# EY Tax and Regulatory Alert

May 2018

Prepared for ACMA

Contents

- Indirect Tax
- Direct Tax
- Regulatory

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# Indirect Tax

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

## Judicial Precedents

1. M/S U.P. Sales & Services
v/s
M/S Vrandavaneshwree Automotive Private Limited

[2018-VIL-01-NAA]

### Background and facts of the case

- The brief facts of this case is that an application dated 01-11-2017 was filed by M/s U.P. Sales & Services ('Appellant') before the Standing Committee, constituted under Rule 123 (1) of the above Rules in which it is stated that appellant had entered into a contract dated 28-04-2017 for supply of a Honda Car having Model No. WR-V 1.2 VX MT (i-VTEC) through the above M/s Vrandavaneshwree Automotive Private Limited ('Respondent'), who was an authorised dealer of M/s Honda Car India Ltd. at Bareilly, for an amount of Rs. 9,13,300/- which included Excise Duty @ 35%, Central Sales Tax (CST) @ 2% and UP Value Added Tax (VAT) @ 14% (Total 51%).

### Appellant's Contention

- It is stated by the appellant that they had taken delivery of the Car on 11-07-2017 after coming into force of the GST w.e.f. 01-07-2017, by paying an amount of Rs. 8,98,750/-.

- Appellant had further stated that after 01-07-2017 the respondent was required to reduce the Excise Duty, CST and VAT amounting to 51% from the price of the Vehicle of Rs. 9,13,300/- and then charge SGST @ 14%, CGST @ 14% and Cess @ 1% (Total 29%) on the reduced price.

### Respondent's Contention

- Respondent's Contention is that they he was registered under the GST and was engaged in trading and servicing of the cars and he was bound to sell cars at the ex-showroom price fixed by M/s Honda Cars Ltd. The respondent had justified the price charged by him from the applicant and maintained that the contention of the applicant that the pre-GST duties and taxes on such cars amounted to 51% was wrong and in fact, the total pre-GST tax incidence was 29.17% only and hence, there was a very negligible difference in the incidence of tax.

- The respondent had also submitted that he had reduced the dealer's margin from Rs. 33,736/- to Rs. 25,826/- and the price of the car by Rs. 4,000/- on account of the change in the colour of the car from Orchid White (premium colour) to Alabaster Silver (base colour), as per the appellant's request.

### Findings of Director General of Safeguards ('DGSG')

- The DGSG had found that the contention of the respondent that he had reduced the dealer's margin was not correct, as was evident from his reply dated 28-01-2018 enclosing therein the price list. It had also been revealed that the respondent, in his first reply dated 26-12-2017, had stated that he had reduced his margin from Rs. 33,736/- to Rs. 25,826/- but in his subsequent reply dated 28-01-2018, he had furnished a post-GST price list wherein two types of dealer's margins were shown, the first was of an amount of Rs. 26,619/- and the second was of an amount of Rs. 7,000/- shown as dealer's margin "1".

- The DGSG had concluded that the total dealer's margin appeared to be Rs. 33,619/- and not Rs. 25,826/-, as claimed by the respondent.

- The DGSG had investigated whether the rate of tax on the car had been reduced post-GST and if so, whether there was substantial reduction in the rate of tax as had been contended by the applicant and whether the benefit of reduction in rate of tax had been passed on to the applicant.

- The DGSG had further found that the contention of the applicant that the total incidence of tax on the car was reduced from 51% to 29% post-GST, was also not correct as there was a minor reduction in the tax rate in the post-GST period and the tax rate had remained more or less the same.

- The DGSG had also found that the allegation of the applicant that the total tax prior to the implementation of GST was 51%, which was reduced to 29% w.e.f. 01-07-2017, was not correct. He had further found that claim of the applicant that though the price charged from him of Rs. 8,98,750/- was less than the contractual

price of Rs. 9,13,300/-, still the said reduction was not commensurate with the reduction in the rate of tax was also not correct.

- The investigation report submitted by the DGSG was considered by the Authority in its meeting held on 01-03-2018. Accordingly vide notice dated 01-03-2018, the applicant submitted his replies vide emails dated 15-03-2018 and dated 16-03-2018.

- With regard to point that "Whether there was a substantial reduction in the rate of tax on the cars after the GST was implemented w.e.f. 1st July 2017 as claimed by the applicant and whether the benefit as emanating from such reduced tax rate has not been passed on to the applicant in the form of commensurate reduction in the price of the car purchased by him". In respect to the same it has been found that that the applicant's contention that the pre-GST rate of tax which was 51% was reduced to 29% in post GST era, was factually incorrect as the pre-GST rate of tax, on the car contracted to be purchased by the applicant, was leviable at 31.25% which was rationalized to 29% (CGST-14%+SGST-14%+Cess-1%), thus there was a reduction of only about 2%.

- With regard to second point that "Whether any input tax credit benefit was to be passed on to the applicant by the respondent". It has been found that the respondent has given details of all the basic components of the price of the car purchased by the applicant as has been mentioned in Table 'B' above and benefit of Rs. 10,550/- on account of reduction of tax by about 2% viz. from 31.254% (pre GST) to 29% (post GST), as discussed above, has already been passed on to the applicant and the amount of Rs. 10,550/- is inclusive of the ITC as has been calculated in Table 'B'. Therefore, no additional benefit on account of ITC is required to be paid by the respondent.

- Based on the above mentioned facts, it has been concluded that respondent has not contravened the provisions of Section 171 of the CGST Act, 2017 and accordingly appeal of appellant has been dismissed.

## 2. Tata Motors Limited v/s Commissioner of Customs (Import) Nhava Sheva

[2018-VIL-307-CESTAT-MUM-CU]

### Background and facts of the case

- Revenue is in appeal against order-in-original of Commissioner of Customs (Adjudication), Mumbai, which, while confirming demand of Rs.15,20,555/- on M/s Tata Engineering and Locomotive Co Limited under section 28 of Customs Act, 1962, holding the goods valued at Rs.47,88,503 to be liable to confiscation under section 111(o) of Customs Act, 1962 and imposing of penalty of Rs. 8,00,000 under section 112 of Customs Act, 1962, had omitted to impose redemption fine in lieu of confiscation under section 125 of Customs Act, 1962.

- It would appear that certain entities had resorted to Duty Entitlement Pass Book Scheme under the Foreign Trade Policy for obtaining scrips to enable import of goods without payment of duty and that the assessee purchased sixteen of those against which imports had been effected vide bills of entry no. 6568/16.10.1998, 611/2.11.1998 and 8244/21.10.1998 for a total value of Rs.47,88,503 and availed exemption to the extent of Rs 15,50,255.

### Judgement

- There is nothing on record to indicate that the imports effected by the importer had been covered by a bond. The non-availability of the confiscated goods is not in question. Therefore, even in the absence of a finding or any justification in the impugned order for non-imposition of fine, there is no scope for quantification of such fine without goods being available for redemption or a bond that covers recovery of fine.

- The principal contention of the appellant-importer is that they procured the scrips without being aware of the background and that licence obtained by misrepresentation is only voidable as held by the Hon'ble Supreme Court in East India Commercial Co Ltd v. Collector of Customs, Calcutta [1983 (13) ELT 1342 (SC)] - 1962-VIL-08-SC-CU and in Union of India v. Summit [1992 (58) ELT 153 (SC)] that the import licence that was valid at the time of importation would prevail over any subsequent cancellation. Intent to evade duty is not manifest in the circumstances in which importer obtained the scrips.

- Following the above decisions of the Hon'ble Supreme Court, demand of duty is upheld but penalty imposed is set aside.

## Key Indirect Tax Developments

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

### 1. Authority for Advance Ruling on taxability of liquidated damages

Background and Facts of the Case:

- Maharashtra State Power Generation Company Limited is a State Power Utility engaged in generation of power with the objective to make power available to all at affordable rates;
- In case of various contracts entered into by the company, there is a clause to deduct Liquidated damages (LD) in case of default by the contractor/vendor to complete the work in time in time. The LD is deducted in two cases:
  - Operation and maintenance activities: If there is delay on the part of the contractor to provide materials/services; liquidated damages (LD) are deducted from the amount payable to vendor. The LD so deducted is treated as income.
  - Construction of new power plants or renovation of old plants: If there is a delay by the contractor in completing the contract, then liquidated damages (LD) are calculated as per contract terms and levied upon the contractor. In accounting, the LD imposed is reduced from the total project cost while capitalizing the asset;

The applicant sought an advance ruling on :

- Whether the recovery of LD from the invoice of the contractor amounts to supply;
- In case the GST is payable on the LD, will the rate of GST be classified as a separate supply of will it be classified under the category in which the services of the contractor are classified;
- Whether the GST on Liquidated Damages is covered under Schedule II entry No 5(2)(e) vide HSN code 9997;
- What will be construed as the time of supply. Will it be the period in which delay is occurring or it is the time when decision to impose Liquidated Damages is taken;
- If some part of delay has occurred before GST roll-out and some part of delay has occurred after GST roll-out, whether GST will be applicable to the Liquidated Damages imposed for entire period of delay or to the period falling after GST roll-out;
- Whether the contractor/ vendor will be able to utilize the amount of LD imposed over him as Input Tax Credit subject to satisfying all other conditions.

Observation by Authority for Advance Ruling ('AAR')

- Contract price and liquidated damages are two separate aspects/events, deduction of one from the other is a mere facilitation towards settlement of accounts;
- The payment of liquidated damages is treated as an independent liability under the contract and consideration for the work done remains unaltered. It is not to be adjusted with other payments due to the owner from the contractor;
- There is no clause in the agreement that would tantamount to reducing the contract price or the contract value of the supplies of goods or services or both as made by the contractor.

Ruling

- Empowerment to levy liquidated damages is for reason that there has been delay and the same would be tolerated but for a price or damages, hence, the income of the applicant would be for a 'supply of service' in terms of clause (e) of Para 5 of Schedule II and hence, GST would be applicable in both the cases;
- Such supply i.e. levy of liquidated damages, would be covered under Heading 9997 i.e. "Other services" under Notification No. 11/2017-Central Tax / State Tax (Rate) exigible to GST at 18%;
- Liability of payment of these liquidated damages by the Contractor will be established once the delay in successful completion of trial operation is established on the part of the Contractor. This would define the time of supply;
- In respect of the liquidated damages, if any collected/received under the previously applicable service tax regime before coming into effect of GST, would be dealt with in accordance with the then existent provisions under applicable laws;

- The question if the contractor/ vendor will be able to utilize the amount of LD imposed over him as Input Tax Credit subject to satisfying all other conditions is not answered as the proper person to ask the above question would be the contractor/Vendor and not applicant.

## 2. Authority for Advance Ruling on canteen service to be classified as outdoor catering attracting 18% GST

- The Applicant is engaged in business of caterers and supply food, beverages and other eatables (non-alcoholic drinks) at various places of its customers, who have in house canteen at their premises.

- While, the Applicant was classifying its services as "outdoor catering" under heading 9963, charging 18% GST on its supplies, one of the customer of applicant asked to treat the supply as akin to service provided by a restaurant, eating joint including mess, canteen which would attract GST at a lesser rate of 5% (earlier at the time of filing AAR, it was 12%)

- As per contract entered between the Applicant and its customer has following:

  - The canteen space and the equipments would be provided by the customer only

  - The applicant would provide service pertaining to Food and edible preparation service.

  - The activity of running of canteen and its total affairs, including supply of snacks, Tea, Lunch and Dinner to the employees/workers of the customer would be undertaken by the applicant

  - The customer have agreed to pay pre-decided rate per card punch for normal or special lunch, with charges for snacks and tea being payable in cash by employee only.

  - The menu would be decided by the canteen committee for time to time, which will consists of 'limited' and 'unlimited' items.

Arguments/submissions by the applicant

- The applicant submitted that it is an industrial canteen contractor providing catering services to manufacturing industries, which is a statutory canteen maintained under law and thus, basis the clarification issued by tax research unit, department of revenue vide circular F. No. 354/03/2018 (Circular No. 28/02/2018-GST dated 08.01.2018), the supply of applicant should attract 5% GST.\

- The supply of applicant shall be classified under sl. No. 7(i) of the Notification No. 11/2017-Central Tax (rate) dated 28.06.2017 ('Notification'), attracting GST at the rate of 5%. The relevant extract of the said entry is reproduced as under:

  > *" Supply, by way of or as part of any service or in any other manner, whatsoever, of goods, being food or any other article for human consumption or drink, where such supply or service is for cash, deferred payment or other valuable consideration, provided by a restaurant, eating joint including mess, canteen, whether for consumption on or away from the premises where such food or any other article for human consumption or drink is supplied, other than those located in the premises of hotels, inns, guest houses, clubs, campsites or other commercial places meant for residential or lodging purposes having declared tariff of any unit of accommodation of seven thousand five hundred rupees and above per unit per day or equivalent"*

Observations and Ruling by AAR

- The rates for the meal, snacks, tea have been fixed and payable by the customer. Also, the menu is required to be decided by the canteen committee of the customer, thus the applicant, who is caterer, is providing service from other than his own premises to the customer. Therefore, the nature of service of the applicant would be that of outdoor catering.

- Even though the meal, snacks, teas are provided to and consumed by the workers/employees of the customer, it is clear from the contract that the applicant is providing service to customer and not to workers/employees of the customer. Basis this, the supply of the applicant would not be in the nature of service provided by a restaurant, eating joint including mess, canteen.

- The AAR also referred the judgement pronounced by the Hon'ble High court of Allahabad in the case of Indian Coffee Workers' Co-op. Society Ltd. Vs.

CCE & ST, Allahabad [2014 (34) S.T.R. 546 (All.)], wherein it was held that:

*" The taxable catering service cannot, in our view, be confused with who has actually consumed the food, edibles and beverages which are supplied by the assessee. Taxability of the charge of tax does not depend on whether and to what extent the person engaging the service consumes the edibles and beverages supplied, wholly or in part. What is material is whether the service of an outdoor caterer is provided to another person and once it is, as in the present case, the charge of tax is attracted".*

- The expression 'outdoor catering' has not been defined under the Central Goods & Services Tax Act, 2017 / Gujarat Goods & Services Tax Act, 2017 or the notifications issued thereunder. In the said scenario, AAR considered the principle laid down under above judgement.

- Basis above, the supply of the applicant would be classified as outdoor catering service attracting GST @ 18% as prescribed under Sl. No. 7(v) of the Notification and the fact that the meal, snacks, tea etc. are consumed by the workers/employees of the recipient would not alter the nature of service provided by the applicant.

## 3. Advance Ruling taxing Hotel accommodation services consumed outside SEZs, as 'intra-State' supplies

Background and facts of the case:

- The Applicant is engaged in hotel business, having hotel "Fairfield Marriott" and provides hotel accommodation & restaurant services to the employees & guests of some of the units in SEZ, Belgavi, in addition to the regular customers, charging SGST & CGST at the applicable rates;

- The SEZ units contended that the services are being supplied / rendered to SEZ units only and hence NIL rate of GST is applicable;

Observation of the AAR:

- On combined reading of Section 16(1)(b) of IGST Act 2017 & Rule 46 of CGST Rules 2017, it is clearly evident that the supplies of goods or services or both towards the authorised operations only shall be treated as Supplies to SEZ Developer / SEZ Unit;

- Also, since the applicant is located outside the SEZ, the services rendered by the applicant are neither the part of authorised operations nor consumed inside the SEZ.

Ruling:

- The Hotel Accommodation & Restaurant services being provided by the Applicant, within the premises of the Hotel, to the employees & guests of SEZ units, cannot be treated as supply of goods & services to SEZ units in Karnataka & hence the intra state supply and are taxable accordingly.

## 4. Advance Ruling on applicability of GST on freight and transportation on supply of works contract services

Background and Facts of the Case:

- The Applicant (EMC Ltd.) is stated to be a supplier of materials and allied services for erection of towers, testing and commissioning of transmission lines and setting up sub-stations collectively called the Tower Package;

- EMC Ltd. seeks to undertake two separate sets of contracts - first contract includes ex-works supply of all equipment and materials such as transmission line towers, spares and accessories thereof, whereas second contract involves supply of allied services like erection of towers, testing and commissioning, including transportation, in-transit insurance etc.;

- The contractee agrees to reimburse the actual GST payable, except on the price component for inland/local transportation, in-transit insurance and loading/unloading and therefore, the applicant raises separate freight bills on the contractee as per the rate schedule annexed to the Second Contract.

- The applicant wants a ruling on whether he is liable to pay tax on freight bills, since Notification No. 9/2017- issued under Integrated Tax (Rate) Dated: 28/06/2017 (attached herewith for your ready reference), grants exemption on transportation service provided by an entity other than goods transport agency (GTA) and the applicant is neither a GTA nor engaged in insurance business.

Observation by Authority for Advance Ruling ('AAR')

- Although goods to be supplied involve movement and / or installation at site, the first contract does not include provision and cost of such transportation and delivery, in other words, the first contract has "no leg" unless supported by second contract;

- It is apparent that the first contract cannot be executed independent of the second contract as there cannot be any "supply of goods" without a place of supply. So, the first contract, however, does not include the provision and cost of such transportation and delivery. It, therefore, does not amount to a contract for "supply of goods" unless tied up with the second contract.

- Further, the two contracts are linked by a cross fall breach clause and therefore, notwithstanding the break-up of contract price, they must be construed as a single source responsibility contract. The composite nature is clear from the clause that defines satisfactory performance of first contract (supply of goods) at the time when goods so supplied are installed and finally commissioned in terms of second contract;

Ruling

- The applicant supplies works contract service, of which freight and transportation is merely a component and not a separate and independent identity, and GST is to be paid at 18% on entire value of the composite supply, including supply of material, freight and transportation, erection, commissioning etc.

## 5. 27th GST council meeting held on 4th May 2018.

New Return Filing Process

- Based on the recommendations of the Group of Ministers on IT simplification, the principles on the new return filing process has been approved by the GST Council.

- Proposed Schema for the new return filing process (key points):

  - One monthly return format with due dates on staggered basis depending on the turnover of the tax payer to manage the load on IT system.

  - Unidirectional flow of invoices – Seller would be required to upload the invoice which would be the valid document to avail input tax credit by the buyer. This can be viewed by the buyer continuously without having to upload the purchase invoices

  - The B2Bdealers will have to fill invoice wise details of the outward supply made by them, based on which the system will automatically calculate his tax liability. The input tax credit will be calculated automatically by the system based on invoices uploaded by his sellers.

  - Automatic reversal of input tax credit from buyer on non-payment of tax by the seller, with some exceptional scenarios to provide an option to the Revenue Authorities to seek reversal of credit from the buyer.

  - Recovery of tax or reversal of input tax credit shall be through a due process of issuing notice and order.

  - Unloading of invoices by the seller to pass input tax credit who has defaulted in payment of tax above a threshold amount shall be blocked to control misuse of input tax credit facility

Transition stages before implementation of new return filing model:

- Stage 1 - GSTR-1 and GSTR-3B (presently followed) would continue for a period not exceeding 6 months by which time new return software would be ready. GSTR2 and GSTR 3 shall continue to remain suspended.

- Stage 2 - The new return will have facility for invoice-wise data upload and also facility for claiming input tax credit on self-declaration basis, as in case of GSTR 3B now. There would be constant update on the amount of credit availed by the tax payer on provisional basis vis-à-vis the amount of credit available as per the invoice uploaded by their seller.

- After 6 months of this phase 2, the facility of provisional credit will get withdrawn and input tax credit will only be limited to the invoices uploaded by the sellers from whom the dealer has purchased goods.

- The details of the design of the return form, contents, business process and legal changes

would be worked out by the law committee based on the principles agreed during the GST Council meeting.

Other matters

- GST Council approved to convert GSTN into a fully owned Government Company.

- Incentives to promote digital transactions – The GST Council has discussed in detail the proposal of a concession of 2% in GST rate. The council has recommended for setting up of a Group of Ministers from State Governments to look into the proposal and make recommendations, before the next Council meeting.

- Imposition of Sugar Cess over and above 5% GST and reduction in GST rate on ethanol – The GST Council discussed the issue of imposition of sugar cess and reduction in GST rate on ethanol in great detail. The council has recommended for setting up of a Group of Ministers from State Governments to look into the proposal and make recommendations, within two weeks.

# Direct Tax

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

## Judicial Precedents

1. Supreme Court (SC) rules that that exclusions from export turnover also to be reduced from total turnover in computing tax holiday benefit

### Background and facts of the case

- Section 10A of the ITL provides tax holiday with respect to profits and gains derived from undertakings engaged in the export of articles or things or computer software for a period of 10 consecutive years, subject to conditions specified therein (Tax Holiday).

- The benefit of Tax Holiday is restricted to profits derived from export of articles or things or computer software and the quantum of such export profits is determined basis the following normative formula:

  $$\text{Total profits of the business of the undertaking} \times \frac{\text{Export turnover (ETO) of the undertaking}}{\text{Total turnover (TTO) of the undertaking}}$$

- For the purpose of Tax Holiday, the term "ETO" defined in the provision excludes recovery or consideration towards (a) freight, telecommunication charges or insurance incurred to deliver the articles or things or computer software outside India and (b) expenses incurred in foreign exchange in providing technical services outside India (Expenses).

- The term "TTO" is not defined for the purposes of Tax Holiday. However, as per its definition in other provisions of the ITL dealing with export incentives, TTO is not to include consideration towards freight or insurance attributable to transport of goods or merchandise beyond custom stations.

- Issue often has arisen in the past as to whether, while resolving normative formula for determining export profits, the recovery of Expenses excluded from ETO (numerator) are also to be reduced from the TTO (denominator) in absence of any definition of TTO in Tax Holiday provision.

- In this regard, The Tax Authority's contentions generally are that when TTO is not defined in Tax Holiday provision, its ordinary meaning should be adopted. Since the ordinary meaning of the said term does not envisage reduction of recovery of any such Expense, the claim of the Taxpayer that recovery of Expenses should be reduced from TTO in calculating Tax Holiday benefit is unwarranted.

- As against that, the taxpayers contend that recovery of Expenses which are reduced from the ETO as per the definition are also required to be excluded from TTO to maintain parity. Any other view may render normative formula with undesirable results.

- Various High Courts (HCs) favored the proposition that recovery of such Expenses which were required to be excluded from ETO are also to be excluded from TTO for the purposes of Tax Holiday benefit.

- The present SC ruling involves a bunch of appeals filed by the Tax Authority against various HC decisions on the issue.

### Issue before the SC

While working out normative formula for determining export profits, whether the recovery of Expenses excluded from ETO (numerator) are also to be reduced from the TTO (denominator) in absence of any explicit definition of TTO in the tax holiday provision?

### Supreme Court ruling

The SC accepted the Taxpayer's contention and held that for proper computation of export profits for Tax Holiday provision, normative formula demands exclusion of recovery of Expenses from TTO as well which are excluded from ETO as per the definition. The SC held as under:
*The term TTO which is defined in other provisions of export incentive cannot be imported to Tax Holiday provision:*

- The term TTO defined under other export incentive provisions of the ITL is defined only for the purpose of those provisions and cannot be adopted for the purpose of Tax Holiday provision.

This is for the reason that the definition of the term is for a specific provision and not for the entire ITL.

- The definition which provides for reduction of recovery of expenses from TTO cannot be adopted for Tax Holiday purposes also for the reason that the ordinary meaning of TTO which is relevant for Tax Holiday benefit does not envisage reduction of recovery of any Expenses from the total amount.

- When the meaning of TTO is clear, there is no necessity of importing the meaning of TTO from the other provisions.

*What is excluded from ETO (numerator) must also be excluded from TTO (denominator):*

- Under common parlance, when the object of formula is to arrive at profits from export business, recovery of Expenses excluded from ETO are to be excluded also from TTO. Any other view would make normative formula unworkable and absurd and would give rise to inadvertent, unlawful, meaningless and illogical result which would cause grave injustice to the taxpayers. Such is not the legislative intent.

- When a term is not defined by the legislature and ordinary meaning is to be attributed to it, such ordinary meaning is to be given in conformity with the context in which it is used. Basis this, what is excluded from the ETO must also be excluded from the TTO as one of the components of the TTO is ETO. Any other interpretation would run counter to the legislative intent and is impermissible.

- If the denominator of the formula (TTO) would include certain amount which the numerator (ETO) does not include, the formula would render undesirable results.

- Provisions of Tax Holiday are to be construed harmoniously and in the manner in which intent of the legislature is preserved and injustice to the taxpayers is avoided.

- An interpretation which makes the enactment as a whole more consistent to the context should be preferred over a construction which creates inconsistency or repugnancy.

*Source: Recent ruling in the lead case of HCL Technologies Ltd. [[2018] 93 taxmann.com 33 (SC)] (Taxpayer) wherein the issue before the Supreme Court*

## 2. Supreme Court rules amendment to disallowance provision to be clarificatory and retrospective in nature

### Background and facts of the case

- Section 40(a)(ia) of the ITL (disallowance provision) (prior to the amendments in 2008 and 2010) provided for disallowance of specified expenses, payable to a resident, on which tax is deductible at source, but such tax has not been deducted or, after deduction, has not been paid on or before the prescribed due date of payment.

- The disallowance provision was amended by the Finance Act, 2008 (2008 Amendment) to provide that no disallowance shall be made in the following cases:

  - Where the tax was deducted in the month of March, the amount of expense would not be disallowed if the tax has been paid before the due date for filing return of income.

  - Where the tax was deducted in any other month of the year, the tax was required to be paid within the month of March of the relevant tax year.

- The 2008 Amendment was made retrospectively applicable from tax year 2005-06, in which the disallowance provision was introduced.

- The disallowance provision was again amended by the Finance Act, 2010 (2010 Amendment), with effect from 1 April 2010, to provide that no disallowance would be made if the tax deducted during the previous year was deposited with the GOI within the due date for filing return of income. In effect, an extended time period for payment of tax deducted was also allowed for cases of tax deducted between April to February of the same year.

- The Taxpayer was a manufacturer and exporter of casting material and had claimed a deduction for certain export commission charges. For tax year 2004-05, the Taxpayer had withheld taxes on the commission charges during July to October 2004, but had deposited tax deducted with the GOI only after the end of the tax year i.e., after 31 March 2005, but before the due date for filing return of income.

- The Tax Authority disallowed an amount of INR 4m paid as commission charges, since the Taxpayer had failed to deposit tax deducted with the GOI before the end of the relevant tax year i.e., within 31 March 2005.

- The First Appellate Authority, the Kolkata Income Tax Appellate Tribunal and the Calcutta High Court (HC) had ruled in favor of the Taxpayer and had held that the amount paid as commission charges should not be disallowed.

- The Tax Authority preferred an appeal to the SC against the order of the Calcutta HC.

## Tax Authority's contentions

- The disallowance provision is prohibitory in nature and requires remittance of the tax amount within the end of the relevant tax year. The 2010 Amendment is prospective in nature and does not apply to the Taxpayer's case. The Tax Authority relied on the decision of the Special Bench of the Mumbai Tribunal in the case of Bharati Shipyard, in which it had held that the 2010 Amendment is prospective in nature.

## Tax Authority's contentions

- The purpose of insertion of the disallowance provision is to ensure compliance with the withholding provisions and not to punish taxpayers which have deposited the taxes with the GOI sooner or later. Reliance was placed on the Delhi HC judgment in the case of Ansal Land Mark Township.

- The 2010 Amendment is also in line with the intention above, that the provision is meant for ensuring compliance with the withholding provisions and not to punish taxpayers and, hence, the 2010 Amendment should be considered as retrospective in nature and should apply to the Taxpayer's case. Reliance was placed on an SC judgment in the case of Allied Motors.

## Supreme Court ruling

## Effect of the 2008 and 2010 Amendments

- The purpose of the disallowance provision was to ensure tax compliance and not to punish taxpayers. The disallowance provision prior to the 2008 and 2010 Amendments caused hardship to taxpayers in respect of tax withheld in the month of March, since they had time of only seven days to deposit the taxes to avoid disallowance.

- To avoid hardship, the disallowance provision was amended by the Finance Act, 2008. However, the 2008 Amendment merely addressed the concerns of those taxpayers which had deducted taxes in the month of March, by allowing them time to deposit the taxes till the due date for filing return of income. Taxpayers which had deducted the taxes before the month of March had to deposit the taxes before the end of March of the relevant tax year and, thus, the hardship faced by these taxpayers remained unaddressed.

- The said hardship is detrimental to small taxpayers which may not be in a position to bear the burden of disallowance.

- The 2010 Amendment removed the hardship by providing that the taxes can be deposited before the due date of filing of return of income by all categories of taxpayers to avoid disallowance. The controversy with the 2010 Amendment is whether it, being curative in nature, should be applied retrospectively, or whether it shall apply from tax year 2010-11 onwards, as clarified in the Explanatory Memorandum to the Finance Act explaining the 2010 Amendment.

## The 2010 Amendment is retrospective in nature

The SC held that the 2010 Amendment is retrospective in nature and, for the following reasons, shall apply to the Taxpayer's case:

- The purpose of the disallowance provision is to ensure tax compliance and not to punish taxpayers. The provision should not be read in a manner which metes out stern punishment and results in malevolent results disproportionate to the offending act and aim of the legislation. The intention of the 2008 and 2010 Amendments was to ensure payment and deposit of taxes withheld with the GOI.

- A provision which is inserted to remedy unintended consequences and to make the provision workable, requires to be treated as retrospective in operation so that a reasonable interpretation can be given to the provision.

- Marginal and medium taxpayers can suffer severe adverse consequences if the 2008 and 2010 Amendments are not given retrospective operation i.e., from tax year 2005-06. Transferring or shifting expenses to a

subsequent year, in such cases, will not wipe off the adverse effect or the financial stress on such taxpayers. This could not have been the intention of the Legislature.

- Reliance was placed on certain past judgements of the SC, wherein it was held that a proviso should be given retrospective effect on the ground that the proviso was added to remedy unintended consequences and to supply an obvious omission. The proviso should ensure reasonable interpretation and retrospective effect would serve the object behind the enactment.

- The 2010 Amendment should be interpreted liberally and equitably so that a taxpayer should not suffer unintended and deleterious consequences beyond the object and purpose of the provision. The 2010 Amendment, being curative in nature, should be given retrospective operation as if the amended provision existed even at the time of insertion of the disallowance provision.

*Source: Recent ruling in the case of Calcutta Export Company [TS-221-SC-2018] (Taxpayer) wherein the issue before the Supreme Court.*

## 3. Supreme Court rules waiver of loan is not taxable as business income

### Background and facts of the case

- In terms of the specific provisions of the ITL, a benefit obtained by a taxpayer by way of remission or cessation of a trading liability, loss or expenditure allowed as a deduction in the past is chargeable as business income in the year of remission or cessation.

- In terms of another specific provision in the ITL, the value of any benefit or perquisite, whether or not convertible into money, arising from business (business perquisite) is treated as business income.

### Facts in the case of lead Taxpayer

- The Taxpayer, an Indian company engaged in the business of manufacturing of jeeps, entered into an agreement with a supplier based in USA (US Co) for purchase of tooling and other equipment for manufacture of jeeps (capital equipment).

- The US Co supplied the capital equipment through its US subsidiary. Further, for procurement of the capital equipment, US Co also provided an interest-bearing loan to the Taxpayer, repayable after 10 years in instalments.

- The Taxpayer capitalized the equipment in its books and claimed depreciation thereon in its tax computation.

- Subsequently, another US entity acquired US Co and also agreed to waive off the principal amount of loan advanced by US Co to the Taxpayer.

- The Taxpayer claimed the principal amount of loan waived as capital receipt not taxable under the ITL. But the Tax Authority treated the waiver amount as Taxpayer's business income.

- The First Appellate Authority ruled in favor of the Tax Authority with certain modifications. On further appeal, the Mumbai Tribunal and the Bombay High Court (HC) ruled in favor of the Taxpayer and held that the waiver was neither taxable as business perquisite nor taxable under the claw back provision.

- Being aggrieved, the Tax Authority appealed further to the SC.

### Facts in the case of Rollatainers Ltd. (Taxpayer2)

- The Taxpayer2 had availed term loans and cash credit facilities from financial institutions. The term loans were utilized for acquiring machineries. The cash credit facilities were used for working capital requirements.

- The Taxpayer2 ran into financial difficulties and was unable to repay the term loans and cash credit facilities. It was referred to the Board for Industrial and Financial Reconstruction (BIFR) as a "sick company". Under a Corporate Debt Restructuring scheme, the financial institutions, *inter alia*, waived a part of the term loans and cash credit facilities. The Taxpayer credited the amounts waived to Profit and Loss Account (P&L).

- The Taxpayer2 claimed that none of the two items were chargeable to tax. The Tax Authority, however, rejected the contention and added the waived amounts of term loans and cash credit facilities to the Taxpayer2's income.

- The First Appellate Authority upheld the Taxpayer2's claim and held that none of the items was liable to tax.

- On further appeal by the Tax Authority, the Delhi Tribunal held that waiver of term loans used for acquiring capital assets is not liable to tax as business perquisite or under claw back provision. But waiver of cash credit facilities used for trading operations is liable to tax since the benefit is in the revenue field and, therefore, in the nature of business perquisite and/or taxable under claw back provision.

- On further appeal by the Taxpayer, the Delhi High Court upheld the taxation of waiver of cash credit facilities as business perquisite. It also held that even if business perquisite is not applicable, the claw back provision is clearly applicable.

- Being aggrieved, the Taxpayer2 appealed further to the SC against the taxation of waiver of cash credit facilities.

- However, the SC considered the facts of lead Taxpayer while rendering its ruling and did not separately consider the facts of Taxpayer2 on the ground that the question of law involved is the same in all connected batch of appeals and they would stand disposed off with a common judgement in lead Taxpayer's case.

## Tax Authority's contentions

- On waiver of loan, the Taxpayer was not required to pay an amount which it was otherwise required to pay and, thus, the waiver results in income in the hands of the Taxpayer.

- The waiver amount is either taxable as business perquisite or under claw back provision as business income.

## Taxpayer's contentions

- The transaction of purchase of capital equipment and transaction of loan provided by US Co are two independent transactions. The purchase of capital equipment was not a transaction of purchase of goods on credit in ordinary course of business. The amount of loan payable to US Co did not represent unpaid purchase consideration for capital equipment to be discharged over a period of time.

- The Taxpayer reflected the loan in the Balance Sheet under the category of unsecured loans and thus, the waiver of such loan liability is on capital account which is not in the nature of business income.

## Issue before the SC

- Whether the waiver of principal amount of loan is taxable as business income under the provisions of the ITL?

## Supreme Court ruling

The SC ruled in favor of the lead Taxpayer and held that the amount of loan waived was neither a business perquisite nor taxable under claw back provision of the ITL.

## On non-applicability of business perquisite taxation

- The term "loan" generally refers to borrowing something, especially a sum of cash that is to be paid back by the debtor along with the interest decided mutually by the parties within a stipulated period of time.

- It is well settled that the creditor or its successor may exercise its "right of waiver" unilaterally to absolve the debtor from its liability to repay. After such exercise, the debtor is deemed to be absolved from the liability of repayment of loan subject to the conditions of the waiver. The waiver may be of part amount of principal or interest or a complete waiver of both principal and interest. Hence, waiver of loan by the creditor results in debtor having extra cash in its hands. It is a receipt in the hands of the debtor-taxpayer.

- The business perquisite provision covers the value of any benefit or perquisite, whether convertible into money or not, arising from business or exercise of a profession.

- A plain reading of the provision makes it prima facie apparent that the income which can be taxed should arise from business or profession. Furthermore, the benefit received has to be in some other form rather than in the shape of money.

- In the present case, the Taxpayer has received the benefit in the form of cash receipt due to the waiver of loan and, hence, the very first condition of the business perquisite provision that the benefit should be in the form other than in the shape of money is not satisfied. Therefore, the amount of loan waive cannot be taxed as business perquisite.

### On non-applicability of claw back provision

- The *sine qua non* of claw back provision is that there should be an allowance or deduction in respect of loss, expenditure or trading liability claimed by taxpayers in any year. Then, subsequently, during any tax year, if the creditor remits or waives such liability, taxpayers are liable to pay tax on such remission. The object behind this provision is to ensure that taxpayers do not get double benefit first by way of allowance of deduction in earlier years and then by not paying tax on the benefit received in subsequent years on remission of the same liability in respect of which the deduction was allowed earlier.

- In the present case, the Taxpayer claimed amortization benefit on capital equipment. Amortization is an accounting term that refers to the process of allocating the cost of an asset over a period of time and, hence, it is nothing else but depreciation. Depreciation is a reduction in the value of an asset over a time, in particular, to the wear and tear. It cannot be equated with interest paid on loan.

- Further, the purchase cost represented capital asset of the Taxpayer. The Taxpayer did not debit the cost of capital equipment to the Trading account or to the P&L in any of the tax years.

- There is difference between "trading liability" and "other liability". The claw back provision deals with remission of trading liability. Whereas in the instant case, waiver of loan amounts to cessation of liability other than trading liability. Hence, remission of loan in the present case cannot be taxed under claw back provision.

*Source: Recent ruling in the lead case of Mahindra and Mahindra Ltd. [Civil Appeal No.6949-6950 of 2004] (Taxpayer) wherein the issue before the Supreme Court.*

## 4. Supreme Court upholds that ICDs are "inland ports" eligible for infrastructure tax holiday benefit

### Background and facts of the case

- Section (S.) 80-IA of the ITL, *inter-alia*, provides profit-linked tax holiday to a taxpayer undertaking the activity of development or operation and maintenance or development, operation and maintenance of an eligible "*infrastructure facility*". The tax holiday operates for a period of 10 consecutive years at the option of the taxpayer, within a period of 15 or 20 years starting from the commencement of operation of the infrastructure facility. A taxpayer claiming benefit is also required to satisfy other conditions provided in the said provision.

- The term "infrastructure facility" is defined in the provision to mean, *inter alia*, a road including toll road, a bridge or a rail system, highway, port, airport, inland waterway, inland port etc.

- The Finance Act 1998 inserted "inland waterways" and "inland port" within the definition of "infrastructure facility" for the first time from tax year 1998–99 onwards.

- The erstwhile definition of "infrastructure facility" in the provision, as was applicable till tax year 2000-01, also included any other public facility which may be notified by Central Board of Direct Taxes (CBDT).

- In exercise of such powers, the CBDT had on 1 September 1998 notified (the CBDT Notification) ICDs and Container Freight Stations (approved as such by the Customs authorities) as eligible "infrastructure facilities".

- Effective from tax year 2001-02, the definition of "infrastructure facility" was amended to withdraw the powers conferred on the CBDT to notify any other public facility, though, the CBDT had clarified subsequently that agreements entered into on or before 31 March 2001 in respect of infrastructure facilities notified prior to the amendment would continue to enjoy the benefit.

- "Inland port" was covered under the definition of "infrastructure facility" throughout the relevant period.

- The Taxpayer is a public sector undertaking formed as a government company under the Ministry of Railways and is engaged in the business of handling and transportation of containerized cargo. It developed and operated ICDs which are at land-locked areas at a distance from the sea ports. i.e. It is relatable to Assessment Year 1999-2000. Under the ITL, law standing on first day of "assessment year" is applied to immediately preceding financial year (known as 'previous year'). Thus, the amendment made effective from 1 April 1999 applies to tax year 1998-99 onwards. Notification No. S.O.

744(E) dated 1 September 1998

- ICDs provide all facilities for loading/unloading of containerized cargo and customs clearance of export and import of goods which are conventionally provided at sea ports.

- For tax years 2002-03 to 2004-05, the Taxpayer claimed that it carried on eligible business of "infrastructure facility" which qualified for tax holiday. It also claimed that the ICDs qualified as "infrastructure facility", being "inland port".

- The Tax Authority disallowed the Taxpayer's claim which was confirmed by the First Appellate Authority and the Tribunal on the following grounds:

  - Post the withdrawal of the CBDT's powers to notify any other infrastructure facility with effect from tax year 2001-02, ICDs cannot be regarded as eligible "infrastructure facility".

  - If ICD was covered under "inland port", there was no need for a separate notification by the CBDT, given that the definition already covered "inland port" at the relevant time.

- Aggrieved, the Taxpayer filed an appeal before the Delhi High Court (HC). The HC ruled in favor of the Taxpayer and held that ICD qualifies as an "inland port". For this purpose, the HC took cognizance of the legislative object and the status of ICD as viewed by other Ministries of the Government which equated ICD with "inland port".

- Being aggrieved, the Tax Authority appealed to the SC.

## Tax Authority's contentions

- The Taxpayer is not entitled to claim tax holiday as the activities undertaken at ICD do not fall within the ITL definition of "infrastructure facility".

- The HC erroneously relied on the CBDT Notification treating ICDs as "infrastructure facility" as it was applicable only up to tax year 2001-2002. The Legislature, by an amendment, specifically withdrew the CBDT's powers to notify any facility as "infrastructure facility" from tax year 2001-2002.

- The ICDs cannot be regarded as "port" or "inland port" referred in the definition of "infrastructure facility". If they qualified as "inland port", there was no need for the CBDT to notify them separately, given that the definition already covered "inland port" at the relevant time.

## Taxpayer's contentions

- The CBDT had validly notified ICDs as eligible "infrastructure facilities" in exercise of its power granted under the definition of "infrastructure facility". Once ICD qualified as eligible 'infrastructure facility' in terms of such Notification, the tax holiday cannot be denied for subsequent years merely on the basis of the withdrawal of the CBDT's powers by the Legislature from subsequent tax year.

- Such subsequent withdrawal of powers does not affect the validity or effect of the past CBDT Notification. Thus, the Taxpayer is eligible to claim tax holiday under provisions of the ITL.

## Supreme Court ruling

The SC upheld the decision of the Delhi HC and held that the Taxpayer was entitled to tax holiday, since the business of setting up and operating an ICD qualified as "infrastructure facility" for the years under consideration. Further, ICD qualifies as an "inland port" which continued to qualify as "infrastructure facility" even after the amendment withdrawing the CBDT's powers, from tax year 2001-02, to notify any public facility as "infrastructure facility".

The SC adopted the following reasoning in brief for its conclusion:

## ICDs qualify as an "inland port":

- The ICDs function for the benefit of exporters and importers located in industrial centers which are situated at a distance from sea ports. The purpose of introducing them was to promote export and import in the country by acting as facilitator and reducing inconvenience to importers/exporters located in landlocked areas, away from sea ports. ICDs reduce bottlenecks by allowing completion of customs formalities at the depots instead of sea ports.

- The ICD cannot fall within the purview of "port" as in commercial terms "port" means a place where a vessel generally loads or unloads goods. The SC noted that the term "port" used in definition of "infrastructure facility" has maritime connotation as it is used distinctly from

airport.

- However, considering that a part of activities that are carried out at ports such as customs clearance are also carried out at ICDs, they can be regarded as "inland ports".

- The term "inland port" is not defined anywhere in the ITL. It is significant to note that the Indian Customs law treats ICD as "customs port". Further, Central Board of Excise and Customs and Ministry of Commerce and Industry have clarified that ICDs can be regarded as "inland port" since custom clearances also take place in ICDs.

- Although notification and communications under indirect tax laws are not binding on the CBDT, the Tax Authority was unable to put forward any reasonable explanation as to why they should not be relied to hold ICDs as "inland ports".

### Impact of subsequent amendment on validity of the CBDT Notification:

- The CBDT Notification specifying ICDs as "infrastructure facility" came into effect on 1 September 1998 even before the facility "inland port" was inserted in definition of "infrastructure facility" with effect from 1 April 1999. Hence, there is no conflict between the CBDT notification and the fact that ICDs are inland ports or not.

- The CBDT Notification, which was issued in legitimate exercise of powers conferred on the CBDT, would not cease to have effect from tax year 2001-02 merely because of the withdrawal of the CBDT's powers to issue such notification in absence of any such specific intention of the Legislature. Therefore, the CBDT Notification was valid for the tax years under consideration.

- The Tax Authority accepted the Taxpayer's entitlement to claim tax holiday before the definition of "infrastructure facility" was amended by withdrawing the CBDT's power to notify a public facility as "infrastructure facility". The tax holiday which applies for a period of 10 consecutive year cannot be denied or curtailed by any subsequent amendment unless such amendment clearly specifies that existing eligible units should also fulfil the new conditions.

*Source: Recent ruling in the case of CIT v. Container Corporation of India Ltd. [Civil Appeal No.8900 of 2012] (Taxpayer) before the Supreme Court.*

## 5. Bangalore Tribunal allows claim of losses in ecommerce business model, denies notional taxation as capital expenditure towards marketing intangibles

### Background and facts of the case

- Under the ITL, a resident is taxable on its total income which is accrued or received or deemed to be accrued/received in India during the tax year. "Income" is inclusively defined to cover different categories of receipts. Furthermore, the ITL provides certain circumstances where the income of a taxpayer needs to meet the arm's length standard which mainly covers transactions with related parties, including specific transactions between domestic related parties in India ("transfer pricing provisions").

- The Taxpayer, an Indian company, is engaged in the wholesale trading business. The Taxpayer acquired goods from various unrelated persons and immediately sold them to third party retail sellers who, subsequently, sold such goods through electronic form (e-commerce) on an internet platform under the name "flipkart.com", owned by the Taxpayer's group entity.

- During the tax year under consideration, the Taxpayer purchased goods (say, at INR100) and, subsequently, sold them to retailers at a lower value (say, INR80). The Taxpayer also offered cash discounts to its customers. Consequently, the Taxpayer incurred substantial losses during the year, amounting to approximately 2.52% of the cost of the purchase value.

- The Tax Authority disallowed the loss claimed by the Taxpayer and concluded that:

  - The Taxpayer's pricing strategy was not in line with comparable wholesale trading businesses which typically earn a profit margin of 16.95%. The Taxpayer's business model incurring loss at gross level is not normal, but exceptional.

  - The Taxpayer indulged in a strategy of "predatory pricing" of selling goods at lower than cost price to establish customer goodwill and brand value in the long run and reap benefits in the future. Therefore, loss incurred by the Taxpayer was to create marketing intangibles and such loss created due to predatory pricing was disallowed, holding it as a capital

expenditure.

- Despite making huge losses, the Taxpayer's shares were purchased by investors at a high premium, which is justified mainly due to the existence of an intangible asset base i.e., the Taxpayer's brand/goodwill. The SARs benefit is received on extinguishment of valuable rights which constitute "capital asset". However, it is a no-cost asset since no consideration was paid by the Taxpayer for allotment of such rights.

- Marketing intangibles so created are used for business purposes and, hence, depreciation at the rate of 25% was allowed as deduction.

- For this purpose, marketing intangibles were valued on the basis of the cost approach , as envisaged by the OECD in its Base Erosion and Profit Shifting (BEPS) project. Accordingly, the difference in price between the sale proceeds of any normal wholesaler in the market and the sale proceeds of the Taxpayer in the same market was considered as the cost incurred on the marketing intangibles. The computation can be understood with the help of the table given below:

| | Particulars | INR |
|---|---|---|
| A | Cost of purchase | 100 |
| B | Average gross margin on cost earned by comparable wholesaler (approximate) | 16 |
| C | Normal sales price (A+B) | 116 |
| D | Sale price of the Taxpayer | 80 |
| E | Value of marketing intangibles (C-D) | 36 |
| F | Less: Depreciation @ 25% of E | 9 |
| G | Addition made to returned income | 27 |

- The Taxpayer preferred appeal before the First Appellate Authority (FAA). The FAA upheld the Tax Authority's order to the extent of disallowance. However, the FAA further enhanced the assessed income by denying depreciation on the marketing intangible on the ground that the owner of such intangible asset was the Taxpayer's group entity, and not the Taxpayer itself.

- Aggrieved by the order, the matter was appealed before the Tribunal.

## Taxpayer's arguments

- Goods were offered at discounted prices to attract customers to purchase goods through e-commerce which was at a nascent stage at that point in time. The strategy to sell at lesser prices than the physical market results in increasing the volume of sales, leading to economies of scale. The intention is to capture the market and generate profits in the long run. It is premature to say that the business strategy would lead to generation of goodwill or brand or any other intangible. If the business model fails, there will be no such intangible in existence.

- What can be taxed is only the income that accrues or arises, as laid down under the charging provisions of the ITL. Hence, there must be an "income" and "its receipt or accrual". Income which has accrued or arisen can only be the subject matter of the total income, and not income which could have been earned but not earned.

- The Tax Authority cannot bring to tax "hypothetical income" by disregarding the Taxpayer's books of account and assuming that capital expenditure was incurred for creation of an intangible asset. When one trader transfers its goods to another trader at a price lesser than the market price, the Tax Authority cannot take into consideration the market price of those goods, ignoring the real price fetched.

- Since the transactions were between unrelated parties, the transfer pricing provisions of the ITL do not apply. In the absence of any specific provisions in the ITL, the Tax Authority cannot re-compute the Taxpayer's income to result in additional taxation.

- Wherever the Legislature wanted to tax income not earned, specific provisions have been made, by way of deeming fiction, to consider the market value as cost/consideration instead of actual cost/sale price. No such provision applies to the present case.

- There was no acquisition of any intangible during the year, since there was no outflow of funds or incurring of a liability to say that any expenditure was incurred. In case of intangibles like goodwill, it is not possible to ascertain the cost of acquisition, addition or alteration to the quality

of goodwill which led to the increase in its value in terms of money.

- Even assuming that the Taxpayer had incurred expenses in creating intangibles/brands, the same are not capital in nature and it should be allowable as revenue expenditure. Furthermore, the presence of enduring benefit element cannot be conclusive to characterize an expenditure as capital.

- An expenditure is allowed as a deduction if it is incurred on the grounds of commercial expediency. What is commercial expediency in the given circumstances is the sole discretion of the Taxpayer, and not of the Tax Authority.

- An expenditure, which is otherwise deductible, cannot be disallowed merely because it also benefitted a third party.

- Without prejudice, the method of computation of the profit margin adopted by the Tax Authority is not recognized by the ITL and, hence, valuation is bad in law. Furthermore, the judicial authorities are require to interpret the law as it exists, and not as it ought to be in light of certain underlying value notions.

- Acquisition of the Taxpayer's shares at a premium was done by the Taxpayer's holding company. It is one way of funding a subsidiary. The investment transactions had undergone scrutiny by the Reserve Bank of India and it does not, in any way, have any implications on the computation of the Taxpayer's business income.

### Tribunal's ruling

The Tribunal denied disallowance made by the Tax Authority and concluded that the loss recognized by the Taxpayer should be accepted.

- Under the ITL, the starting point of computing income from business is the profit or loss as per the P&L account of the Taxpayer. The Tax Authority cannot go beyond the books of account to disregard the Taxpayer's computation, unless it is dissatisfied about the correctness or completeness of the same, which is not the case of the Tax Authority.

- There should be income and its receipt or accrual that can subject to tax. In the present case, there nothing to show accrual/receipt of any income beyond what is realized by the Taxpayer.

- There is no provision in the ITL by which the Tax Authority can ignore and enhance the sale price declared by a taxpayer, unless there is evidence to suggest that the transaction is not bona fide or if the transaction is subject to transfer pricing provisions or unless there is a provision which permits notional taxation. The present case does not get covered in the transfer pricing provisions. The Tax Authority was not correct in ignoring the books profits of the Taxpayer and estimating the total income in the manner in which it did.

- The Tax Authority is not correct in considering profit margins forgone by the Taxpayer as expenditure incurred in creating marketing intangibles, for the following reasons:

  - There was no liability incurred or actual outflow in respect of any expenditure, which is also acknowledged by the Tax Authority.

  - As pointed by the SC in the case of B.C. Srinivasa Setty (supra) and the Bombay HC in the case of Evans Frazer & Co (supra), in case of intangibles like goodwill, it is not possible to ascertain the cost of acquisition, addition or alteration to the quality of goodwill which lead to the increase in its value in terms of money.

  - The Tax Authority's argument on the existence of marketing intangibles on the basis of purchase of the Taxpayer's shares at a huge premium cannot be accepted in the absence of any material on record to suggest that such valuation was done only because of the value being ascribed to such marketing intangibles.

- In view of the above conclusion, other issues i.e. correctness of the method applied by the Tax Authority for re-computation of income, whether the expenditure on creating intangible (if any) would be considered as capital or revenue in nature, do not require discussion.

*Source: Recent ruling in the case of Flipkart India [TS-209-ITAT-2018(Bang)] (Taxpayer) before the Bangalore Income Tax Appellate Tribunal (Tribunal).*

## 6. SC rules Stock Appreciation Rights benefit received prior to tax year 1999-2000 to not be taxable as perquisite

### Background and facts of the case

- The salary taxation provisions of the ITL include "perquisites" and "profits in lieu of salary" within the scope of "salary". One of the items of "profits in lieu of salary" is any payment due to or received by employees from an employer or a former employer (subject to certain exceptions).

- Prior to tax year 1999-2000, the ITL did not contain a specific provision for taxing employee share-based rewards as perquisites.

- However, a Circular issued by the Central Board of Direct Taxes (CBDT), *inter alia*, clarified that where an employer offers shares to its employees at a price lower than that offered to other shareholders/public, the difference between the two is taxable as "perquisite".

- The Finance Act, 1999 introduced a specific provision to tax share-based rewards, effective from tax year 1999-2000. But, it was withdrawn the next year, with a corresponding amendment to the definition of "perquisite" to provide that share-based rewards provided under the qualifying Employees Stock Option Plan or Scheme (ESOP), in accordance with guidelines issued by the Central Government, shall not be regarded as "perquisite".

- However, taxation of ESOPs was reintroduced in 2007 by way of "fringe benefit tax" on the employer and, then, by way of perquisite taxation in the hands of employees from 2009 onwards.

- The Taxpayer, the Chairman-cum-Managing Director of an Indian company, was working as a salaried employee. The US-based parent of the Indian company issued SARs to the Taxpayer from the year 1991 to 1996, for which no amount was paid by the Taxpayer. The Taxpayer redeemed such SARs in tax year 1997-98, in lieu of which the Taxpayer received an amount of INR 68m from the US parent.

- The Taxpayer did not offer the SARs benefit to tax on the basis that it was a capital receipt received on "transfer" of capital asset (viz., SARs), but not liable to "capital gains" since the Taxpayer had not incurred any cost thereon (i.e., "no cost asset"). The Taxpayer relied on an SC ruling in the case of CIT v. B.C. Srinivas Setty for the proposition that the charging provision and the computation provision constituted an integrated code, and where no cost can be ascertained for a capital asset, the capital gains provisions cannot apply.

- The Tax Authority held that the SARs benefit was taxable as "salary" income by way of "perquisite" or, alternatively, as a business perquisite. The First Appellate Authority upheld the Tax Authority's view.

- On further appeal by the Taxpayer, the Ahmedabad Income Tax Appellate Tribunal (Tribunal) ruled that the benefit was not taxable as "perquisite", but taxable as capital gains.

- Both the Taxpayer and the Tax Authority appealed further to the Gujarat High Court (HC). The Taxpayer's claim being that the benefit was not taxable at all, whereas the Tax Authority's claim was that the benefit was taxable as "perquisite".

- The Gujarat HC ruled in the Taxpayer's favor and dismissed the Tax Authority's appeal by accepting the Taxpayer's claim of non-taxable capital receipt.

- Being aggrieved, the Tax Authority appealed to the SC against the Gujarat HC's ruling.

## Tax Authority's contentions

Before the SC, the Tax Authority argued that the SARs benefit was taxable as "perquisite", based on the following contentions:

- Reliance was placed on the Mumbai Tribunal's Special Bench (SB) ruling in the case of Sumit Bhattacharya v. ACIT which, on identical facts, held that SARs were taxable as salary income, even if not received from the direct employer. The SB further held that, if not as salary income, they are definitely taxable as Income from other sources, since they are in the nature of deferred wages related to employment but not received from the employer.

- Alternatively, they are taxable as benefit or perquisite arising from the exercise of business or profession, as per a specific provision of the ITL.

## Taxpayer's contentions

The Taxpayer argued that the SARs benefit is a non-taxable capital receipt, based on the following contentions:

- The SARs benefit is received on extinguishment of valuable rights which constitute "capital asset". However, it is a no-cost asset since no consideration was paid by the Taxpayer for

allotment of such rights.

- Reliance was placed on an earlier SC ruling in the case of CIT v. Infosys Technologies (Infosys ruling), where the SC had held that for a benefit to be taxable, there should be a specific provision in the ITL. Prior to tax year 1999-2000, there was no provision to tax share-based rewards. In any case, in the facts before the SC, the shares were not directly allotted to the employees, but settled in a trust with a lock-in period. Hence, allotment of shares on exercise of ESOPs in that case was held not taxable as "perquisite" in the absence of a specific provision.

- Similarly, in the present case, the SARs benefit received prior to tax year 1999-2000 was not taxable since the amendment was prospective in nature, and not a clarificatory provision.

### Supreme Court ruling

The SC ruled in favor of the Taxpayer and held as follows:-

### Distinction between "perquisite" and "capital gains"

- There is a distinction between "perquisite" and "capital gains". Perquisites are perks or benefits attached to employment, usually of non-cash nature, provided in addition to salary or remuneration to retain talented employees in the organization. Some instances of "perquisites" are concessional rent accommodation, sum paid by the employer in respect of personal obligation of the employee etc.

- On the other hand, "capital gains" means profit from sale of property or an investment. It could be long-term or short-term and is charged to tax in the year of "transfer" of the capital asset.

### Non-applicability of the specific provision inserted from tax year 1999-2000 to tax share-based rewards

- The intention of the amendment by the Finance Act, 1999 was to bring the share-based rewards granted by the employer to the employee within the ambit of tax. It was by virtue of this amendment that the Legislature spelt out which securities would constitute taxable benefit, coverage by direct or indirect transfer to the employee during or after the employment and how the cost of such securities would be determined. It is evident that the Taxpayer's case falls under such clause.

- But, the transaction in the present case pertains to tax year prior to the above amendment. Hence, it cannot be covered by the above clause in the absence of an express provision of retrospective effect.

- It is a fundamental principle of law that a receipt under the ITL must be made taxable before it can be treated as income. An individual cannot be made to pay tax in violation of a constitutional right, in the absence of a specific provision.

- The SC, in the Infosys ruling, made it clear that the above referred amendment was not clarificatory and, hence, was not retrospective in nature.

### Redemption of SARs not taxable as perquisite

- It is true that the Circular clarified that issue of shares to employees at a price lesser than that offered to other shareholders/public constitutes taxable perquisite. But, in the present case, the Taxpayer was allotted SARs, and not shares. Hence, the Circular has no applicability in the present case.

### Redemption of SARs not taxable as business income

- The amount received on redemption of SARs could not be treated as benefit or perquisite arising from the exercise of business or profession, since the applicability of the provision is confined to cases where there is any business or profession-related transaction involved. In the Taxpayer's case, who is a salaried employee, there was no such transaction involved.

*Source: Recent ruling in the case of Bharat V. Patel [TS-204-SC-2018] (Taxpayer) before the SC.*

## 7. Supreme Court upholds lease equalization adjustment in finance lease as per the ICAI Guidance Note for tax purposes

### Background and facts of the case

- Under the ITL there are no special provisions for tax treatment of finance lease.

- Prior to the notification of Accounting Standard

(AS) 19 Lease under the corporate law, the accounting principles for lease transactions were governed by the GN issued by the ICAI initially issued in 1988 and subsequently revised in 1995. The accounting treatment and rationale thereof was explained by the SC in the case of J. K. Industries Ltd. v. UOI as follows:

*"110. A leasing company deducts an amount of lease equalization charges from lease rental income. For that purpose, the company makes a provision for the said charges in accordance with the guidelines issued by the Institute on "Accounting of income, depreciation and other aspects for leasing company". This charge is created to equalize the imbalance between lease rentals and depreciation charges over the period of lease. It is based on the rationale of matching costs with revenues so that the periodic net income from a finance lease is true and fair. Such matching is achieved by showing the lease rentals received under finance lease separately under gross income in the P&L a/c of the relevant period and against such lease rental income, a matching lease annual charge is made to the P&L a/c. This annual lease charge represents recovery of the net investment/fair value of the leased asset over the lease period and is calculated by deducting the finance income for the period from the lease rent for that period. Accordingly, where the annual lease charge is more than the statutory depreciation under the IT Act, lease equalization charge account would be debited to that extent; whereas when annual lease charge is less than statutory depreciation under the IT Act, a lease equalization would emerge. Therefore, lease equalization charge is created as a result of debit to the P&L a/c. It is a charge which has to be deducted to arrive at the true and correct profit of the leasing business and is neither an appropriation of profit nor a reserve. This example indicates applicability of matching concept."*

- AS-19 issued in 2001 replaced the GN. AS-19 provides for different treatment for finance lease in terms of which, instead of recognizing lease rental income in full and then making lease equalization adjustment, only the net finance income embedded in lease rental receipts is recognized as income.

- The present case pertains to tax years 1995-96 to 1999-2000 when the GN was in force. In 1998, an amendment was made to erstwhile corporate law in terms of which companies were mandated to follow accounting standards issued by the ICAI until accounting standards are prescribed by Central Government (CG).

- The Taxpayer, a company, followed GN for accounting treatment of assets given on finance lease and, accordingly, debited lease equalization adjustment to its Profit & Loss Account (P&L).

- However, the Tax Authority disallowed the lease equalization adjustment on the ground that the ITL does not provide deduction for such adjustment. The First Appellate Authority upheld the Tax Authority's view.

- On further appeal by the Taxpayer, the Income Tax Appellate Tribunal accepted the Taxpayer's claim and allowed deduction of lease equalization charges.

- Being aggrieved, the Tax Authority filed further appeal to the Delhi High Court (HC) which also ruled in Taxpayer's favor. The HC held that the Tax Authority could not have rejected the method of accounting adopted by the Taxpayer in compliance with the GN issued by an expert accounting body like ICAI, vested with powers to recommend accounting standards. The lease equalization is a method of recalibrating of depreciation claimed by taxpayers in a given accounting period by bifurcating lease rentals between capital recovery and revenue income. The lease equalization debits and credits over the full term of lease square off against each other. The adjustment results in reflection of "real income" of the Taxpayer. The Tax Authority misconstrued the lease equalization debit as a "deduction" claimed by the Taxpayer.

- Being aggrieved by the HC ruling, the Tax Authority filed further appeal before the SC.

## Issue before SC

Whether the lease equalization adjustment debited to P&L in case of finance lease as per the GN issued by the ICAI is admissible for tax purposes?

It may be noted that the controversy in the present case was limited to the admissibility of lease equalization in finance lease and not on the aspect of admissibility of depreciation to lessor on assets given on finance lease.

## Tax Authority's contentions

- The lease equalization debit is an additional deduction debited to P&L in addition to the depreciation claimed in the books so as to make it equal to capital recovery.

- This is an artificial calculation which bifurcates lease rental between capital recovery and interest component.

- The entire lease rent constitutes the Taxpayer's income. There is no specific provision under the ITL which provides for deduction of lease equalization charges.

### Taxpayer's contentions

- The lease equalization debited to P&L is in compliance with the GN issued by the ICAI as a method of adjusting the depreciation claimed in books of account which reflects the real income of the Taxpayer.

- It is a settled principle that the GN issued by the ICAI carries great weight and the real income determined basis such GN cannot be disregarded by the Tax Authority.

### Supreme Court ruling

The SC ruled in Taxpayer's favor and held that the lease equalization debit cannot be disallowed for following reasons:

### Significance of the GN issued by the ICAI in computation of taxable income

- The GN issued by the ICAI, being an expert body, reflects the best practices adopted by the accountants throughout the world. The ICAI is vested with an authority to recommend accounting standards for the presentation of true and fair financial statements. The accounting standards are made by a body of experts after extensive study and research.

- The corporate law amendment was to give clear sight that the accounting standards issued by the ICAI shall prevail until accounting standards are prescribed by the CG. The purpose of accounting standards is to arrive at the real income after adjusting the permissible depreciation.

- Reliance was placed on the earlier ruling of the SC in the case of CIT v. Punjab Stainless Steel Industries where the SC referred to the meaning of "turnover" as explained by the ICAI in "Guidance Note on Tax Audit under Section 44AB of the Income Tax Act" by holding that the material published for its members by the recognized body of accountants after due deliberations and consideration can be relied upon.

### GN on Leases reflects "real income" from finance lease transaction

- The method of accounting provided in the GN captures "real income" by separating the element of capital recovery (i.e. repayment of principal amount by the lessee representing lessor's net investment in the lease) and finance income.

- While the finance income represents revenue receipt to be included in income for the purpose of taxation, the capital recovery element is not classifiable as income, as it is not, in essence, a revenue receipt chargeable to tax.

- The method of accounting as per the GN is a valid method of capturing real income based on substance of a finance lease transaction. It is a cardinal principle of law that the difference between capital recovery and interest/finance income is essential for accounting for such transaction with reference to its substance. If such bifurcation is not carried out, taxpayers will be assessed not merely on revenue receipt but also non-revenue item which is completely contrary to the principles of the ITL and to its scheme and spirit.

### Lease equalization adjustment is not an artificial adjustment or deduction

- The bifurcation of lease rental between capital recovery and finance income is, by no stretch of imagination, an artificial calculation. It is an essential step in the accounting process to ensure that real income from lease transaction in the form of revenue receipts only is captured for the purposes of income tax. There is no express bar in the ITL which precludes such bifurcation.

- The bifurcation is analogous to the manner in which a bank treats an EMI payment made by a debtor on a loan advanced by the bank. The repayment of principal would be a balance sheet item and not a revenue item. Only the interest earned would be a revenue receipt chargeable to income tax. Hence, there is no force in the Tax Authority's contention that the whole revenue from lease is subject to tax under the ITL.

- The Tax Authority's main contention about absence of express provision allowing such deduction under the ITL cannot be accepted since the Taxpayer can be charged only on real income which can be calculated only after applying the prescribed method. The ITL is silent

on such deduction. Hence, the Taxpayer has to adopt the GN prescribed by the ICAI and it is only after applying the method prescribed in the GN that the Taxpayer can show fair and real income liable to tax.

- As per a conjoint reading of the corporate law and the ITL, the Taxpayer is entitled to bifurcate lease rentals received on finance lease between capital recovery and revenue income. Therefore, it is wrong to say that the Taxpayer claimed deduction by virtue of the GN. Rather, it has only applied the method of bifurcation as prescribed by the GN and such bifurcation is in accordance with the principles of law to reach the real income for tax purposes.

*Source: Recent ruling in the case of Virtual Soft Systems Ltd. [Civil Appeal No. 4358 of 2018] (Taxpayer) before the SC.*

## 8. Supreme Court affirms set off of interest income earned on deposit of share application money against share issue expenses

### Background and facts of the case

- As a general rule, interest income is considered to be revenue in nature and taxable as a separate source of income. However, in certain cases where interest income is earned pursuant to a statutory mandate or has inextricable nexus with project construction or asset acquisition, the same may be permitted to be set off against the project cost or related expenditure.

- The SC, in the case of CIT v. Bokaro Steel (two judge ruling) (Bokaro ruling), while dealing with a case of a taxpayer during pre-set up period, permitted set off against the construction cost in respect of interest income earned on advances to the contractor, rent income from quarters let out to employees and hire charges earned on plant and machinery let out to the contractors. According to the SC, if there exists a nexus between deployment of funds (which generate income) and the project under construction, income on such funds can be regarded as capital receipt capable of being set off against the cost of project. Similarly, in the case of CIT v. Karnal Co-operative Sugar Mills (two judge ruling) (Karnal ruling), the interest on deposit kept for supporting the letter of credit for purchase of machinery, during the pre-set up period, was permitted to be set off against the purchase cost of plant and machinery, as the deposit was directly linked with the purchase of the asset.

- As against this, the SC, in the case of Tuticorin Alkali Chemicals & Fertilizers v. CIT (three judge ruling) (Tuticorin ruling), held that interest income arising from temporary deployment of unutilized borrowed funds for a project not immediately required, is taxable as revenue income and cannot be set off from the project cost. Similarly, in the case of CIT v. Autokas (three judge ruling), interest earned on a short-term deposit of the amount borrowed for setting up of the business was held to be taxable as revenue income, by relying on the Tuticorin ruling. However, these rulings are not referred to in the present ruling.

- The Taxpayer, an Indian company, in the course of business, had come out with an initial public offering (IPO) during the relevant tax year.

- The amount of share application money received by the Taxpayer was deposited with the banks, pursuant to a statutory requirement, until completion of allotment of shares. Interest earned on such deposit was initially offered by the Taxpayer as "income from other sources" under the ITL while filing its return of income.

- However, later, during the Income Tax Appellate Tribunal (Tribunal) proceedings, the Taxpayer claimed set off of interest income on deposits against the share issue expenses, by relying on the Bokaro ruling.

- The Tax Authority, however, rejected the Taxpayer's claim on the ground that interest income is always regarded to be revenue in nature, unless it is received by way of damages or compensation. The Tribunal allowed the benefit of set off of interest income from the share issue expenses.

- The Tax Authority preferred an appeal before the Gujarat High Court (HC), wherein the HC dismissed the Tax Authority's appeal and, thus, ruled in favor of the Taxpayer.

- Aggrieved, the Tax Authority appealed before the SC.

### Issue before the SC

Whether interest earned on the share application money kept in a separate account till the allotment of shares was completed, can be set off against the IPO issue expenses or is to be taxed separately as revenue income.

### Supreme Court ruling

The SC, basis the below reasoning, affirmed the view of the HC and held that interest earned on deposit of the share application money till the allotment of shares was completed, pursuant to a statutory requirement, is to be set off against the IPO issue expenses and not taxable separately as interest income, as it was inextricably linked with the Taxpayer's requirement to raise share capital.

- The share application money was statutorily required to be kept in a separate account till the allotment of shares was completed.
- The interest income was inextricably linked with the Taxpayer's requirement to raise share capital and can, thus, be adjusted towards the cost of raising share capital i.e., IPO issue expenses.
- In light of the Bokaro and Karnal rulings, the SC observed that if any surplus money which is lying idle has been deposited in the bank for the purpose of earning interest, it is liable to be taxed as income from other sources. However, if the income earned is merely incidental and not the prime purpose of doing the act which resulted in accrual of additional income, then the income is not liable to be taxed and is eligible to be set off against the expenses.
- Since the share application money is deposited pursuant to a mandatory statutory requirement till the allotment of shares was complete, interest income earned thereon is not taxable and is eligible for deduction against the IPO issue expenses.
- The fact that part of the share application money would normally be returned by the Taxpayer to unsuccessful applicants would not make any significant difference to the present proposition.
- The issue of shares relates to the capital structure of the company and, hence, expenses incurred in connection with the issue of shares are to be capitalized. Since the purpose of the deposit is not to make some additional income, but to comply with the statutory requirement, interest accrued on such deposit is merely incidental.
- The interest earned was inextricably linked with the Taxpayer's requirement to raise share capital. Thus, interest earned is required to be set off against the share issue expenses.

*Source: Recent ruling in the case of CIT v. Shree Rama Multi Tech [Civil Appeal No. 6391 of 2013] (Taxpayer) before the SC.*

## Key Direct Tax Developments

### 1. Central Board of Direct Taxes issues draft rule prescribing methodology for determination of fair market value of inventory which is converted into a capital asset

### Background and facts

- Prior to the FA 2018, there was no provision under the ITL dealing with the tax implications on conversion of an inventory into a capital asset. Therefore, taxability upon conversion or treatment of an inventory into a capital asset was the subject matter of debate before various Appellate Authorities and Courts.
- In order to bring certainty regarding taxation of conversion of an inventory into a capital asset, the FA 2018 introduced a set of provisions under the ITL in terms of which the FMV of an inventory, as on the date of conversion into a capital asset, shall be taxed as business income in the year of conversion. Thus, the new provision provides for an upfront taxation with respect to the FMV as business income on conversion of an inventory into a capital asset, as against a converse situation of conversion of a capital asset into an inventory wherein the capital gains are taxed in the year of eventual sale of the converted inventory and not in the year of conversion.
- The new provision introduced vide the FA 2018 confers the power on the CBDT to prescribe the rule for determination of the FMV of an inventory.
- The FA 2018 has also introduced back-up provisions in the ITL to deal with subsequent taxation of a capital asset which is converted from an inventory. For this purpose, the FMV determined on the conversion of an inventory into a capital asset is deemed to be the cost of acquisition of the converted capital asset, and if such converted capital asset is utilized for the purpose of business or profession carried on by the taxpayer, then the FMV so determined is treated as an actual cost for the purpose of depreciation. The ITL, as amended vide the FA 2018, also provides that the period of holding of

the converted capital asset is reckoned from the date of conversion. The aforesaid amendments are effective from 1 April 2019 (i.e., tax year 2018-19 onwards) and apply to conversions undertaken on or after 1 April 2018.

### The Rule for determination of the FMV of an inventory converted into a capital asset

- The CBDT has published the Rule which provides the methodology for determination of the FMV of an inventory which is converted into a capital asset.

- The Rule provides the methodology for determination of the FMV of different classes of inventory, as follows:

| Inventory | Valuation methodology to be adopted as on the date of conversion |
|---|---|
| Immovable property (being land or building) | Value adopted or assessable for purpose of payment of stamp duty |
| Jewellery, Archaeological collection, drawing, painting, sculpture, any work of art, shares or securities | Valuation determined in accordance with the valuation rules prescribed for the purpose of gift taxation under the ITL, with the valuation date being the date of conversion of the inventory into a capital asset |
| In case of other Property | Price the property would ordinarily fetch on sale in the open market |

- The Rule is proposed to be made applicable from 1 April 2019 (i.e., tax year 2018-19 onwards), in line with the effective date of the parent provision in the ITL.

- Stakeholders may provide their comments/ suggestions on the Rule by 14 May 2018 at dirtpl2@nic.in

*Source: Draft valuation rule published by CBDT (Source – www.incometaxindia.gov.in)*

## 2. CBDT issues draft Notification for granting benefit of 10% LTCG for non-STT based share acquisitions

Finance Act 2018 brought a radical change in taxation of long term capital gains (LTCG) arising on transfer of equity shares of company, units of equity oriented mutual funds and units of business trust (specified capital asset). The amendment withdrew exemption granted u/s 10(38) of Income-tax Act, 1961 ('ITA') and introduced 10% LTCG tax (plus applicable surcharge and cess) on such transactions.

The new capital gains taxation scheme is applicable subject to compliance of following conditions:

- Total income of the taxpayer should include LTCG arising on transfer of specified capital asset

- Securities Transaction Tax is paid on acquisition and transfer of equity shares and transfer of units of equity oriented mutual fund and units of business trust

Section 112A provides for 10% tax (plus applicable surcharge and cess) on LTCG exceeding INR 1lac. Further, all gains arising on specified capital asset up to 31 January 2018 are grandfathered.

Section 112A(4) of ITA empowers Central Government to specify the nature of acquisition in respect of which condition of payment of Securities Transaction Tax is relieved on equity shares. Consequently, LTCG on such shares shall be eligible for 10% tax despite non-payment of STT on acquisition. This is akin to exemption available under section 10(38) to non-STT based acquisitions as notified under Notification No. 43/2017 dated 5 June 2017.

Central Board of Direct Taxes vide FAQ No. 2 of Press Release dated 4 February 2018 had clarified that, Notification No. 43/2017 dated 5 June 2017 issued in the context of section 10(38) will be reiterated for the purpose of section 112A of ITA. In this regard,
the CBDT vide Press Release dated 24 April 2018 has issued draft Notification ('draft Notification') for public comments. The stakeholders are requested to submit their comments/suggestions on the Draft Notification by 30 April 2018 at the e-mail address dirtpl2@nic.in.

The draft Notification is identically worded as Notification No. 43/2017 and provides for exemption from condition of payment of STT on all equity shares except for a negative list of shares acquired on or after 1 October 2004 The negative list is identical to the negative list specified under Notification No. 43/2017 as follows :

(a) Acquisition of existing listed equity shares which are not frequently traded on an recognised stock exchange (RSE) by way of preferential issue

(b) Acquisition of existing listed equity shares otherwise than through an RSE

(c) Acquisition of unlisted equity shares during the period between the delisting and day immediately preceding the re-listing of such shares on RSE.

Alongside the negative list, the draft Notification also provides carve-outs to insulate genuine acquisitions, for which 10% LTCG shall continue to apply identical to Notification No. 43/2017.

Thus, on lines of Notification No. 43/2017, the draft Notification proposes to protect genuine cases of non-STT based acquisitions like Initial Public Offering, Follow-on Public Offering, bonus or rights issue by a listed company, acquisition approved by Court/NCLT/SEBI/RBI, acquisition pursuant to exercise of ESOPs, etc. It may be recollected that Notification No. 43/2017 was also issued after public consultation.

The draft Notification provides another opportunity to stakeholders to convey their concerns which were not addressed earlier by Notification No. 43/2017.

*(Source: CBDT draft Notification No. 43/2017)*

# Key Regulatory amendments

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

## Notifications/ circulars issued by Reserve Bank of India (RBI)

### 1. RBI revised norms for investment by foreign portfolio investor (FPI) in debt securities

- RBI has made changes in the operational aspects of FPI investment in debt securities. Accordingly, the key changes introduced in the revised framework are as under:
- Government securities (G-Secs) and State Development Loans (SDLs)
  - Removal of minimum residual maturity requirement: The minimum residual maturity requirement for G-secs and SDLs categories stands withdrawn, subject to the condition that investment in securities with residual maturity below 1 year by an FPI under either category shall not exceed, at any point of time, 20% of the total investment of the FPI in that category. Further, It is also clarified that FPIs can now invest in Treasury bills
  - Online monitoring of G-sec utilisation limits: The existing auction mechanism which is triggered after aggregate FPI investments reach 90% of the limits has been discontinued with effect from 01 June 2018, and the limits would henceforth be monitored on an online basis by the Clearing Corporation of India Limited (CCIL).
  - Revised security wise limit: The cap on aggregate FPI investments in any Central Government security, currently at 20% of the outstanding stock of that security, stands revised to 30% of the outstanding stock of that security.

Corporate bonds

- Liberalisation of minimum residual maturity: FPIs are now permitted to invest in corporate bonds with minimum residual maturity of more than 1 year instead of 3 years. Further, FPI's investment in corporate bonds with less than 1 year residual maturity, should be less than 20% of its total investments in corporate bonds.
- Investments by an FPI/ related FPIs should not exceed 50% of the issue size: Investments by a single FPI along with its 'related FPIs' taken together, shall not exceed 50% of any single issue of corporate bond. The term 'related FPIs' refers to all FPIs registered by a non-resident entity. For example, if a non-resident entity has set up five funds, each registered as an FPI for investment in debt, total investment by the five FPIs will be considered for application of concentration and other limits.
- Concentration limit for an FPI for its corporate bond portfolio to a single corporate: Investments made by an FPI in corporate bonds of an Indian company as well as related entities of such company (as defined in Indian Companies Act, 2013) shall not exceed 20% of the total corporate bond portfolio of the FPI.

Other changes/ clarifications

- There would be a continuous monitoring of 20%

- limit on securities with less than one year residual maturity. In cases where an FPI is in breach of this limit as on 02 May 2018, it should align its portfolio within 6 months to comply with the new 20% restriction.

- Concentration Limit: Apart from the overall limits, a new restriction has been introduced whereby investment by a single FPI as well as related FPIs in shall not exceed following limits:

  - Long term FPIs: 15% of prevailing investment limit for that category;

  - Other FPIs: 10% of the prevailing investment limit for that category.

  - All other FPIs will be allowed to invest up to the applicable concentration limit.

- No FPI shall invest in partly paid instruments.

*Source: A.P. (DIR Series) Circular No. 24 dated 27 April 2018 read with A.P. (DIR Series) Circular No. 26 dated 01 May 2018*

2. RBI liberalized the norms applicable on external commercial borrowings ('ECBs')

- RBI has, in order to facilitate cheaper access of overseas funds, liberalised the extant ECB guidelines. The key amendments are:

- Rationalization of all-in-cost ('AIC') ceiling: An uniform all-in cost ceiling of 450 basis points over the benchmark rate, which will be 6 month USD LIBOR (or applicable benchmark for respective currency) for Track I and Track II, while it will be prevailing yield of the Government of India securities of corresponding maturity for Track III (Rupee denominated ECBs) and rupee denominated bonds ('RDBs').

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

- Expansion of list of borrowers:

  - In Track I & II, Housing Finance Companies, regulated by the National Housing Bank and Port Trusts constituted under the Major Port Trusts Act, 1963 or Indian Ports Act, 1908 have been included as eligible borrowers; and

  - In Track III (INR), companies engaged in the business of Maintenance, Repair and Overhaul and freight forwarding has been included as eligible borrowers.

- Rationalisation of end-use provisions: There will be a negative list for all 3 tracks of ECB's, which would include the following:

  a) Investment in real estate or purchase of land except for affordable housing construction and development of SEZ and industrial parks/ integrated townships

  b) Investment in capital market

  c) Equity investment

  Additionally for Tracks I and III, the following negative end uses will also apply except when raised from Direct and Indirect equity holders or from a Group company, and provided the loan is for a minimum average maturity of five years:

  d) Working capital purposes.

  e) General corporate purposes.

  f) Repayment of Rupee loans.

  It may be noted that for all Tracks, the negative end use of on-lending to entities for the above activities from (a) to (f) will also apply.

*Source: A.P. (DIR Series) Circular No.25 dated 27 April 2018*

3. RBI introduced monitoring system in respect of foreign investment limits in listed Indian companies

- RBI in consultation with SEBI has, in order to monitor foreign investment limits in listed Indian companies, decided to put in place a new system for monitoring foreign investment limits, for which the necessary infrastructure and systems for operationalizing the monitoring mechanism, shall be made available by the depositories. The same has also been notified by SEBI vide circular IMD/FPIC/CIR/P/2018/61 dated April 05, 2018 read with Circular IMD/FPIC/CIR/P/2018/74 dated April 27, 2018 ('SEBI circulars').

- In terms of the SEBI circulars, all listed Indian

companies are required to provide the specified data/ information on foreign investment to the depositories. The requisite information may be provided before 15 May 2018. The listed Indian companies, in non-compliance with the above instructions will not be able to receive foreign investment and will be non-compliant under Foreign Exchange Management Act, 1999 ('FEMA').

*Source: A.P. (DIR Series) Circular No. 27 [(1)/ 20(R)] dated 03 May 2018*

# Our offices

Ahmedabad
2nd floor, Shivalik Ishaan
Near. C.N Vidhyalaya
Ambawadi,
Ahmedabad – 380 015
Tel: + 91 79 6608 3800
Fax: + 91 79 6608 3900

Bengaluru
12th & 13th floor
"U B City" Canberra Block
No.24, Vittal Mallya Road
Bengaluru – 560 001
Tel: + 91 80 4027 5000
+ 91 80 6727 5000
Fax: + 91 80 2210 6000
+ 91 80 2224 0695

Prestige Emerald, No. 4,
1st Floor, Madras Bank Road,
Lavelle Road Junction,
Bangalore - 560001

Chandigarh
1st Floor
SCO: 166-167
Sectr 9-C, Madhya Marg
Chandigarh – 160 009
Tel: + 91 172 671 7800
Fax: + 91 172 671 7888

Chennai
Tidel Park,
6th & 7th Floor
A Block (Module 601,701-702)
No.4, Rajiv Gandhi Salai
Taramani
Chennai – 600 113
Tel: + 91 44 6654 8100
Fax: + 91 44 2254 0120

Hyderabad
Oval Office
18, iLabs Centre,
Hitech City, Madhapur,
Hyderabad – 500 081
Tel: + 91 40 6736 2000
Fax: + 91 40 6736 2200

Kochi
9th Floor "ABAD Nucleus"
NH-49, Maradu PO,
Kochi – 682 304
Tel: + 91 484 304 4000
Fax: + 91 484 270 5393

Kolkata
22, Camac Street
3rd Floor, Block C"
Kolkata – 700 016
Tel: + 91 33 6615 3400
Fax: + 91 33 2281 7750

Mumbai
14th Floor, The Ruby
29 Senapati Bapat Marg
Dadar (west)
Mumbai – 400 028
Tel + 91 22 6192 0000
Fax + 91 22 6192 1000

5th Floor Block B-2,
Nirlon Knowledge Park
Off. Western Express Highway
Goregaon (E)
Mumbai – 400 063
Tel: + 91 22 6192 0000
Fax: + 91 22 6192 3000

NCR
Golf View Corporate
Tower – B
Near DLF Golf Course,
Sector 42
Gurgaon – 122 002
Tel: + 91 124 464 4000
Fax: + 91 124 464 4050

4th & 5th Floor, Plot No 2B,
Tower 2, Sector 126,
Noida – 201 304
Gautam Budh Nagar, U.P. India
Tel: + 91 120 671 7000
Fax: + 91 120 671 7171

Pune
C–401, 4th floor
Panchshil Tech Park
Yerwada (Near Don Bosco School)
Pune – 411 006
Tel: + 91 20 6603 6000
Fax: + 91 20 6601 5900

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EY contacts for ACMA Knowledge Partnership:

- Rakesh Batra, National Automotive Sector Leader – rakesh.batra@in.ey.com / +91 124 464 4532
- Deepshikha Anand, ACMA Knowledge Partnership Coordinator – deepshikha.anand@in.ey.com / +91 124 612157