid at the time of clearance of such cars. After collecting the required details, the Department proceeded against the appellant/assessee to demand differential duty of central excise, wherever cars were cleared with a transaction value, which was below the manufacturing cost, as ascertained from the data.

- Appellant strongly presented their case by stating following points

- Decision in fiat case is not applicable on them as Fiat was selling all their cars for more than 5 years constantly at a huge loss of 145% When the cost of production was Rs.4,53,739/-and sale price was of Rs.1,85,400/-, the Company categorically admitting that the strategy was to penetrate the market in India.

- On the same side appellants pleaded that same model car was sold both at profit and at loss in the same financial year because of the disruption in supply of critical components imported from Japan and Thailand had serious implication on cost over a certain period.

- The impugned order did not at all examine these factors. Admittedly such disruption and exchange rate fluctuation will have adverse effect on manufacturing cost of the appellant - the Original Authority did not examine the true legal implication of Section 4(1)(a) and the clarification issued by the Board on the implication of decision in Fiat case on such legal provision - the impugned orders cannot be sustained in their present form.

- Accordingly, these orders are set aside with direction to the Original Authority to take up all the issues afresh – there is no reason to invoke allegation of suppression, mis-representation with an intention to evade payment of duty on the part of the assesse.

- The price for the cars is dictated by supply and demand, cost escalation due to reasons beyond apellant's control and such price is purely for sale of goods with no extra commercial consideration. The price fixed was apparently to compete with similarly placed products. It would appear that the lower authority had taken such assertion of fixing competitive price as fixing price for "penetration of market". Such assumption is without basis and is apparently factually wrong. There is no such admission by the appellant; neither there is allegation by the Revenue with supporting evidence. If the lower price is due to commercial consideration of competing in the market with no evidence of flow back of extra commercial consideration, revenue find no reason to hold that the transaction value is not based on the principle of price being the sole consideration.

3. M/S Intercontinental Consultants
Vs
Union of India & others

Backgrounds and facts of the case

- The assessee is a provider of consulting engineering services and is specialized in highways, structures, airports, urban and rural infrastructural projects.
- The assessee was discharging service tax in respect of amounts received by it for the services rendered to its clients. However, it was not paying service tax in respect of expenses like air travel, hotel stay etc. incurred by it,which were reimbursed by the client.
- Revenue referred Rule 5(1) of the Service tax (Determination of Value) Rules, 2006 and issued Show Cause Notice (SCN) demanding service tax on the amount of reimbursements received along with interest.
- Rule 5(1) provides that any expenditure or costs which is incurred by the service provider in the course of providing taxable services, are required to be included in the value of services for levying service tax.
- Further, Section 67 of the Finance Act, 1994 (Act) provides that the value of any taxable service shall be the gross amount charged by the service provider for such service provided or to be provided.
- The assessee preferred writ petition before the Delhi High Court (HC) challenging the validity of Rule 5(1).
- The HC2 opined that scope of Rule 5 goes beyond the Section 67 of the Act which was impermissible and held that the expenditure or cost incurred by the service provider in the course of providing the taxable service can never be considered as the gross amount charged by the service provider "for such service" provided by him.
- Aggrieved by the HC's order, the Revenue filed the appeal before the Supreme Court (SC).

Assessee's Contention

- Section 67 of the Act was amended w.e.f. 14 May 2015 to insert an explanation that consideration includes reimbursement of expenditure or cost incurred by the service provider. Thus, prior to 14 May, 2015, the term 'consideration' was having limited sphere, viz. it was only in respect of taxable services provided or to be provided.
- The assessee also referred to para 2.4 of Circular/Instructions F. No. B-43/5/97-TRU dated June 6, 1997 wherein it is clarified that '…various other reimbursable expenses incurred are not to be included for computing the service tax".
- The assessee submitted that the High Court was right in holding that as per Section 66, which was a charging section, service tax is to be charged only on the 'value of taxable services'. Likewise, Section 67 which deals with valuation of taxable service categorically mentions that it was only on the gross amount charged for providing 'such' taxable service. Therefore, any amount collected which is not for providing such taxable service could not be brought within the tax net.
- In support of its above contention, the assessee relied on various rulings.

Revenue Contention's

- Rule 5 is inserted with effect from 19 April 2006. Therefore, prior to that, the value of taxable services was covered by Section 67 of the Act.
- The connotation 'gross amount charged' in Section 67 denotes the total amount which is received in rendering those services and would include the other amounts like transportation, office rent, office appliances, furniture and equipment etc. Thus, the essential input cost had to be included in arriving at gross amount charged by a service provider.
- Section 67 was amended w.e.f. 18 April 2006 and subsection (4) of the amended section provides that the value has to be determined in such a manner as may be prescribed and in pursuant thereto. Thus, provision of Rule 5 did not go contrary to Section 67 as it only mentions what would be the meaning of gross amount charged.
- The Revenue relied on SC's judgment in the case of *Bombay Tyre International Limited & Ors.4* and submitted that while dealing with the valuation of a taxable service, the provision which deals with valuation has to be taken into consideration and no assistance can be taken from charging section.
- The Revenue contended that the HC had committed serious error in relying upon Section 66 of the Act (which is a charging section) while

interpreting Section 67 of the Act, or for that matter, while examining the validity of Rule 5.

- Revenue also relied upon the dictionary meaning of the word "gross amount".

- At the end, Revenue submitted that Section 67 which uses the term "any amount" in the definition of consideration, would include quantum as well as the nature of the amount and, therefore, cost for providing services was rightly included in Rule 5, which was not *ultra vires* the Section 67 of the Act.

- Supreme Court ruling
  - SC noticed that Section 66 of the Act refers to service tax in respect of those services which are taxable and specifically referred to in various sub-clauses of Section 65.
  - Further, it also specifically mentions that the service tax will be @ 12% of the 'value of taxable services'. As a necessary corollary, it is the value of the services which are actually rendered, the value whereof is to be ascertained for the purpose of calculating the service tax payable thereupon.
  - Thus, the expression 'such' occurring in Section 67 of the Act assumes importance.
  - SC observed that, any other amount which is calculated not for providing such taxable service cannot be a part of that valuation as that amount is not calculated for providing such "taxable service".
  - The SC further observed that the position did not change even in the amended Section 67. Section 67(4) empowers the rule making authority to lay down the manner in which value of taxable service is to be determined. However, Section 67(4) is expressly made subject to the provisions of sub-section (1) of the said section.
  - The SC relied on its ruling in the case of *Babaji Kondaji Garad5* and iterated that rules cannot go beyond the statute. Treating the amendment in Section 67 as "substantive change", SC stated that the same will be effective prospectively. In this regard, the SC relied on the ruling of the Constitution Bench in the case of *Vatika Township Private Limited*..
  - Thus, the SC upheld the HC's decision holding that the value of taxable service shall be the gross amount charged by the service provider 'for such service' and the valuation of taxable service cannot be anything more or less than the consideration paid as *quid pro quo* for rendering such a service.

Key Indirect Tax Developments

This section summarizes the regulatory updates for the month of March 2018.

1. Decisions in GST 26th Council Meet dated 10th March 2018

- Implementation of E-way Bill
  - Inter-State movement of goods – E waybill to be generated from **April 1, 2018.**
  - Intra-State movement of goods – E waybill to be implemented from **April 15, 2018**, in a phased manner by dividing it into 4 categories. All States expected to be covered latest by **June 1, 2018**.
- Current system of filing simplified GST return in form GSTR 3B extended for next three months i.e. till **June 2018**.
- Exemption to registered persons from paying GST under reverse charge on the supply of goods or services from an unregistered person, has been further suspended till **July 1, 2018** *(earlier the suspension was effective till 31 March 2018).*
- Owing to the lack of proper IT system in place, the Council also extended the applicability of TDS and TCS provisions till **June 30, 2018**
- Export promotion schemes and tax exemptions on imports effected by exporters such as GST payment @ 0.1% by merchant exporters, treatment of domestic procurement under Advance Authorization, EPCG & EOU schemes as 'deemed exports', further extended by 6 months i.e. till **October 1, 2018. New functionality** to be introduced on the GST portal to expedite the GST refund to exporters.
- In addition to the above, the Group of Ministers (GoM) presented two return filing models. However, the Council did not take any decision on the simplification of GST return filing system. The Council has entrusted the panel of ministers to come up with a simpler and evasion proof **single page return form.**

2. Amendments made under Central Goods and Service Tax Rules, 2017 (CGST Rules) vide Notification No. 12/2018 dated 7th March, 2018 issued by the Central Government.

- **Government prescribes deadline for Tran-2**

  - Central Government amends CGST Rules 2017 to inter alia prescribe time limit of March 31, 2018 for submission of statement in Form GST TRAN-2 by persons unregistered in earlier regime, in respect of notional credit of goods lying in stock, for each of the 6 tax periods during which the scheme is in operation

- **Changes in E-way bill**

  - Rule 138 has been amended to include provisions in regard to furnishing of information by a transporter in Part A of Form GST EWB-01 on an authorisation received from the registered person. Further, in case of goods supplied through an e-commerce operator, the information in part A of FORM GST EWB-01 may be furnished by the e-commerce operation.

  - In case where goods are sent by principal located on one state to job worker located in another state, E-way bill can also be generated by job worker (if registered). Earlier, the E-way bill was required to be generated by principal only.

  - Proviso to 138 (3) has been amended to extend the distance for no conveyance details in Part B of Form GST EWB-01 to 50 kms within State / Union Territory (from 10 km), while also extending the validity of Unique Number generated under Rule 138(1) to 15 days for updation of Part B (from 72 hours).

  - Explanation 2 of Rule 138 (1) has been amended to exclude the value of exempt supply of goods while determining "consignment value" where the invoice is issued in respect of both exempt and taxable supplies

  - Rule 138 (2A) has been inserted wherein goods are transported by railways or air or vessel, E-way bill shall be generated by supplier or recipient in PART B of form EWB-01. In this regard, in the absence of e-way bill at the time of delivery, goods shall not be delivered.

- Rule 138 (7) has been amended to exclude railways, air, vessel from generation of consolidated E-way bill.

- Validity of E-way bill or consolidated e-way bill shall be as follows –
  - Upto 100 km – 1 day in cases other than Over Dimensional Cargo,
  - For every 100 km or part thereof thereafter - 1 additional day in cases other than Over Dimensional Cargo,
  - Upto 20 km – 1 day in case of Over Dimensional Cargo,
  - For every 20 km or part thereof thereafter – 1 additional day in case of Over Dimensional Cargo,

where the expression "Over Dimensional Cargo" means a cargo carried as a single indivisible unit and which exceeds the dimensional limits prescribed in Rule 93 of Central Motor Vehicle Rules, 1989, made under the Motor Vehicles Act, 1988

- The person shall be deemed to have accepted the details in Part A of Form GST EWB-01 if he does not communicate his acceptance or rejection within 72 hours of details being made available to him on common portal or the time of delivery of goods, whichever is earlier

- Insertions have been made in Rule 138 (14) to include entries wherein no E-way generation is required in following cases –

  - where goods are being transported

- under customs bond from an ICD or CFS to a customs port, airport, air cargo complex and land customs station, or from one customs station / port to another customs station / port, or
- under customs supervision or under customs seal,

  - where goods being transported are transit cargo from or to Nepal / Bhutan,
  - where goods being transported are exempt from tax under Notification No. 7/2017-Central Tax (Rate) and 26/2017-Central Tax (Rate),

- any movement caused by defence formation under Ministry of Defence as consignor or consignee,
- where the consignor of goods is Central Govt., State Govt. or local authority for transport of goods by rail.

3. CGST Circular No. 37/11/2018 dated 15 March 18 - Clarifications on exports related refund issues

- **Non-availment of drawback:** Supplier availing drawback only with respect to basic customs duty (i.e., not availing drawback in respect of central tax, integrated tax, State / Union territory tax/ Cess) shall be eligible for refund of unutilized input tax credit of central tax / State tax / Union territory tax / integrated tax / compensation cess. Further refund of eligible credit on account of State tax shall be available even if the supplier of goods or services or both has availed of drawback in respect of central tax.

- **Mis-match between GSTR 3B and GSTR 1:** Refund claims not processed on account of mis-matches between data contained in Form GSTR 1, GSTR 3B and shipping bills/bill of export, below is clarified:

  - In case of errors in the details of invoice / shipping bill / bill of export in GSTR 1, same can be rectified by amending the same through Table 9 of GSTR 1. Thus for processing of refund claims, information contained in Table 9 of GSTR 1 of subsequent periods should be taken into cognizance, wherever applicable.

  - In case of errors made while filing the GSTR 3B, rectification can be done as per the procedure provided vide Circular 26/26/2017 – GST dated 29 December 2017. ***Therefore, in case of discrepancies between the data furnished by the taxpayer in FORM GSTR-3B and FORM GSTR-1, the officer shall refer to the said Circular and process the refund application accordingly.***

- **Export without LUT**: In case where exports have been undertaken before filing of LUT, it has been emphasised that the substantive benefits of zero rating may not be denied where it has been established that exports have been undertaken, by condoning the delay in filing of LUT and the facility for export under LUT may be allowed on ex post facto basis taking into account the facts and circumstances of each case.

- **Exports after specified period:** In case where exports are made without payment of tax (under LUT/bond) after the expiry of the prescribed time limit (i.e. on expiry of 15 days after 3 months from the date of issue of export invoice), it has been clarified that the exporters should not be emphasised to pay tax on exports and then subsequently claim refund of the same (upon actual exports) and that jurisdictional Commissioner may extend the time limit keeping in view the facts and circumstances of each case. Similar procedure to be followed for export of services as well.

- **Deficiency Memo:** If the refund application made is complete in all respects, an acknowledgement in Form GST RFD 02 shall be issued else **deficiency memo** in Form GST RFD 03 shall be issued. Where such memo is issued, applicant is required to file a fresh refund applications after rectifications of deficiencies.

Further once an application has submitted afresh pursuant to a deficiency memo, the proper officer cannot serve another deficiency memo for the same unless the deficiencies pointed out in the original memo remain unrectified or *any other substantive deficiency is noticed subsequently*.

- **Self-declaration for non-prosecution:** For refund of unutilised input tax credit ('ITC'), self-declaration for non-prosecution is not required to given with every refund claim since the same is already given at the time of submission of LUT.

- **Refund of taxes paid under earlier laws:** Refund of tax/duty paid under earlier laws shall be disposed in accordance with the provisions of the earlier laws and refund applications made in Form GST RFD 01A for such amount of pre-GST taxes would be rejected.

- **Filing frequency of refunds:** In respect of frequency of refund applications, exporters at their option may file refund claim for one calendar

  month / quarter or by clubbing successive calendar months / quarter. However same cannot spread across different financial years (this is to overcome scenarios where the exporters may have only credit availed without any export billings and vice versa).

- **BRC/ FIRC for export of goods:** For export of goods, the insistence on proof of realisation of export proceeds (BRC / FIRC) for refund claims has not been envisaged in the law and the same should not be insisted upon. However the same is required for export of services.

- **<u>Supplies to Merchant Exporters:</u>** Suppliers supplying goods at concessional rate of 0.1% are also eligible for refund on account of inverted tax structure as provisions of Section 54(3) of CGST Act, 2017. It may also be noted that as per Notification No. 3/2018 – Central Tax dated 23 January 2018, exporters procuring goods from merchant exporter can export the goods only under LUT/bond and cannot export on payment of IGST.

- **<u>Requirement of invoices for processing of claim of refund:</u>** Since the refund applications are filed and processed in semi-electronic environment, various documents required for processing the refund claims have to be manually submitted. A list of documents required for processing refund claims on exports in provided in below points

  - **<u>For Export of Services with payment of tax (Refund of IGST paid on export of services)</u>**
    - Copy of FORM RFD-01A filed on common portal
    - Copy of Statement 2 of FORM RFD-01A
    - Invoices w.r.t. input, input services and capital goods
    - BRC/FIRC for export of services
    - Undertaking / Declaration in FORM RFD-01A

  - **<u>Export (goods or services) without payment of tax (Refund of accumulated ITC of IGST / CGST / SGST / UTGST / Cess)</u>**
    - Copy of FORM RFD-01A filed on common portal
    - Copy of Statement 3A of FORM RFD-01A generated on common portal
    - Copy of Statement 3 of FORM RFD-01A
    - Invoices w.r.t. input and input services
  - BRC/FIRC for export of services
  - Undertaking / Declaration in FORM RFD-01A

4. Bombay HC refuses to strike down 1 year transitional credit limitation

- This to update you that on the recent ruling, dated 20 March 2018, in the case of ***Evergreen Seamless Tubes Pvt. Ltd. & Ors. vs. Union of India & Ors.*** wherein the Bombay High Court have refused to strike down 1 year transitional credit limitation.

- Hon'ble High Court dismissed the writ petition that was challenging the constitutional validity of Section 140(3)(iv) of CGST Act, by refusing to strike down 1 year time limit for transitional credit availment as it believed that 1 year limit has clear nexus with objective sought to be achieved by GST legislation and therefore, cannot be struck down.

- Further, it referred to the SC ruling in the case of Jayam & Co. where it was held that when concession in form of Input Tax Credit is given by a Statute, the legislature has power to make provision stating the form and manner in which such concession is to be allowed and there was no right, inherent or otherwise, vested with dealers to claim ITC benefit. Transitional credit under GST law is a clear case of concession subject to fulfilment of conditions stipulated u/s 140 of CGST Act.

Direct Tax

This Section of Tax alert summarizes the Direct tax updates for the month of March 2018

Judicial Precedents

1. Supreme Court (SC) upholds disallowance of expenditure in relation to exempt dividend income from shares held as "strategic investment" and "stock-in-trade"

Background and facts of the case

- The Finance Act, 2001 inserted the Section, with retrospective effect from 1 April 1962 i.e., from the date of inception of the current Income Tax Laws (ITL). The Section provides that for the purposes of computing total income under Chapter IV of the ITL, no deduction shall be allowed in respect of expenditure incurred by a taxpayer, in relation to the exempt income.

- The Finance Act, 2006 further amended the Section, with effect from 1 April 2007, to provide that the amount of disallowance shall be computed as per the prescribed methodology where the Tax Authority is not satisfied with the claim of the taxpayer or where the taxpayer claims that no expenditure has been incurred by it in relation to exempt income. The Central Board of Direct Taxes (CBDT) [The apex administrative direct tax authority in India] prescribed the methodology by Rule 8D which was inserted in the Income Tax Rules, with effect from 24 March 2008.

- For the relevant tax year under consideration, Rule 8D prescribes computation of disallowance under three limbs viz., (a) Direct expenditure. (b) Indirect interest expenditure computed on pro rata basis in proportion of average value of investments to the total assets. (c) 0.5% of the average value of investments [Notification No. 43/2016 dated 2 June 2016 partially substituted then existing Rule 8D and provides for a new method for computation of disallowance of expenditure which, in addition to the amount of expenditure directly relating to exempt income, shall include an amount equal to 1% of annual average of monthly averages of the opening and closing balance of the value of investment, which gives rise or may give rise to exempt income. However, the total amount of disallowance shall be restricted to total expenditure claimed by the taxpayer].

- Since the enactment of the Section, there have been various controversies/issues surrounding interpretation of the Section, resulting in significant tax litigation.

- In the recent past, the SC has settled the following controversies on the scope of the Section:

  - In the case of Godrej & Boyce Manufacturing Company Ltd. v. DCIT [[(2017) 394 ITR 449 (SC)]], the SC held that the mere fact that dividend suffers dividend distribution tax in the hands of the company before reaching the shareholders as exempt income, does not preclude the applicability of the Section.

  - In the case of CIT v. Essar Teleholdings Ltd. [(2018) 90 taxmann.com 2 (SC)], the SC held that while the Section is inserted with retrospective effect, Rule 8D, inserted with effect from 24 March 2008, has prospective effect and cannot be applied to tax years prior to tax year 2007-08.

- Another issue where there is divergence of judicial views is whether any disallowance is required in relation to expenditure incurred to earn exempt dividend income from shares held as "stock-in-trade" and not as investment.

- There were two types of Taxpayers before the SC. In the case of the first Taxpayer, it held the shares as "trading assets" acquired with the intention of retaining controlling interest over the investee company. In the second case, the Taxpayer (being a bank) held the shares as "stock-in-trade" for the purposes of purchase and sale in the ordinary course of banking business to earn trading profit.

- Both Taxpayers earned exempt dividend income from such shares. Both Taxpayers claimed that the dominant purpose of investing in shares was not to earn dividend income and, hence, did not offer any disallowance under the Section.

- The Tax Authority, in both the cases, made pro rata disallowance of interest expenditure, but restricted the disallowance to the quantum of exempt dividend income.

- In the case of the first Taxpayer, the disallowance was upheld by the First Appellate Authority, the Income Tax Appellate Tribunal (Tribunal) and the Delhi High Court (Delhi HC). The Tribunal held that investment in shares, representing controlling interest, did not amount to carrying on of business (it would normally be on capital account and not a trading asset) and, therefore, interest expenditure incurred on acquisition of shares of group companies was disallowable under the Section. The Delhi HC [Maxopp Investment Ltd. v. CIT [(2012) 347 ITR 272 (Del)] held that the phrase "in relation to" used in the Section means "in connection with" or "pertaining to" and, hence, needs to be construed widely. The Section would apply regardless of the intention/motive behind the investment.

- In the case of the second Taxpayer, the First Appellate Authority enhanced the disallowance up to the full amount, as per Rule 8D. However, the Tribunal and the Punjab & Haryana HC (P&H HC) [Pr. CIT v. State Bank of Patiala [(2017) 391 ITR 218 (P&H)]] ruled in the Taxpayer's favor and deleted the disallowance. The P&H HC held that the purpose of the purchase of shares was not to earn exempt dividend income, but to earn trading profits. The term "'investment" employed in Rule 8D does not include "stock-in-trade". Since the Section and Rule 8D constitute an integrated code, the Section also cannot be read to include "stock-in-trade".

- In view of the conflicting HC rulings, the respective losing parties appealed to the SC.

- Issue before the SC is Whether disallowance under the Section is attracted in a case where exempt dividend income is earned from shares held as "trading assets" or "stock-in-trade" where the predominant intent of investing in shares is not to earn exempt dividend income, but to either retain controlling interest over the investee company or to earn profit from trading in shares.

SC's ruling

On applicability of the Section to exempt dividend income on shares held as "trading assets"

- The SC affirmed the view of the Delhi HC and held that if dividend income received is exempt, the disallowance under the Section is triggered in all cases, even where the investment in shares is not with the main object of earning dividend income. It adopted the following reasoning for its conclusion:
  - As per the Section, expenditure incurred "in relation to" exempt income is not allowed as deduction. If an expenditure incurred has no casual connection with the exempt income, such that it cannot be treated as related to the exempt income, then such an expenditure would be allowed as business expenditure. There is no judicial divergence on this aspect.
  - Controversy arises on interpretation to be given to the words "in relation to" in a scenario where exempt dividend income is earned, but the dominant purpose of investing in shares is not to earn exempt dividend (dominant purpose test).
  - The Section was introduced against the backdrop of SC rulings which had held that, where a taxpayer has an indivisible business giving rise to both exempt and taxable incomes, the expenditure incurred in such indivisible business cannot be apportioned between the two types of incomes. Such expenditure has to be fully allowed as deduction.
  - The Legislature perceived this as resulting in a double benefit to taxpayers, which reduced the tax payable on the non-exempt income by debiting the expenses incurred to earn the exempt income against taxable income.
  - As held by the SC in the case of CIT v. Walfort Share and Stock Pvt. Ltd [(2010) 326 ITR 1 (SC)], the Section incorporates the principle of apportionment of expenditure between exempt income and taxable income.
  - Keeping in mind the above object of the Section, if expenditure is incurred on earning the dividend income, pro rata expenditure attributable to the dividend income has to be disallowed.
  - The dominant purpose test is not relevant to trigger the Section. The dominant purpose for which the investment is made by the Taxpayer is not relevant. The fact remains that dividend received is exempt from tax.

On applicability of the Section to dividend income on shares held as "stock-in-trade"

- In the context of shares held as "stock-in-trade" and not as "investment", particularly by banks, the SC overruled the P&H HC ruling and held that disallowance is attracted even where the predominant intent of acquiring shares was not to earn exempt dividend income, but to earn profit from trading. The SC held as under:
  - In the case of CIT v. Nawanshahar Central Cooperative Bank Ltd. [(2007) 160 Taxman 48 (SC)] the SC held that investments in approved securities statutorily made by a banking

company are part of the banking business and, thus, income arising from such investments is taxable as business income, and not as income from other sources. Pursuant to this ruling, the CBDT clarified vide Circular No. 18 of 2015 dated 2 November 2015 (Circular) that although the ruling is in the context of profit-linked tax holiday deduction for a cooperative bank, the principle laid down in the ruling is equally applicable to all banks.

- The P&H HC held that the Circular carves out a distinction between "stock-in-trade" and investment and provides that if the motive behind purchase and sale of shares is to earn profit, then the same would be treated as trading profit and if the object is to derive income by way of dividend, then the profit would be said to have accrued from the investment. The SC agreed with the P&H HC ruling on such distinction between "stock-in-trade" and investment. However, it disagreed with the application of the dominant purpose test by the P&H HC to determine trigger of disallowance under the Section. The SC held that the Section triggers even if exempt dividend income is incidentally earned in the course of trading activity.

- In the context of shares held as "stock-in-trade", if certain dividend income is earned, though incidentally, the Section would trigger, which is based on the theory of apportionment of expenditure between taxable and exempt income and, depending upon the facts of each case, the pro rata expenditure incurred in acquiring those shares is to be apportioned. This is irrespective of the fact that the main purpose in the case of shares held as "stock-in-trade" is to earn profits by liquidating those shares whenever the share prices go up.

- In the facts of the case, the Tax Authority had computed disallowance by applying the principle of apportionment and restricted it to quantum of exempt income. However, the First Appellate Authority had enhanced the disallowance. This is considered by the SC to be untenable. The conclusions of the Tribunal and the Delhi HC were considered to be right in deleting the additional disallowance made by the First Appellate Authority – although they were perceived to have erred in applying the theory of dominant intention.

On the Tax Authority's obligation to record satisfaction

- The SC held that before applying the theory of apportionment, the Tax Authority needs to record satisfaction that suo moto disallowance made by the Taxpayer under the Section was incorrect. While recording such satisfaction, the Tax Authority also needs to examine the nature of loan taken by the Taxpayer for making investment in shares.

Source: Ruling of Supreme Court dated 12 February 2018 in case of Maxopp Investment Ltd [(2018) 91 taxmann.com 154 (SC)].

2. Mumbai Income Tax Appellate Tribunal (Tribunal) rules on interpretation of the phrase "beneficially held"; allows set off of losses when 51% voting power beneficially held by the same set of individuals

Background and facts of the case

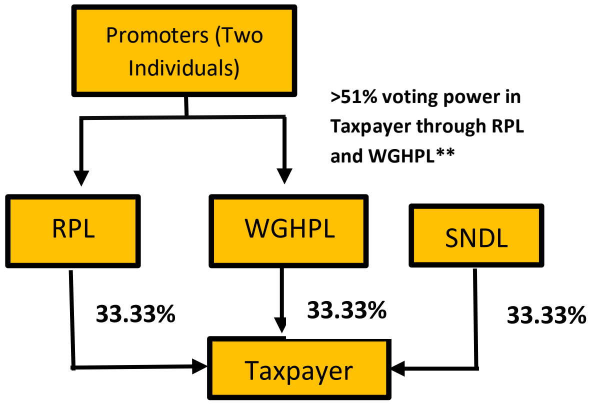
- As per the provisions of the ITL, a taxpayer is eligible to carry forward loss from house property for a period of 8 years, subject to fulfilment of certain conditions. Furthermore, in the case of a closely-held company (CHC), Section 79 of the ITL creates a limitation on carry forward and set off of losses of earlier years from the income of current TY, when there is a change in the shareholding of the taxpayer, such that, 51% of the voting power is not beneficially held by the same set of shareholders which held such voting power at the end of the year in which the losses were incurred. In case of start-up companies, the condition is that shareholders holding 100% of voting power in the year of incurrence of loss should continue to be shareholders (without any condition of holding minimum percentage of voting power) in the current TY.

- The Taxpayer, a CHC in India, incurred losses from house property in TYs 2008-09 and 2009-10. In these years, the Taxpayer was directly held by three Indian companies i.e., Rajdhani Properties Pvt. Ltd. (RPL), Wadhwa Group Holding Pvt. Ltd. (WGHPL) and Shree Naman Developers Ltd. (SNDL), in equal proportions of 33.33%. These shareholders were, in turn, held by 2 individuals in majority i.e., Mr. Vijay Wadhwa and Mrs. Vinita Wadhwa (promoters). There was no direct shareholding of the promoters in the Taxpayer. However, they indirectly held beneficial voting power in excess of 50% in the Taxpayer through RPL and WGHPL.

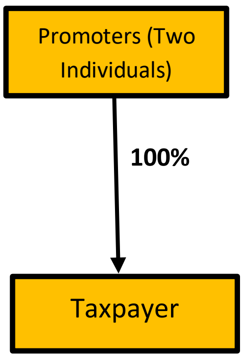
- In the TY under consideration i.e., 2011-12, the shareholders of the Taxpayer transferred their respective shares to the promoters, such that, post transfer of the shares, the Taxpayer was 100% held by the promoters directly.

- The pictorial depiction of the shareholding in the Taxpayer is as follows:

TY 2008-09 and 2009-10



TY 2011-12



** Small percentage shareholding of RPL and WGHPL was held by other than promoters. On derivative basis, promoters indirect beneficial holding in taxpayer retained at >51% by the Tribunal.

- The Taxpayer claimed set off of losses of TY 2008-09 and TY 2009-10 against its income of TY 2011-12.

- The Tax Authority disallowed such set off of losses on the ground that the transfer of shares in TY 2011-12 resulted in a breach of the condition of 51% beneficial shareholding held by the same persons, under Section 79 of the ITL.

- The First Appellate Authority upheld the Tax Authority's action. Aggrieved by the above, the Taxpayer preferred an appeal before the Tribunal.

Taxpayer's contentions

- The limitation under Section 79 is not triggered, as the "beneficial shareholders" of the Taxpayer remained unchanged. Though there was a change at the level of the immediate shareholders, there was no change in the beneficial shareholding, as the promoters continued to hold at least 51% of the voting power in the Taxpayer, post transfer of the shares.

- The Taxpayer placed reliance on the Karnataka HC decision in the case of Amco Power Systems Ltd. (supra), where the HC had held that it is the beneficial shareholding of 51% (direct or through intermediaries), and not the direct ownership of shares that is relevant for the purpose of the Section.

Tax Authority's contention

- There was no evidence to prove that the shares were beneficially held by the promoters during the years when losses were incurred.

- Reliance was placed on the decision of the Supreme Court (SC) in the case of Vodafone International Holdings B.V. (Vodafone) [(2012) 341 ITR 1] to support that registered shareholders were also beneficial shareholders and any change in the shareholding may trigger the provisions of Section 79 to deny set off of losses.

Tribunal's ruling

- The Tribunal ruled in favor of the Taxpayer and held that the limitation under Section 79 was not triggered in the present case for the reasons highlighted below.

No change in beneficial voting power of 51%

- There was no change in the beneficial voting power in the Taxpayer which continued to remain with the promoters in both the years of incurrence of loss and the claim of set off. The promoters continued to hold 51% of the voting power post transfer of the shares in the TY under consideration.

- The relevant provisions of Section 79 lay emphasis on "voting power" and not "shareholding". The condition is not on the direct holding of shares of the taxpayer, but exercise of the voting power, such that, the parity of the shareholders holding beneficial voting power of 51% should be maintained to avoid the limitation of this Section.

- The provisions applicable to start-up companies specifically refer to "shareholding" and not "voting power". The sharp contrast in language clearly shows that the provisions applicable for taxpayers are not on shareholding, but on voting power.

- The phrase used in Section 79 is "beneficially ***held***, and not "beneficially owned", which indicates that ownership of shares by the same persons is not contemplated for the purpose of set-off of loss. What is to be seen is whether the benefit of voting rights is held by the same person.

- "Beneficially held" suggests a wider meaning to cover a situation wherein, if a person is able to influence voting rights to the extent of 51% through a chain of holding, then, the same would be sufficient to not trigger the limitation under Section 79. As long as such person continues to hold 51% beneficial holding in the year of set-off. It indicates indirect control of voting rights through a chain of holding in the same group.

- Reliance was placed on the Karnataka HC's decision in the case of Amco Power Systems Ltd. (supra), where the Karnataka HC had held that it is the beneficial shareholding with voting power of 51%, and not the direct ownership of shares that is relevant for the purpose of the Section. In the case before Karnataka HC, a shareholder company holding 100% shares directly in taxpayer company was reduced to 6%. However, such shareholder continued to hold 51% beneficial voting power through its wholly-owned subsidiary basis which Karnataka HC allowed carry forward and set-off of losses.

- Reliance was also placed on the Delhi HC's decision in the case of Select Holiday Resorts [4]. In the case before the Delhi HC, the taxpayer company was directly held to the extent of 98% by one shareholder company. Such shareholder company (amalgamating company) merged with the taxpayer company and, by virtue of the merger, the shareholders of the [(2013) 35 taxmann.com 368] [(2013) 35 taxmann.com 368] amalgamating company became direct shareholders of the taxpayer company. The Delhi HC denied applicability of Section 79 on the ground that there was no change in the control and management of the taxpayer company post amalgamation and the change in the shareholding was a consequence of the amalgamation where the shareholder company of the taxpayer company (amalgamating company) ceased to have legal existence.

- The SC decision in the case of Vodafone (supra) was distinguished on the basis that SC applied the concept of "separate legal entity" for the purpose of levy of capital gains on indirect transfer of shares of foreign entities where there was a consequent change in control over the Indian company. The SC decision was not on the scope of Section 79, which uses the phrase "beneficially held" which may include entire group control or holding voting power through intermediate/chain holdings.

- The Delhi HC decision in the case of Yum Restaurants India [(2016) 380 ITR 637] was distinguished on the ground that the taxpayer had failed to justify that the beneficial owner of shares continued to remain the same post transfer of the shares. In the case before the Delhi HC, there was transfer of 100% shares of the taxpayer company between sister subsidiaries.

Section 79 not applicable on brought forward losses

- Section 79 may not be apply for set off of brought forward losses. The limitation under this Section would apply only to determine the eligibility of carry forward and set off of losses incurred in subsequent years when there is a breach of 51% shareholding with beneficial voting power.

Source: Ruling of the Mumbai Tribunal in the case of Wadhwa & Associates Realtors Pvt. Ltd [TS-82-ITAT-2018].

Key Direct Tax Developments

1. Central Board of Direct Taxes (CBDT) notifies "Centralised Communication Scheme (CCC), 2018" for issuance of e-notices and verification of information

Background

- The Tax Authority, under the provisions [Section 133(6) of the ITL] of the ITL, could seek a statement or information from any person, including banking companies, which may be relevant in relation to any enquiry or proceedings carried on against a specific taxpayer. The cross verification of information collected generally used to happen only in the course of scrutiny assessment against the specific taxpayer.

- Finance Act 2014 introduced new provisions wherein the Tax Authority, for the purpose of verification of information already in its possession relating to any person, is empowered to call from such person information or documents relevant to any inquiry or proceedings under the ITL. The information sought under these provisions is required to be furnished by taxpayers irrespective of pendency of any proceedings against such taxpayers.

- Subsequently, vide Finance Act 2017 an amendment was carried out providing the power to the CBDT to make a scheme for centralized issuance of e-notices and processing of information/documents furnished by taxpayers and making available the outcome of such processing to the Tax Authority.

- In furtherance, the CBDT has, vide Notification no. 12 of 2018 dated 22 February 2018, notified the Scheme for centralized issuance of notice.

CBDT Notification

Key features of the Scheme are as under:

- Under this Scheme, the Centralised Communication Centre (CCC) shall issue notice to any person from whom it requires information or documents for the purpose of verification of information in possession of the CCC.

- The notice, with the digital signature of the designated authority, shall be served by delivering a copy via email or by placing a copy in the registered e-filing account of taxpayers on the web portal of the CCC, followed by an intimation through phone text message.

- The required information or documents, shall be furnished by taxpayers on or before the date specified in the notice and the designated authority shall also ensure its compliance by way of sending emails, text messages, reminders, letters and outbound calls.

- The CCC may prescribe a machine-readable structured format for furnishing of information or documents. Further, the procedure, format and standard in which the response is required to be furnished will also be specified by the concerned authority [Principal Director General of Income-tax (Systems) or Director General of Income-tax (Systems)].

- Further, in order to carry out any proceedings, no person shall be required to appear personally or through authorized representative before the designated authority at the CCC.

- Additionally, for effective functioning of the CCC, procedures and processes shall be specified in future on the below illustrative matters:

  - format and procedure for issue of notices;

  - procedure of receiving any information or document in response for the notices;

  - mode and format for issuance of acknowledgments of the responses furnished;

  - provision of web portal facility including login facility, tracking status of verification, display of relevant details, and download facility;

  - call centre to answer queries and provide support services, including outbound calls and inbound calls seeking information or clarifications;

  - managing administration functions such as receipt, scanning, data entry, storage and retrieval of information and documents in a centralized manner;

  - grievance redressal mechanism in the CCC

Source: A recent Notification no. 12 of 2018 dated 22 February 2018 (Notification) issued by CBDT (The apex administrative body for direct taxes in India), which provides for a scheme for centralized issuance of notice, called as Centralised Communication Scheme, 2018.

2. Finance bill, 2018 (the bill) proposes tax on long-term gains arising on sale of listed equity shares – Impact on employee stock option plans

Background

- As per existing provisions of Section 10(38) of the Act, long-term capital gains arising from transfer of, inter alia, equity shares of a company are exempt from Income-tax.

- The exemption from tax under Section 10(38) of the Act can be claimed if:

  - such equity shares are held for a minimum period of 12 months from the date of acquisition; and

  - STT is paid at the time of transfer. However, in case of equity shares acquired after 1 October 2004, STT is required to be paid even at the time of acquisition (subject to notified exemptions (Notification No.43/2017 dated 5 June 2017)).

- Notification no. 43/ 2017 dated 5 June 2017 issued by the Central Board of Direct Taxes (CBDT) provides exemption for certain modes of acquisition of equity shares to which the requirement of payment of STT at the time of acquisition does not apply for the purpose of claiming tax exemption under Section 10(38) of the Act. The modes of acquisition to which the exemption applies includes acquisition of shares under ESOPs framed under the guidelines issued by the Securities and Exchange Board of India (SEBI) (It is important to note that though Notification No. 43/2017 mentions schemes framed under the Securities and Exchange Board of India (Employee Stock Option Scheme and Employee Stock Purchase Scheme) Guidelines, 1999, the said guidelines have been replaced by Securities and Exchange Board of India (Share Based Employee Benefits) Regulations, 2014 effective 28th October 2014.

- Based on this, long-term capital gains arising from sale of listed equity shares allotted under an employee stock option plan are exempt from tax under the existing provisions even though STT was not paid at the time of allotment of such shares.

- Further, long-term capital loss from such shares cannot be set-off in the current year or carried forward for set-off against future long-term capital gains.

Proposed changes

- The Bill proposes to withdraw this exemption under Section 10(38) of the Act.

- The proposed provisions would, inter alia, impact long term capital gains arising from sale of listed equity shares allotted to employees under ESOPs.

- Gains from sale of equity shares in a company listed on a recognized stock exchange in India held for a minimum period of 12 months from the date of acquisition are proposed to be taxed as long-term capital gains with effect from 1 April 2018.

- The proposed regime will apply to such shares if STT is paid at the time of acquisition as also transfer. However, this condition may be relaxed for specified nature of acquisition as may be notified by the Government.

- The Government has also issued Frequently Asked Questions (FAQs) (F. No. 370149/20/2018-TPL dated 4 February 2018) to clarify various questions that may arise in relation to this proposal.

- As per the FAQs, Notification No. 43/2017 is proposed to be reiterated for the purpose of the proposed regime of taxation of long-term capital gains arising on transfer of listed equity shares.

- The taxability would occur on gains exceeding INR 1 lakh.

- The applicable tax rate would be 10 percent without the benefit of indexation and foreign exchange fluctuation (plus applicable surcharge and cess).

- Tax treatment of shares acquired prior to 1 February 2018 – Grandfathering provisions are as follows:

  - For computing gain/ loss in relation to shares acquired prior to 1 February 2018, the cost of acquisition shall be higher of (a) and (b)

    (a) Actual cost of acquisition

    (b) Lower of :

    - Fair Market Value (FMV) of such assets as on 31 January 2018; or

    - Full value of consideration accruing or arising on transfer of such asset.

  - FMV in relation to a listed equity share means the highest price of such share quoted on a recognized stock exchange on 31 January 2018 or if there is no trading on 31 January

2018, the highest price on the immediately preceding date when it was traded on such exchange.

Impact on listed shares acquired under ESOPs – Our analysis

- **Additional tax burden on sale of listed equity shares**
  - The proposed amendment impacts taxability of listed equity shares acquired by employees under ESOPs irrespective of whether shares were listed or unlisted at the time of acquisition/ allotment.
  - Where the listed equity shares are sold after 1 April 2018, long-term capital gains exceeding INR 1 lakh will be subject to tax at 10 percent without indexation benefit and foreign exchange fluctuation as per proposed Section 112A, though the benefit of grandfathering based on FMV as on 31 January 2018 would be available.
  - Therefore, based on above, there is an impact on potential wealth realization of employees under ESOPs of listed companies due to additional tax burden at the time of sale of shares.
  - The taxability arising on sale of shares would vary depending on whether shares were listed or unlisted at the time of allotment of shares.
- **Long-term capital loss from sale of listed equity shares**
  - Under the existing provisions, long-term capital loss from sale of listed equity shares cannot be set-off in the current year or carried forward for set-off against future long-term capital gains.
  - However, under the proposed provisions, if the sale of listed equity share results in a loss, such loss would be allowed to be set-off or carried forward for set-off against future long-term capital gains as per provisions of the Act.
  - Therefore, in case the employees are expecting a loss on sale of listed equity shares, they may plan to sell shares after 1 April 2018 to avail the benefit of set-off and carry forward of long-term capital loss.
- **Shares allotted by companies pre Initial Public Offering (IPO).**
  - There is an ambiguity in calculation of long-term capital gain on equity shares which were allotted pre-IPO before 31 January 2018 but would be sold on or after 1 April 2018 after being listed.
  - The proposed Section 112A specifies the manner of calculation of FMV for the purpose of computation of the capital gains, inter alia, arising from sale of listed equity shares. However, the said section or FAQs are silent on the manner of calculation of FMV in case of shares which were unlisted as on 31 January 2018 but which are subsequently listed.
  - This has resulted in uncertainty on whether the benefit of grandfathering in the form of stepped up cost of acquisition based on FMV as on 31 January 2018 would apply in such cases.
  - In case benefit of grandfathering is not available, it may result in a higher tax burden for individuals who were planning to liquidate/ sell the unlisted shares allotted to them under ESOPs.
  - There is a need for the Government to come up with a clarification to cover the shares which were not listed as on 31 January 2018 (but have been subsequently listed) under the grandfathering provisions.
- **Unlisted shares subscribed by an ESOP trust**
  - Typically, a lot of companies allot shares to a trust pre- IPO under an ESOP which are later sold by the trust post listing. Under the existing provisions, sale of listed equity shares by the trust is exempt from tax under Section 10(38) of the Act.
  - However, under the proposed provisions, where unlisted shares were acquired by the trust (no STT paid), long-term capital gains arising on of sale of listed shares by the trust may be taxable under Section 112A at 10% if the Notification issued in context of Section 10(38) is reiterated.

Illustration – Impact of proposed amendment

Ref	Particulars	Taxability pre-budget	Taxability post-budget
A	Date of allotment of shares	1 Jan 2015	1 Jan 2015
B	Exercise price (INR)	80	80
C	FMV of shares on date of exercise (INR)	100	100
D	Perquisite value on allotment of shares (INR) (c-b)	20	20
E	FMV of shares on 31 January 2018 (INR)	200	200
F	Date of sale of Shares	31 March 2018	1 April 2018
G	Sale consideration (INR)	250	250
H	Cost of acquisition (INR)	100	200 [Higher of c and (lower of e and g)]
I	Indexed cost of acquisition (INR) (Note 1)	113 (100*272/240)	Indexation not available
J	Long-term capital gains (INR)	137	50
K	Tax (INR)	Exempt under Section 10(38)	5

Note 1: Cost Inflation Index (CII) for tax year 2014-15 = 240 and for tax year 2017-18 = 272

Source: The Finance Bill, 2018 (the Bill)

Key Regulatory amendments

This section summarizes the regulatory updates for the month of March 2018.

Notifications issued by Reserve Bank of India (RBI)

RBI revised the directions on 'Hedging of commodity price risk and freight risk in overseas markets'

RBI has issued the guidelines for hedging commodity price risks and freight risks in overseas markets wherein the majority of powers has been delegated to the Authorized Dealer banks (AD Banks). The said directions will come into effect from 1st April 2018.

In this regard, the key amendments made in the revised directions are listed below:

- Residents (non-individuals) hedging their commodity price risks and freight risks under a specific approval from RBI given under the approval-route based on the previous set of guidelines would be permitted to continue hedging under the said approval till 30 June 2018 or the last date specified in the approval, whichever is earlier.
- Eligible commodities whose price risks may be hedged would include all commodities, except gold, gems and precious stones in case of direct exposure, and in regard to indirect exposures, whose price risks could be hedged would include aluminium, copper, lead, zinc, nickel, and tin.
- In this regard, the term 'direct exposure to commodity price risk' has been defined as-
  - if an eligible entity purchases/ sells a commodity (in India or abroad) whose price is fixed by reference to an international benchmark ; or
  - if an eligible entity purchases/sells a product (in India or abroad) which contains a commodity and the price of the product is linked to an international benchmark of the commodity.

- Structured products may be permitted to eligible entities who are listed on recognised domestic stock exchanges or fully owned subsidiaries of such entities or unlisted entities whose net worth is over INR 200 crore, subject to the condition that such products are used for hedging as defined under the directions.
- AD Banks licensed as AD – Category I by RBI, may permit eligible entities to hedge commodity price risk and freight risk overseas using permitted products and may remit outside India foreign exchange in respect of such transactions after satisfying themselves that :
    - The entity has exposure to commodity price risk or freight risk, contracted or anticipated.
    - The quantity proposed to be hedged and the tenor of the hedge are in line with the exposure.
    - In case of OTC derivatives, the requirement to undertake OTC hedges is justified.
    - In case of hedging using a benchmark price other than that of the commodity exposed to, the requirement to undertake such hedges is justified.
    - Such hedging is taken up by the management of the entity under a policy approved by the Board of Directors of a company or equivalent forum for other.
    - The entity has the necessary risk management policies in place.
    - The entity has reasonable understanding of the utility and likely risks associated with the products proposed to be used for hedging.
- Realisation and repatriation of foreign exchange due or accruing to an eligible entity resulting from permitted transactions under this direction shall be guided by the provisions of the Foreign Exchange Management (Realisation, repatriation and surrender of foreign exchange) Regulations, 2015.
- AD Banks are permitted to issue Standby Letters of Credit (SBLC)/ guarantees, for a maximum period of one year, on behalf of their clients in lieu of making a remittance of margin money for commodity hedging transactions entered into by their customers. AD Banks should ensure that these SBLCs/ guarantees are used by their clients for the intended purposes.
- AD Banks shall undertake immediate corrective action in case of any irregularity or misuse of these directions. All such cases should be reported to Chief General Manager, Financial Markets Regulation Department, RBI.

Source: A.P. (DIR Series) Circular No. 19 dated 12 March 2018