EY Tax and Regulatory Alert

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Contents

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Indirect Tax

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

Judicial Precedents

1. M/s Renault Nissan Automotive India Pvt Ltd
Vs
The Deputy Commissioner – II (FAC)

[2018-VIL-470-MAD]

Background and facts of the case

- The petitioner is a manufacturing Company of motor vehicles and also a registered dealer on the file of the respondent under the provision of Tamil Nadu Value Added Tax Act, 2006 and the Central Sales Tax Act, 1956.
- The petitioner sold the motor vehicles to two of its sister Companies which are marketing Companies and separate entities. The said marketing Companies namely, M/s.Renault India Private Limited and M/s. Nissan Motor Private Limited, are separate business entities and are engaged in the activities of marketing, distribution and selling the motor vehicles manufactured by the petitioner.
- They purchase motor vehicles from the petitioner on payment of appropriate tax on principle to principle basis and sell the same to the dealers, with whom those Companies have business arrangements, on payment of appropriate tax. Those dealers, thereafter, sell the motor vehicles to users on payment of appropriate tax.
- In the regular course of business, the marketing Companies place purchase orders on the petitioner with delivery instructions on the basis of the orders received by them from their dealers.
- The petitioner has privity of contract with the marketing Companies alone who are purchasers from the petitioner. There is no privity of contract between those dealers and the petitioner or the customers and the petitioner.
- In respect of the motor vehicles that are delivered outside the State of Tamil Nadu, the petitioner raises sales invoice on the marketing Companies with instructions to deliver the vehicles at the particular place, as directed by the Marketing Companies and collects and pays tax under the CST Act, 1956, on the sale price mentioned in the sales invoice of the petitioner Company.
- In respect of the interstate sales, for which purchase orders are placed by the marketing companies, these marketing companies effect second interstate sale by transfer of documents of title of the goods in favour of the dealers, claiming exemption under section 6(2)(b) of the CST Act, 1956.
- The respective Branch office of the marketing companies issues "C" declaration form to the petitioner and the petitioner, in return issues "E1" declaration form to them.
- The petitioner has submitted the "C" declaration forms in support of the interstate sales to the Office of those two Companies situated outside Tamil Nadu and paid tax at 2% on the interstate sales effected by the petitioner.
- The assessment under CST Act, 1956, for the assessment years 2014-15 and 2015-16 in respect of Andhra Pradesh office of M/s. Nissan Motor India Private Limited, has been completed by the Assessing Officer, Chittoor, and exemption under section 6(2)(b) of the CST Act, 1956, was granted on the second interstate sales effected by them in respect of the motor vehicles sold by the petitioner.

Respondent's contention

- The respondent herein issued notice dated 26.10.2016 proposing to levy higher rate of tax and disallow exemption for non-filing of declaration forms. Another notice dated 08.12.2016, also was issued to furnish copies of invoices. The petitioner submitted the same.
- Thereafter, the respondent passed the assessment order dated 23.01.2017, levying tax at 2% in respect of interstate sales turnover covered by "C" declaration forms and higher rate of tax in respect of interstate sales turnover not covered by "C" declaration forms.
- Likewise, exemption was granted on export sales under section 5(1) and 5(3) of the CST Act, 1956. The respondent also disallowed the turnover, for which documents and Form "H" declaration had not been filed. However, on filing of those

documents, revised assessment orders dated 14.02.2017 and 28.03.2017 were passed by the respondent.

- While so, the respondent issued notice dated 24.01.2017 contending that goods have moved from Tamil Nadu directly to the dealers in pursuant to the orders placed by them on M/s. Nissan India Private Ltd., and M/s.Renault India Private Ltd., who claimed exemption as second and subsequent sale under section 6(2)(b) of the CST Act, 1956 and therefore, it is a sale falling under section 3(a) of the CST Act and not under section 3(b) of the CST Act. Thus, the respondent claimed that the petitioner is liable to pay the tax on the value at which the goods were sold to the purchasers and not the value on which the petitioner paid tax in CST Act, 1956.

- The petitioner filed its reply on 24.02.2017 explaining the background and sale process along with set of documents to prove that there was no privity of contract between the petitioner and the dealer and that the petitioner was liable to pay tax only on the sale consideration received by it from those two marketing Companies. Personal hearing was conducted on 22.05.2017. Thereafter, the respondent passed the impugned order.

- Writ petitions are filed thereafter.

Decision taken

- Considering the above stated facts and circumstances, the Court is of the view that the present writ petitions are not maintainable against the orders of assessment.

- Consequently, these Writ Petitions were disposed of by granting liberty to the petitioner to file a statutory appeal before the Appellate Authority within a period of 30 days from the date of receipt of a copy of this order by observing all other statutory requirement for filing such appeal.

- If any such appeal is filed within the time stipulated supra, the same shall be taken up and considered by the said Appellate Authority on its own merits and appropriate orders in accordance with law shall be passed, after giving due opportunity of hearing to the respective parties, without reference to the period of limitation. Such exercise shall be done by the Appellate Authority within a period of six weeks from the date of receipt of appeal.

- Since the Court has granted liberty to the petitioner to file the statutory appeal as observed supra, the respondent is directed not to take any coercive steps against the petitioner till such appeal is filed within the time stipulated as stated supra. It is also made clear that this Court is not expressing any view on the merits of the assessment. No costs. Consequently, connected miscellaneous petitions are closed.

2. M/s Saraswathi Metal Works

[Kerala Authority for Advance Ruling] [2018-VIL-243-AAR]

Background and facts of the case

- M/s Saraswathi Metal Works is a manufacturer of Marine propellers, Rudder set, Stern tube set, Propellers shaft, MS shaft for couplings used in fishing or floating vessels.

- Applicant requested advance ruling on the following:
  - Whether replacement of parts during warranty period constitute supply under GST
  - Whether eligible to avail 18% input tax credit on purchase of raw materials where the manufactured products are taxable @ 5%

Observation of the AAR

- The replacement of parts during warranty period is a free supply. Warranty is a written guarantee, issued to the purchaser of goods by its manufacturer, promising to repair or replace it if necessary within a specified period of time. If the goods are supplied with warranty, the consideration received as part of supply includes the consideration for "the promise to repair or replace". Since the parts are provided to a customer without consideration under warranty no GST is chargeable on such replacement. The value of supply made earlier includes the charges to be incurred during the warranty period. Therefore, the supplier who has undertaken the warranty replacement is not required to reverse the input tax credit on the parts / components replaced.

- Even though the raw materials consumed are attracting higher tax rate than the finished products or parts, input tax paid is eligible to avail as input tax credit subject to a condition that such goods or services or both are used or intended to be used in the course or furtherance of his business. Further, as per Section 54 (3) of the GST Law, where the credit has accumulated on account of rate of tax on inputs being higher than the rate of tax on output supplies, un-utilized input tax credit at the end of any tax period can be claimed as refund except input tax paid under IGST.

Ruling

- The supply of parts under warranty being without consideration, no GST is payable. The value of supply made earlier includes the charges to be incurred during the warranty period. Therefore, the applicant who undertakes the warranty replacement is not required to reverse the input tax credit on the parts / components replaced.

- The supplier/ manufacturer is eligible to avail the credit of higher input tax paid on purchase of raw materials, even though the manufactured products are taxable at lesser tax rate.

3. M/s Maruti Ispat & Energy Private Limited

[Andhra Pradesh Authority for Advance Ruling]
[2018-VIL-254-AAR]

Background and facts of the case

- M/s Maruti Ispat & Energy Private Limited is involved in manufacturing of Steel, and production of Power.

- The applicant has filed an application for seeking advance rulings on :

  - Whether they are eligible to take GST input on Goods which are used for installation (Foundation) of plant and machinery?
  - Whether they are eligible to take GST input services which are used for installation (Foundation) of plant and machinery?
  - Whether they are eligible to take GST input on goods which are used for protection (by creating sheds) for plant and machinery?
  - Whether we are eligible to take GST inputs on services which are used for protection (by creating shed) for plant and machinery?

Observation of Authority for Advance Ruling

- The nature of industry and product requires buying of large plant and machinery for installation and protection of this plant & machinery, they required to lay foundations, and also to construct the sheds.

- The digging process is done with regard to creation of foundation for specific installation of plant & machinery and is completely suitable only for the specific plant & machinery.

- The applicant highlighted the word 'support' used in explanation not only means support from base, but also support from all the ways, creating sheds is to protect the plant & machinery.

- On perusal of photographic evidences and submissions made by the applicant, we are of the opinion that the argument of the applicant to treat civil structures as structural support for plant and machinery is not tenable.

- The civil structures under consideration is squarely falls other civil structures which is excluded as per the explanation to the proviso of Section 17(5) of CGST Act.

Ruling

- As per the material on record and photographic evidences of the applicant, on which sought for clarification does not fall under the ambit of explanation to the proviso to the Section 17(5) of CGST / APGST Act, 2017. Hence, M/s Maruti Ispat & Energy Private Limited is not entitled to claim the input tax credit on the goods and services.

4. M/s Trailer Springs

[Andhra Pradesh Authority for Advance Ruling]
[2018-VIL-261-AAR]

Background and facts of the case

- M/s Trailer Springs is engaged in the activity of manufacturers of Tractor Trailers and Leaf Springs.

- The applicant seeks advance ruling on the following issue:

  - Applicable rate on agricultural tractor trailers parts leaf springs, disks, axels, hubs, & shackle pins meant for tractor trailers.

Observation of Authority for Advance Ruling

- The HSN: 8433.59.00 referred to by the applicant is not relevant to the products that are being manufactured by them.

- As per the description given by the applicant along with the photographs, the commodity shall be classified as 'springs and leaves for springs of iron and steel', the commodity falls under the HSN Code 7320.

Ruling

- The commodity 'Springs & leaves for springs of iron and steel', falls under entry number 234 of schedule III of notification number 01/2017 - Central tax (Rate), dated: 28.06.2017 and taxable at 9% under CGST Act' 2017 and 9% under APGST Act, 2017.

5. M/s Nissan Motors India Pvt Ltd Vs Commissioner of GST & Central Excise Chennai Outer

[2018-VIL-738-CESTAT-CHE-CE]

Backgrounds and facts of the case

- The appellants are engaged in manufacture of Nissan and Renault brand of cars.

- During the course of investigations conducted by DGCEI, it was found that there was difference in the assessable value adopted by the appellant when cars were cleared from its factory premises and the final sale price adopted by Renault India Pvt. Ltd. to the dealer.

- The appellants were in the practice of paying excise duty on the price adopted by RIPL to dealers.

- Thereafter, the appellant took an exercise of finding out the highest dealer price cleared from their factory to various dealers and it was found that there was excess payment when the price was adopted with Delhi dealer and there was shortage of Rs.20,94,086/-.

- Show cause notice was issued proposing to demand the differential duty for the impugned period from July 2011 to March 2012 along with interest and also for imposing penalties.

- After due process of law, the original authority confirmed the demand, interest and imposed equal penalty. In appeal, Commissioner (Appeals) upheld the same. Hence this appeal has been filed.

Appellant's contentions

- The appellant is contesting only the penalty imposed. The duty demand along with interest has been paid by the appellant much before the issuance of show cause notice.

- The difference / shortage was only because of the mistake in the method adopted by the appellant for arriving the assessable value.

- They had adopted the assessable value of the clearances made to the dealers in Delhi on the belief that this is the highest price.

- On intimation by the department, the appellant itself had undertaken the exercise of verifying the difference in the price for clearances made to the different dealers. On such verification, it was found that there was an excess payment of Rs.10,06,683/- and shortage of Rs.20,94,086/-.

- The appellant in their letter dated 29.3.2016 issued to the Assistant Director of DGCEI had given the details of such difference of value adopted for discharging the central excise duty. In the order in original, the adjudicating authority has noted the reply filed by the appellant with regard to the excess payment also.

- It is thus argued by him that the appellant had no intention to evade payment of duty by suppression of facts. The shortage of payment was only due to the error in calculating the assessable value. The same has been rectified immediately on being pointed out by the department.

Revenue's Contention

- The revenue argued that the impugned payment of duty would not have come to light unless the department conducted investigations.

- The appellants have violated the provisions of law since they have wrongly arrived at the assessable value.

- The ingredients of imposing equal penalty are sufficiently attracted and there is no ground for interference with the order impugned.

Observations and decisions taken

- The appellant themselves have undertaken the exercise of verifying whether there is difference in the higher value adopted by them for discharging the central excise duty.
- They had been in the practice of adopting the price of cars cleared to the Delhi dealers on the notion that, that was the highest price.
- After conducting verification by themselves, it was found that clearances made to some other dealers were also on higher rate. They have immediately discharged the excise duty along with interest.
- It is also noted in the reply to the notice that they had discharged excess duty of Rs.10,06,683/- and they have not filed any refund claim for this amount since the same was hit by limitation.
- The fact that the appellants have discharged excess duty during the impugned period and also the fact that the department has quantified the figure on the basis of the exercise undertaken by the appellant themselves for confirming the demand, the tribunal is of the view that the ingredients necessary for imposing penalty under section 11AC is not attracted in the present case.
- There is nothing to establish that the appellants have suppressed facts with intent to evade payment of duty. The scenario that short-payment of duty had occurred was only because the appellants were arriving the assessable value on the basis of the cars cleared to their Delhi dealers.
- The impugned order is modified to the extent of setting aside the penalty imposed without disturbing the duty demand or interest thereon. The appeal is partly allowed in the above terms with consequential relief, if any.

6. M/s Jamna Auto Industries Ltd Vs CCE & ST, Ujjain

[2018-VIL-761-CESTAT-DEL-CE]

Backgrounds and facts of the case

- The appellants are engaged in manufacture of leaf springs falling under Chapter 73 of the 1st Schedule to the Central Excise Tariff Act, 1985 and in supply of the same to various manufacturers of the motor vehicles, such as, Ashok Leyland, Tata Motors etc.
- During 2014, the appellants got an order from the Government of India's Defence Equipment making factory namely vehicles factory Jabalpur.
- As an a established practice, the appellant have been availing Cenvat credit on the inputs, input services and on capital goods as per the provisions of Cenvat Credit Rules, 2004.

Revenue's Contention

- According to the department, the appellants were clearing the leaf springs to the Jabalpur vehicles factory by availing the benefit of exemption Notification No. 64/95-CX, however, they have not followed the laid down procedure as provided under Rule 6 of Cenvat Credit Rules.
- Further, the department have believed that the appellant have availed the Cenvat credit on all the raw materials, inputs, components, which were used by them in manufacture of both dutiable finished goods as well as exempted finished goods.
- It is contended by the Department that on the clearances affected under Notification No. 64/95, the appellants should have reversed Cenvat credit @ 6% of the value of the exempted goods as no separate accounts of Cenvat credit availed on exempted and dutiable goods have been maintained by them.
- Accordingly, two show cause notices one dated 03/06/2015 demanding reversal of the Cenvat credit of Rs. 1,15,34,488/- and second show cause notice dated 10/03/2016 demanding reversal of Cenvat credit of Rs. 27,80,175/- came to be issued which have been adjudicated by learned Commissioner, Ujjain vide this common order-in-original No. 50-51/COMMR/CEX/UJN/2017 dated 22/03/2017.

Appellant's contentions

- The applicant submitted that the provisions of Rule 6 of Cenvat Credit Rules, 2004 are not applicable in the case of the appellant as the goods have been cleared under Notification 65/95-CE which provides conditional exemption benefit from payment of central excise duty and exemption is available to the recipient of the goods and not to the manufacture, therefore, the applicability of Rule 6 of Cenvat Credit Rules is not there in their case.

- They have further assailed the confirmation of Cenvat credit on the ground that the exemption under Notification 65/95-CX. is akin to the provisions of Chapter X in the erstwhile rules wherein the duty on otherwise excisable goods is remitted when the same are put forth to a specified use and the procedure set out in the said rule is followed.

- It has also been added that for making the provisions of Rule 6 of Cenvat Credit Rules applicable, there should be two different final products being manufactured by the same manufacturer, wherein one of the final product is cleared on payment of duty and other product is cleared without payment of duty.

- The Appellant also contested that the penalty under Rule 15 of the Cenvat Credit Rule readwith Section 11AC of Central Excise Act is not imposable in their case as the issue involves interpretation of statutory provisions and as soon as it has been pointed out by the department that violation of Rule 6 of Cenvat Credit Rules have taken place, the Cenvat credit availed on proportionate basis on the goods cleared under exemption notification have already been reversed back by them.

Observations and decisions taken

- The provisions of Rule 6 cover the exempted goods also and no specific provisions is there for the goods where the provisions of goods at concessional rate of duty for manufacturer excisable goods Rule 2001 are also required to be followed.

- If any input, input services or capital goods find place in manufacture of goods which are exempted from payment of central excise duty in that case, the manufacture is legally required to reverse back the 6% of the value of clearances from the accumulated Cenvat credit.

- The provisions are very clear that manufacturer is also free to maintain separate account of inputs and the credits thereon for both dutiable as well as exempted goods and in that case the requirement of 6% of the value of clearances is need not to be followed.

- In this case, since the appellants have not maintain separate account of Cenvat credit availed on exempted as well as dutiable final products, hence, legally they are required to reverse back the 6% of value of clearances of the exempted goods from the Cenvat credit.

- In the present case, the final products are Extra Neutral Alcohol and Denature Ethyl Alcohol. Denatured Ethyl Alcohol is obtained by adding denatured element to "Heads & Tails" for which also the input is Molasses.

- The assessee is supposed to maintain separate accounts for the receipt, consumption, etc. of the inputs. When the separate accounts are not maintained, the assessee shall reverse 8% of the price of the exempted final products.

- The order of the Commissioner is set aside and the appeal (E/171/2006) of the assessee is allowed and the Revenue's appeal (E/457/05) has been dismissed by upholding the Commissioner's (Appeals) order

- The appellant are legally required to reverse back the input credit availed on the inputs going into the exempted final products.

Key Indirect Tax updates

This section summarizes the regulatory updates for the month of November 2018

<u>Notification No. 58/2018 – Central Tax dated 26 October 2018</u>

- The Government vide this notification has notified that the persons whose registration under GST Act has been cancelled by the proper officer on or before the 30th September 2018, as the class of persons who shall furnish the final return in FORM GSTR-10 of the GST rules till the 31st December, 2018.

<u>Notification No. 59/2018 – Central Tax dated 26 October 2018</u>

- The Government vide this notification has extended the time limit for furnishing the declaration in FORM GST ITC-04, in respect of goods dispatched to a job worker or received from a job worker or sent from one job worker to another, during the period from July, 2017 to September, 2018 till the 31 December, 2018.

Notification No. 61/2018 – Central Tax dated 5 November 2018

- The Government vide this notification has exempted the supply from PSU to PSU from applicability of provisions relating to TDS with effect from 1 October 2018.

Circular No. 40/2018-Customs dated 24 October 2018

- CBIC has introduced several options and alternative mechanisms through which various mismatch errors between the Shipping Bill (SB) and GSTR 1 data can be handled in the system.

- CBIC has issued various circulars - 05/2018-Customs dated 23.02.2018, 08/2018-Customs dated 23.03.2018, 15/2018-Customs dated 06.06.2018 and 22/2018-Customs dated 18.07.2018 respectively wherein an alternative mechanism with an officer interface to resolve invoice mismatches (SB005 error) was provided for the shipping bills filed till 30.06.2018.

- Although the cases having SB005 error have gone down, but still representations have been received from exporters / associations that some exporters had, due to lack of familiarity/awareness, committed the same mistake due to which their IGST refunds are stuck and requested for extension of date.

- Giving high priority to the interests of exporters, the Board has extended the rectification facility to Shipping Bills filed up to 15.11.2018. However, it has been reiterated that the exporters shall have to take care to ensure the details of invoice, such as invoice number, IGST paid etc. under GSTR 1 and shipping bill match with each other since the same transaction is being reported under GST laws and Customs Act.

Circular No. 69/43/2018-GST dated 26 October 2018

- The above circular has been issued to provide clarification on various issues in relation to processing of the applications for cancellation of registration filed by taxpayers in FORM GST REG-16.

- In cases where it is difficult exactly identify or pinpoint the day on which occurrence of the event warranting cancellation of registration occurs, 30-day deadline may be liberally interpreted and taxpayers application for cancellation of registration may not be rejected because of possible violation of deadline;

- Further directs proper office to accept all applications within 30 days (except where application is incomplete or in case of transfer, merger or amalgamation where new entity is unregistered) since cancellation of registration has no effect on liability of taxpayer for any acts of commission/omission committed before or after date of cancellation;

- Person whose registration has been cancelled shall file a final return in FORM GSTR-10, failing which notice in FORM GSTR-3A has to be issued and in case the failure continues, assessment order in FORM GST ASMT-13 u/s 62 shall be issued to determine liability of taxpayer.

Circular No. 70/44/2018-GST dated 26 October 2018

- The above circular has been issued to provide clarification on various issues related to refund.

- Status of refund claim after issuance of deficiency memo and re-credit of electronic credit ledger:
  - It was clarified (vide circular no. 59/33/2018-GST dated 04th September 2018), that once a deficiency memo has been issued against an application for refund, the amount of Input Tax Credit is required to be re-credited to the electronic credit ledger of the applicant and the taxpayer was expected to file a fresh application for refund;
  - As the GST web-portal does not allow a taxpayer to file a fresh refund application after issuance of a deficiency memo; it has been presently clarified that till such facility is developed, the applicants would be required to submit the rectified refund application under the earlier Application Reference Number (ARN) (and re-credit in the electronic credit ledger will not be required).

- Allowing exporters who have received capital goods under Export Promotion Capital Good scheme ("EPCG") to claim refund of IGST paid on exports:
  - It has been further clarified that exporters who are importing goods in terms of the below mentioned notifications (except the exporters who are receiving capital goods under the

EPCG scheme) would not be eligible for refund of IGST paid on exports w.e.f October 9, 2018.

Type of supply	Notification reference
Import	IGST and cess exemption for EOUs (Notification No. 78/2017 – Customs)
Import	IGST and cess exemption for Advance Authorisation holder (Notification No. 79/2017 – Customs)
Import	IGST and cess exemption for EPCG holder (Notification No. 79/2017 – Customs)

Direct Tax

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

Key Judicial Precedents

1. Mumbai Tribunal rules conversion of compulsory convertible preference shares into equity shares is not "transfer"

Background and Facts

- Under the provisions of Income-tax Act, 1961 (the Act / ITL), capital gains on sale of a capital asset is taxable in the year in which transfer of such asset takes place. The term "transfer" is defined in an inclusive and wide manner, to include inter alia, sale, exchange, relinquishment of asset or extinguishment of any rights therein.
- Further, as per the ITL, cost of acquisition of a capital asset, being a share or a stock of a company, which becomes the property of a taxpayer on conversion of one kind of shares into another kind of shares, shall be calculated with reference to the cost of acquisition of the shares or stock from which such asset is derived (cost substitution provision).

  E.g. Where a taxpayer acquires Compulsory Convertible Preference Shares (CCPS) at INR 100 and same gets converted at a later date to equity shares with fair market value (FMV) of INR 120 on the date of conversion, the cost of acquisition of equity shares on subsequent transfer will be the cost incurred for acquisition of CCPS (i.e. INR 100) and not the FMV of INR 120 on the date of conversion.
- The ITL did not provide for specific exemption in relation to such conversion until the recent amendment in the Finance Act, 2017, as introduced with effect from 1 April 2018.
- The Taxpayer was engaged in the business of investment activities.
- The Taxpayer invested in CCPS of a listed company in a rights issue in tax year 2010-11, which got automatically converted into equity shares at ratio 1:1 in the tax year 2011-12. There was neither any option with the Taxpayer nor any further step that was required to be taken by the Taxpayer for such conversion.
- The FMV of equity shares on date of conversion was higher than cost incurred by taxpayer on acquisition of CCPS.
- The Taxpayer treated the event of conversion as tax-neutral and did not offer any income to tax on such conversion.
- However, basis the wide definition of "transfer", the Tax Authority contended that conversion of CCPS into equity shares is a "transfer" by way of "exchange" and taxed the difference in market value of equity shares and cost of CCPS as long term capital gains (LTCG).
- The First Appellate Authority (FAA) upheld the order passed by the Tax Authority.
- Aggrieved, the Taxpayer preferred an appeal before the Tribunal.

Tax authority's contentions

- "Transfer" is defined widely to include "exchange" or barter transactions. The Tax Authority placed reliance on the Supreme Court (SC) ruling in the case of CIT v. Motors & General Stores (P.) Ltd , where the SC held that exchange of cinema hall for preference shares resulted into transfer. Similarly, the event of conversion involves exchange of preference shares with equity shares resulting in "transfer" of a capital asset.
- Preference shares and equity shares represent two distinct types of assets. The Bombay High Court (HC) ruling in the case of CIT v. Santosh L Chowgule and others categorically held that preference share and equity shares are different.

- Consideration for such transfer is the FMV of equity shares received on conversion which, in the present case, is higher than the cost incurred on acquisition of CCPS. Hence, the difference between the two is taxable as LTCG.

Taxpayer's contentions

- The event of conversion of CCPS into equity shares does not result in "transfer".

- The amount paid by the Taxpayer in the present case for acquisition of CCPS was not merely towards subscription of CCPS but also towards the automatic and compulsory conversion of CCPS into equity shares within a short period after subscription of CCPS. The seed to get converted share was already sown at the time of subscription of CCPS itself. The equity shares were already embedded at the time of issue of CCPS, the conversion only blossomed that right into fully grown equity share.

- The Taxpayer relied on a CBDT Circular (Circular), which clarifies that conversion of one type of shares into another type of share (including conversion of debentures into equity shares), does not result into "transfer" of a capital asset. This view is also supported by Mumbai Tribunal decision in the case of ITO v. Vijay M Merchant.

- Further, the above Circular is in consonance with legislative scheme of taxing capital gains, which is evident from the cost substitution provision. If, upon conversion, the difference between the FMV of equity shares and original cost of CCPS is taxed in the year of conversion, it may result into double taxation on sale of newly converted shares, since cost of acquisition shall be cost incurred for acquiring CCPS.

  E.g. For instance, on conversion of CCPS, capital gains shall be computed on difference between the FMV of equity shares and cost of acquisition of CCPS, (i.e. INR 120 - INR 100 = INR 20) and upon subsequent transfer of equity shares for a consideration of INR 150, capital gains shall be the difference between full value of sale consideration and cost of acquisition of CCPS (i.e. INR 150 - INR 100 = INR 50). It can be seen from this example that INR 20 gets taxed twice in the hands of the Taxpayer.

- Since the Circular is beneficial to the Taxpayer, it has to be adopted by the Tax Authority without any option.

- Further, the Taxpayer distinguished the decisions referred by FAA as follows:

  - In the case of CIT v. Santosh L Chowgule and others (supra), taxpayer acquired certain irredeemable preference shares in exchange of equity shares as a result of capital structure re-organization. When such irredeemable preference shares were subsequently sold by the taxpayer, the Bombay HC held that the period of holding of irredeemable preference shares should be counted from date of acquisition of such shares and not the date of acquisition of original equity shares. Since rights and obligations of both types of shares are different, the date of acquisition of equity shares cannot be the same as date of acquisition of irredeemable preference shares. The ruling is distinguishable since it was not concerned with the present controversy.

  - The SC decision in the case of CIT v. Motors & General Stores (P.) Ltd (supra) was passed before the following developments and, hence, the SC had no occasion to consider their impact.

    - The introduction of cost substitution provision on conversion of one kind of shares into another kind of shares; and

    - The Circular as referred above clarifying that there is no 'transfer' on conversion of one type of share into another.

- The Taxpayer placed reliance on SC decision in the case of CIT v. Gillanders Arbuthnot & Co. and Bombay HC ruling in the case of CIT v. Texspin Engg. & Mfg. Works , where the courts held that the FMV of asset transferred itself cannot be regarded as full value of consideration received or accruing on its transfer. It is the FMV of the thing/new asset acquired that constitutes full value of consideration.

Tribunal Ruling

Tribunal held in favour of the Taxpayer that conversion of CCPS to equity shares does not amount of "transfer" under the ITL and made following observations:

- The Circular has clarified that where one type of share is converted into another type of share, there is no transfer of capital asset. Further, Mumbai Tribunal in the case of ITO v. Vijay M Merchant (supra) has upheld this position.

- Present case is not a case where one form of share has been exchanged, bartered, swapped for other form of share. Rather, it is a case of conversion of one type of share into another type of share where earlier type of shares cease to exist. Such conversion is not a "transfer" of capital asset as per the ITL.

- The provisions of ITL which specifies the mode of computation of capital gains, makes it clear that computation of capital gains contemplates the ascertainment of full value of consideration "receiving" or "accruing" as a result of transfer of capital asset. The word "received" means actually received and the word "accruing" means the debt created in fav our of the Taxpayer as a result of the transfer. Both the terms used indicate actual receipt or accrual and not refer to estimated amounts such as 'FMV'.

- There is no leakage of income where the above interpretation is adopted and is in furtherance of the legislative intent of cost substitution provisions of the ITL.

- Tax Authority's view that conversion of preference shares into equity shares results in "transfer" is not only against the legislative intention but also makes the computation of capital gains unworkable and leads to double taxation. This is because, upon conversion as well as subsequent transfer of converted shares, cost of acquisition will be the cost incurred for acquiring original shares.

- The SC ruling in the case of CIT v. Motors & General Stores (P.) Ltd (supra) is distinguishable on facts, as in this case, allotment of preference shares as a consideration for sale of a cinema house was held to be "exchange" which is distinguishable from "sale" and hence not covered by "claw-back" provision for depreciation which refers only to "sale" of depreciable asset and not to "exchange".

- The other rulings relied by the Tax Authority are also distinguishable since they were not concerned with the issue whether conversion of CCPS into equity shares constitutes 'transfer

Source : ITA No. 1944/Mum/2018 - TS-659-ITAT-2018(Mum)

2. Chennai Tribunal rules that income from sale of ESOP's of a foreign company exercised when taxpayer was a non-resident, but paid through an current employer (which is an Indian subsidiary of foreign company) shall not be taxable in India.

Background and Facts

- Dr. Muthian Sivathanu (Taxpayer 1), an individual had received stock options under an ESOP scheme from a foreign company (F Co) for services rendered to F Co outside India. According to the taxpayer, the shares from the exercise of the stock options were allotted to Taxpayer1, when Taxpayer1 was NR in India.

- Subsequently, Taxpayer1 took up employment with the Indian subsidiary of F Co (I Co). When Taxpayer1 was NOR, F Co sold the shares received on the exercise of options and remitted the proceeds to Taxpayer1, through I Co.

- ICo1 treated the share sale proceeds as taxable perquisite and added it to salary income for salary withholding purpose. However, Taxpayer1 offered a smaller amount as capital gains in his return of income.

- The Tax Authority taxed the entire amount received on the sale of shares as 'perquisite' u/s 17(2)(vi) taxable under the head 'salary', The Tax Authority relied on the fact that in the Form

16 issued by the employer (i.e. I Co), I Co had added the sale proceeds of shares to salary income.

- The First Appellate Authority (FAA) also upheld the Tax Authority's contention and held that the entire income received by Taxpayer1 is taxable as salary income. The FAA held that employees who accept ESOPs receive something in addition to their salary and this additional income will come within the definition of salary income. The FAA also held that whether the amount is paid by the employer (i.e. I Co) or by employer's parent (i.e. F Co) on behalf of the employer will not make any difference. F Co extended ESOP benefit to I Co's employees by treating I Co's business as its own business.

- Aggrieved by FAA's order, Taxpayer 1 appealed further to the Tribunal.

- Before the Tribunal, Taxpayer1 argued that he was NR and served abroad when he exercised the stock options and was NOR in the tax year under consideration when the shares were sold.

- Taxpayer1 further argued that entire value received on the sale of shares, cannot be treated as 'perquisite' as the stock option was exercised in the earlier assessment year when Taxpayer1 was NR and only the capital gain accruing to the Taxpayer1 when he is NOR can be brought to tax in the relevant tax year.

Tribunal Ruling

- The Tribunal accepted the Taxpayer1's factual representation that the entire stock option were exercised when Taxpayer1 was NR and hence the entire value of the shares allotted cannot be treated as income of Taxpayer1 as such income accrued to Taxpayer1 for services rendered outside India when he was NR.

- The asset (viz. FCo's shares) had already vested in Taxpayer1 before the relevant tax year and hence any gain arising on the sale of such asset, when he is NOR has to be treated as 'capital gains' in the hands of Taxpayer 1. Further, the value of the stock allotted to Taxpayer1 has to be treated as the cost of acquisition of the shares.

- Both Tax Authority and FAA had erred in treating the entire amount received on the sale of share as perquisite.

- The fact that I Co had treated the sale proceeds as salary income in Form 16 is not relevant since income should be assessed based on actual facts and as per the provisions of the Act and not in accordance with what is stated in Form 16 issued by the employer.

- However, the Tribunal noted that there are discrepancies in the assessment order issued by the Tax Authority and in the return of income, filed by Taxpayer1 by noting the following:

  - The Tax Authority in its assessment order mentioned that Taxpayer1 had claimed short term capital gain of INR 145 million but in the return of income, Taxpayer 1 had offered short term capital gain of INR 0.8 million.

  - The Tax Authority in its assessment order mentioned that Taxpayer1 has offered total income of INR 418 million, but in the return of income, Taxpayer1 had declared total income of INR 283 million only.

- The Tribunal held that since there are factual discrepancies, the matter had to be remanded back to the Tax Authority to verify the facts and to decide the matter in accordance with law and as per the observations of the Tribunal.

Source: Shri Dr Muthian Sivathanu v Assistant Commissioner of Income Tax
(ITA No. 553/CHNY/2018)

3. Bangalore Tribunal holds capital gains arising from buy-back of options as long term considering holding period from date of grant

Background and Facts

- As per the Act, a capital asset held for more than 36 months preceding the date of transfer is considered as a long-term capital asset except in case of certain specified capital assets where a shorter duration is prescribed. The gains arising from transfer of such assets is classified as LTCG.

- Further, as per Section 54EC of the Act as applicable for FY 2006-07, where LTCG is invested in specified assets such as notified bonds issued by Rural Electrification Corporation Limited (REC Bonds), within a period of six months after the said transfer, such LTCG can be claimed as exempt subject to conditions specified.

- The Taxpayer, an employee of Infosys BPO Limited, was granted options under an Employee Stock Option Plan (ESOP) as provided below:

  - 1,250 options on 28 February 2003
  - 2,500 options on 2 February 2004
  - 2,250 options on 1 June 2005

- The 6,000 options granted were bought back by Infosys Technologies Limited on 7 March 2007 vide an Option Transfer Agreement. The options were not exercised by the Taxpayer prior to the transfer.

- The Taxpayer treated the gains arising from the transfer of 3,750 options granted on 28 February 2003 and 2 February 2004 as LTCG since these were held for more than three years prior to the transfer. The India tax return for FY 2006-07 was filed accordingly and the Taxpayer also claimed exemption under Section 54EC of the Act.

- The Assessing Officer (AO) treated the gains as Short Term Capital Gains (STCG) and denied the exemption claimed by the Taxpayer. The Commissioner of Income Tax (Appeals) [CIT(A)] dismissed the Taxpayer's appeal against the order of the AO.

- Aggrieved by the order of the CIT(A), the Taxpayer appealed before the Tribunal.

Taxpayer's contentions

The Taxpayer contended that the gains arising from transfer of the options is LTCG based on the following:

- The holding period of the options needs to be considered from the date of grant. Therefore, the holding period was more than three years and the gains are long term in nature. Consequently, the exemption under Section 54EC should also be allowed. The Taxpayer relied on previous judicial precedents in support of this

- Vesting and exercise of options are not relevant in the Taxpayer's case since the options were transferred to Infosys Technologies Limited without any exercise and since the period of holding of the options was more than three years, the gains need to be considered as LTCG.

Tax Authority's contention

- The Tax Authority argued that the period of holding of the options for computation of capital gains cannot be counted from the date of grant of options since prior to the vesting date, the Taxpayer could not have exercised any right.

- Therefore, AO and CIT(A) were justified in treating the capital gains arising on transfer of the options as STCG and thereby denying the exemption claimed by the Taxpayer under Section 54EC of the Act.

Tribunal's ruling

- Vesting and exercise of options were not relevant in the Taxpayer's case since the options were transferred to Infosys Technologies Limited without any exercise and since the period of holding of the options was long term, the gains need to be considered as LTCG.

- The AO and CIT(A) have ignored the important fact that the options were sold to Infosys Technologies Limited without any exercise of options. If options had been exercised and the shares allotted were sold after allotment, then the gains arising would have been STCG. However, in the present case, the options were transferred without any allotment of shares. It is a case of buy-back of options by Infosys Technologies Limited.

- The options provided valuable right to the Taxpayer to exercise and have allotment of shares. They were thus 'capital assets' held by the Taxpayer from the date of grant (i.e. 28 February 2003 and 2 February 2004 respectively) for which consideration was paid to the Taxpayer under the Option Transfer Agreement. The contention that the Taxpayer cannot exercise the options in the absence of vesting is not relevant as the options were transferred without any exercise.

- The Tribunal also discussed the case laws relied on by the Taxpayer and held that the capital gain arising from the transfer of the options should be considered as LTCG. Accordingly, the Tribunal also allowed the Taxpayer's claim for exemption under Section 54EC in relation to investment of LTCG in REC Bonds.

  Source: Shri N R Ravikrishnan v Assistant Commissioner of Income Tax (ITA No. 2348/Bang/2018)

Key Regulatory amendments

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

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

1. **External Commercial Borrowings (ECB) Policy – Review of minimum average maturity (MAM) and hedging provisions**

- RBI has liberalized the extant ECB guidelines with respect to MAM and hedging requirements in the infrastructure space for availing ECBs. The key changes are provided as under:

- MAM requirement for ECBs in the infrastructure space raised by eligible borrowers has been reduced from 5 years to 3 years.

- MAM requirement reduced from extant 10 years to 5 years for exemption from mandatory hedging provision applicable to ECBs raised by eligible borrowers in the infrastructure space.

- Further, mandatory hedge coverage to be reduced from 100 per cent to 70 per cent for ECBs raised under Track I of the ECB framework by eligible borrowers i.e. Companies in infrastructure sector, Non-Banking Financial Companies - Infrastructure Finance Companies (NBFCIFCs), NBFCs-Asset Finance Companies (NBFC-AFCs), Holding Companies and Core Investment Companies (CICs), Housing Finance Companies, and Port Trusts for MAM between 3 to 5 years.

  In addition to above, RBI has clarified that ECBs falling under the aforesaid revised provision but raised prior to the date of this revision circular will be required to mandatorily roll-over their existing hedge(s) only to the extent of 70 per cent of outstanding ECB exposure.

Source: A.P. (DIR Series) Circular No.15 dated 26 November 2018 read with A.P. (DIR Series) Circular No.11 dated 06 November 2018

2. Liberalization of Deposit Regulations

- RBI has amended the extant provisions of the Foreign Exchange Management (Deposit) Regulations, 2016 ('Deposit Regulations'). The key changes are provided as under:

- The said Regulations now permits an AD bank to allow Foreign Portfolio Investor and Foreign Venture Capital Investor (registered with SEBI) to open and maintain a non-interest bearing foreign currency account to align the same with foreign investment regulations.

- The eligibility criteria for Non-Resident Ordinary Account ('**NRO Account**') by a person resident outside India has been amended as follows:

- Citizen of Bangladesh and Pakistan belonging to minority community in those countries (Hindus, Sikhs, Buddhists, Jains, Parsis and Christians), residing in India and holding Long Term Visa ('**LTV**') by the Central Government are permitted to open only one NRO account with the AD Bank. The said NRO account would be converted to a resident account once such person becomes a citizen of India within the meaning of Indian Citizenship Act 1955;

- Such nationals of Bangladesh and Pakistan of minority community who is residing in India and has applied for LTV which is under consideration of Central Government, is permitted open only one NRO account with an AD bank for a period of 6 months and may be renewed at 6 monthly intervals subject to the condition that such individuals holds a valid visa and a valid residential permit issued by Foreign Registration Office ('**FRO**')/ Foreign Regional Registration Office ('**FRRO**').

- The specific restriction of *'no operations beyond 7 years'* of the opening of the Special Non-Resident Rupee Account (SNRR) by any person resident outside India has been removed for the purpose of making investment in India in accordance with foreign investment regulations. Further, RBI approval would be required for obtaining renewal of SNRR account.

- The permitted transactions by non-resident on Escrow Account have now been amended to replace "transfer of shares/ convertible debentures through open offers" with "transfer of capital instruments/ convertible notes through open offers", thereby, widening the nature and spectrum of transactions allowed on Escrow Account;

- The permitted credits on the Escrow Account by non-resident now also includes guarantee issued by an authorized dealer bank.

Source: FEMA Notification No. G.S.R. 1093(E) dated 09 November 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