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A Monthly Journal of

The Chamber of Tax Consultants

THE CHAMBER'S JOURNAL

Vol. VI | No. 6 March 2018

YOUR MONTHLY COMPANION ON TAX & ALLIED SUBJECTS

Mergers & Acquisitions

HOT SPOT COVERS

i) NFRA

ii) SC Judgment of S. Sukumar vs ICAI

Other Contents

- Direct Taxes
- Other Laws
- Best of the Rest
- Indirect Taxes
- International Taxation
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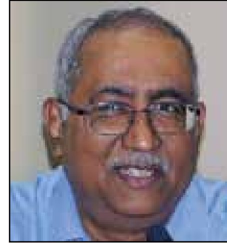
Direct Taxes Committee

Half Day Workshop on Direct Tax Provisions of Finance Bill, 2018 jointly with WIRC of ICAI was held on 10th February, 2018 at Babubhai Chinai Committee Room, 2nd Floor, IMC, Churchgate

Faculties

Mr. Ajay R. Singh, Advocate (President) delivering opening remarks

CA Ashok Mehta (Chairman) welcoming the speakers



CA Gautam Nayak addressing the participants

CA Yogesh Thar addressing the participants

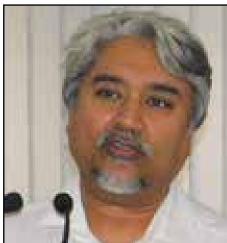
Dignitaries on dais. Seen from L to R: CA Dinesh Poddar (Convenor), CA Nishtha Pandya (Hon. Jt. Secretary), Ms. Priti Savla (RCM – WIRC of ICAI), CA Gautam Nayak (Speaker), Mr. Ajay R. Singh, Advocate (President), CA Yogesh Thar (Speaker), CA Ashok Mehta (Chairman) and CA Ketan Vajani (Hon. Jt. Secretary)

IT Connect Committee

Half Day Seminar on Bitcoin/Crypto-Currencies: Investment, Legal and Tax Issues was held on 16th February, 2018 at Jai Hind College, A. V. Room, Churchgate

Mr. Ajay R. Singh, Advocate (President) delivering opening remarks

CA Dinesh Tejwani (Chairman) welcoming the speakers. Seen from L to R: CA Maitri Savla (Vice-Chairperson), Mr. Ajeet Khurana (Speaker), Mr. Ajay R. Singh, Advocate (President), Mr. Meyyappan Nagappan (Speaker) and CA Alok Jajodia (Convenor)



Mr. Ajeet Khurana (Speaker) addressing the participants

Mr. Meyyappan Nagappan (Speaker) addressing the participants

Holi Wishes to Shri V. H. Patil, Past President

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Editorial

The Financial Year 2017-18 is coming to an end. This Financial Year was very significant with respect to the changes which took place in the field of indirect taxes. During this financial year there were ramifications of certain events which happened in the earlier financial year, especially, the demonetisation. The introduction of GST from 1st July, 2017 was a learning experience for all the stakeholders. This kept the professionals as well as the professional bodies like ours academic calendar hectic. The disruptions which have taken place due to introduction of GST may take a while to settle down. Looking at the way GST Council is functioning, the clarity on law and procedure will be much expeditious. A close look into the happenings of this financial year show that the law makers have been pushing for economic reforms, hence, we are on the path of irreversible course of economic reforms. The above personal view of mine is strengthened by the provisions of the Finance Bill, 2018, especially, those pertaining to the direct taxes. The legislature has not tried to dilute the statutory provisions for the sake of some political grand standing. If this trend is maintained, it may help the nation in the long run and it may even change the perception of the law makers that in a democracy, you have no need to keep on obliging the pressure groups. A strong and good policy adopted by the governing dispensation will not adversely impact their political dividends.

The second issue which I would like to touch upon is the tumbling out of skeletons in the banking sector. Consistently and at regular frequency, the banking system has been abused by the unscrupulous elements and the people responsible to safeguard the interest of the society woke up after the culprits had left long ago. The checks and balance which were put in place have proved to be insufficient. Unfortunately, in these circumstances, the regulatory body of the professionals is being exposed to criticism. This issue of the Chamber's Journal contains an article by the past President of Institute of Chartered Accountants of India – Mr. Manoj Phadnis – NFRA & Other Challenges Before the Professions and Analysis of the Apex Court's decision dated 23rd February, 2018 in the case of *S. Sukumar vs. the Secretary of Institute of Chartered Accountants of India* under the Column HOT SPOT.

I am personally thankful to Mr. Manoj Phadnis and Mr. C. N. Vaze for accepting to write for the Chamber's Journal at a very very short notice.

This issue of Chamber's Journal is on Mergers & Acquisitions. Eminent professionals have covered issues arising under the Corporate Laws as well as Direct and Indirect Taxes. The topic chosen by the Committee is Apt for the times.

I thank all the contributors of this issue for sparing their valuable time for the Chamber's Journal.

K. GOPAL
Editor

From the President

Namaskar,

Dear Members & Readers,

The Union Cabinet on March 1 2018, approved setting up of the National Financial Reporting Authority (NFRA), which will be an independent regulator for the auditing profession. While rules are yet to be notified about the composition of the National Financial Reporting Authority (NFRA), a debate rages about who should or should not be part of the NFRA. National Financial Reporting Authority (NFRA) will be having one post of Chairperson, three posts of full-time Members and one post of Secretary for NFRA.

The NFRA will act as an independent regulator for the auditing profession which was one of the key changes brought in by the Companies Act, 2013. NFRA would be an oversight body for auditors and its jurisdiction would extend to all listed companies as well as large unlisted public companies. National Financial Reporting Authority (NFRA) is a body proposed in Companies Act, 2013 for the establishment and enforcement of accounting and auditing standards and oversight of the work of auditors.

The decision comes against the backdrop of various auditing lapses in the banking sector, including the ₹ 12,600 crore fraud at Punjab National Bank. The country is witnessing probably the biggest scam in the banking industry where thousands of crores are at stake. The banking industry is bleeding hard and the confidence of citizens is shaken considerably. No one is sure as to what went wrong and who is ultimately responsible for the painful episode. While the truth will ultimately triumph, the auditors of banks cannot shrug off their responsibility totally. Lessons will have to be learnt from the carnage and one will have to redesign audit programme in more exhaustive manner. It is classically said that the auditor is a watchdog and not a bloodhound. However, it seems that in the changing scenario, the auditors will also need to develop skill to sniff a probable fraud.

In sport arena Ms. Navjot Kaur made all of us proud by her dominating performance in the final of the women's 65 kg. freestyle category to clinch the gold medal in what was a day to remember for Indian wrestling at the Asian Wrestling Championships in Bishkek, Kyrgyzstan. In the process, Navjot Kaur became the first Indian woman who has stood at the top of the podium at the senior Asian Wrestling Championships.

The point to be noted is that Navjot had reached the final in 2013 and lost. In fact, she had lost to the same Japanese opponent in the first round at Bishkek, but in the final, she hit two four-pointer throws with her signature leg flip move known as the 'tang' to break the jinx. There is a lesson to be learnt, never give up. If you are determined you can rise from the dust.

At Chamber, we had a very successful 41st RRC at Amritsar, diverse and dynamic speakers and brains' trustees provided in-depth study on the subject of Direct Taxes. The course was inaugurated by Mr. Sudeep Kumar, Commandant, Border Security Force, followed by his keynote address. Visit to Wagha border, Golden Temple and the Gala Dinner Musical Evening brought together the professionals as well as friends from around different cities.

CTC had organised jointly with Goa Chamber of Commerce & Industry and Goa ICAI Branch, one day Seminar on "GST Case Studies and Anti Profiteering in Real Estate and Tourism Sectors" on 3rd March, 2018. We are thankful to Mr. Parimal Kulkarni, Chairman, Taxation Committee, GCCI, Goa and Mr. R. S. Kamath, DG, GCCI, Goa for organising a very educative Seminar at Goa.

A piece of advice, one of the important attributes of a good professional is his integrity, respect for the fellow brothers and high standard of professionalism which I feel we should cultivate in upcoming professionals.

The Special Story for the month is on "M&A". I thank all the authors for sparing their valuable time and for their contribution to the Chamber's Journal for this month.

I end with a quote

Life is Beautiful,

Stay connected.

Fly high, but not by cutting others...

....

Jai Hind !

AJAY R. SINGH
President

Chairman's Communication

Dear Readers,

The month of February witnessed one of the biggest ever scams in the Banking Sector involving about ₹ 12,000 crore. Magnitude of this scam which went unnoticed for six to seven years and that too in one of the largest Public Sector Banks is something which is shocking and perplexing. On the basis of news reports it appears to be a combination of multiple factors viz. lack of adequate internal controls, inefficiency of integrated IT System and more importantly connivance by the bank officials with the borrowers. The whole episode brings into focus one very important aspects that irrespective of the strong system an entity has, unless the people in an organisation have highest level of integrity and moral values, systems are bound to fail. There were internal audits, inspection by the regulator and various other auditors which were taking place in the branch where this fraud was perpetrated. However only the external auditors are the soft targets and their profession is maligned, which is unfortunate.

Banking sector has been passing through one of its worst phases due to the problem of mounting NPAs especially in the Nationalised Banks and the scam has aggravated the problem. Is privatisation of the banks the solution to this problem or overhauling the manner in which their board functions? The Government has to seriously consider this problem and come out with a structure which would make the functioning of the banks more professional in overall interest of all the stakeholders.

It is more than a year since the implementation of the Bankruptcy Code. Initially there were apprehensions about the success of the Code. However, recently, there are some positive outcomes in terms of resolution of some big accounts. Though the banks would suffer in terms of hair cut in the loan amount, it seems that in the long run the Code would make working of the banks more healthy and the borrowers also would be more disciplined.

It is always the endeavour of the Journal Committee to bring out issues on topics which are most relevant to professionals. After the enactment of the Companies Act, 2013, there have been quite a few changes in the provisions for Mergers and Acquisitions. The subject is also of practical relevance to many professionals. Considering this, the current issue is planned on Mergers and Acquisitions. I would like to thank my colleague CA Sanjeev Shah for designing this issue and CA Mitesh Majithia for overall co-ordination. I am sure the readers would find this issue very useful and also find permanent place in their library.

My gratitude to all the learned authors for sparing their valuable time despite their busy schedule and sharing their knowledge on a complex subject like mergers and acquisitions.

Wishing you and your family a very happy Gudi Padwa!

VIPUL K. CHOKSI
Chairman – Journal Committee

CA Shailesh Bathiya & CA Anand Bathiya

Mergers and Acquisitions – Companies Act Framework and Broad Process

Businesses in modern-day economies are comprehensively different from their counterparts in earlier times. Modern-day economies are characterised by an extremely dynamic, rapidly evolving and vibrant environment under which business models are put to trial on a regular basis. The increasing adaptation and proliferation of technology is further challenging the way in which established businesses operate. Under this backdrop coupled with a wave of globalization, the landscape of mergers & acquisitions **('M&A')** has gained significant importance in the recent times. An enabling framework under corporate and tax laws goes a long way in enhancing the effectiveness of a functional M&A regime in the economy. Mature economies invariably boast of a supportive and contemporaneous framework under its corporate and tax laws that act as a catalyst in facilitating inorganic growth in the economy.

Businesses are necessitated to undergo a M&A endeavour on account of various considerations. Some of them include:

- Achieving growth through inorganic pursuits
- Achieving synergies through complimentary pursuits
- Eliminate or reduce competition
- Market access, product access, technology access, etc.
- Diversification of business interests
- Regulatory, tax and fiscal considerations

A loosely referred term, M&A, as usually understood and also commonly used under this article includes the other forms of effectuating a transaction including demerger, amalgamation, spin-off, reverse merger, business transfer, etc. Under this backdrop let us discuss the broad regulatory framework surrounding the M&A regime in India in relation to corporate entities. Various pieces of the below regulatory framework have been discussed in the other chapters of this publication.

a. Companies Act, 2013

b. SEBI (Listing Obligation & Disclosure Requirements), 2015

c. SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011

d. Income-tax Act, 1961

e. Competition Act, 2002

f. Foreign Exchange Management Act, 1999

g. Indian Stamp Act, 1899 and other State Stamp Acts

h. Central Goods & Services Act, 2017 and other State GST Acts

i. Rules, regulations, circulars, directions, notifications issued under the above

Companies Act Framework

Sections 230 to 240 of the Companies Act, 2013 cover the statutory provisions governing M&As including arrangements involving companies, their members and creditors. All sections other than section 234 have been notified effective from December 15, 2016 with section 234 being notified on April 13, 2017. Apart from the substantive provisions mentioned in sections 230-240, guidance on procedural aspects is covered in Companies (Compromises, Arrangements and Amalgamations) Rules, 2016 **('CAA Rules')**. The provisions relating to sections 230 to 240 are different from erstwhile sections 391 to 394 of the Companies Act, 1956 **('1956-Act')** on account of various aspects. Some of them are as below:

a. ***Mandate of the National Company Law Tribunal ('NCLT'):*** After a long legal encounter over constitutional validity of certain provisions, the NCLT saw light of the day in 2016. Delay in setting up of NCLT and the surrounding infrastructure resulted in a delay in implementation of sections 230-240 of the Companies Act, 2013. In a marked departure from the 1956-Act, the body for adjudging on M&A matters involving an arrangement shifted from respective High Courts to a more specialised judicial body aka NCLT. NCLT being a focussed body for corporate law matters brings alongside the desired focus and the right understanding in dealing with complex corporate law matters. There are currently 11 benches of the NCLT including the principal bench being in Delhi. Appeals against the orders of the NCLT lie with the National Company Law Appellate Tribunal **('NCLAT')** at Delhi.

b. ***Introduction of Fast-Track merger process:*** The entire process of effectuating a M&A involving an arrangement passes through various levels of filings, approvals, compliances and processes. A lot of these steps are extraneous when the companies involved in the M&A are extremely small companies or parent-subsidiary company. Accordingly, a fast-track merger process also commonly known as "House-Merger" is conceptualised in Companies Act, 2013. We discuss the process of a fast-track merger in latter part of this article.

c. ***Two-way cross-border amalgamations:*** The 1956-Act much like a one-way street allowed foreign companies to merge into Indian companies but did not specifically provide for the other way round. Companies Act, 2013 allows merger of Indian companies also into foreign companies subject to checks and balances as laid down. Section 234 deals with such schemes of mergers and amalgamations between companies registered under this Companies Act, 2013 and companies incorporated in the jurisdictions of such countries as may be notified from time to time by the Central Government. Further, the Companies Act, 2013 also requires prior approval of the Reserve Bank of India for effectuating such schemes. The Reserve Bank of India has issued draft rules in this matter which *inter alia* prescribes conditions for in-bound and outbound schemes. Further, Annexure – B of CAA Rule 25A also prescribes the jurisdictions in which the foreign company(ies) is incorporated, with which cross-border mergers can be undertaken.

d. ***Quantified threshold for objecting to the scheme:*** The Companies Act, 2013 prescribes a threshold beyond which a stakeholder can object to the scheme of arrangement. A proposed scheme can be objected only by shareholders having not

less than 10% shareholding or creditors whose debt is not less than 5% of total outstanding debt as per the last audited financial statement or the provisional financial statements which is not older than six months 1956. Act did not have any threshold.

e. ***Certification from statutory auditors:*** The Companies Act, 2013 prescribes that no arrangement shall be sanctioned by the NCLT unless a certificate by the company's auditor has been filed with the NCLT to the effect that the accounting treatment, if any, proposed in the scheme of arrangement is in conformity with the Accounting Standards prescribed under section 133 of the Companies Act, 2013. Such a requirement has hitherto been applicable in case of listed companies only.

f. ***Procedural ease:*** Companies Act, 2013 proposes certain smaller process eases to facilitate a smoother approval. These include flexibility of e-voting, electronic submission of documents with NCLT, exit offer to dissenting shareholders under section 235, obligation to purchase of minority shareholders share under section 236, etc.

Representation by other professionals: Since Chartered Accountants, Company Secretaries and Cost Accountants can also appear (besides Advocates) before NCLT, they will be able to take up M&A cases before NCLT which earlier they could not as earlier respective High Courts were handling schemes of arrangement. **Process for effectuating a M&A through a scheme of arrangement (NCLT route) under section 232 of Companies Act, 2013**:

Broad Procedure to be followed for scheme of amalgamation or arrangement (involving a listed company) under section 232 of the Companies Act, 2013:

Step	Broad Process for scheme involving a listed company	
1	Conceptualisation stage and pre-board meeting preparations	
	•	Evaluation of transaction structure and review of all aspects before taking final decision on M&A involving a scheme of arrangement.
	•	Review of relevant documents and preparation of project activity plan basis of the shortlisted option.
	•	Preparation and finalisation of Scheme of Amalgamation / Arrangement.
	•	Complete valuation of the companies and obtain valuation reports from Registered Valuer Obtain Fairness Opinion from a registered merchant banker.
	•	Call for an Audit Committee and approve the valuation report in the Audit Committee.
	•	Obtain auditors report for (a) scheme being in compliance with the requirements of Accounting Standards (b) scheme being in compliance with the requirements of SEBI circulars/LODR provisions.
	•	Preparation of secretarial documents in relation to calling of a board meeting and intimation to recognised stock exchange(s), regarding holding of board meeting and outcome board meeting.
2	Convene the Board Meeting for approval of the Scheme of Amalgamation and Arrangement and appointment of professionals, etc.	
3	Application to Stock Exchange(s) (electronic mode) for Approval/observations on the Scheme and/or Application to RBI (physical mode) for Foreign Company amalgamation. Obtain Approval/Observation Letter from stock exchanges.	

Step	Broad Process for scheme involving a listed company	
4	Initial Application for Scheme of Amalgamation and Arrangement involving Merger/ Demerger	
	•	After approval from Stock Exchange(s) has been received, file application with the NCLT along with below documents: – Application seeking NCLT order for holding meeting(s) (Form NCLT-1) – Notice of admission (Form NCLT-2) – Affidavit (Form NCLT-6) – Copy of scheme which should include disclosures required u/s 230(2) such as latest financial position, auditor's report and details about pending investigations/ proceedings, etc
	•	Hearing of application at the NCLT and directions w.r.t members/creditors meeting which may cover matters stated in Rule 5 of CAA Rules.
5	Drafting of Advertisements, Notices of Meeting of Members, Creditors and Statutory Authorities along with Explanatory Statement as per Rule 6 of CAA Rules, 2016;	
6	Convene the Board Meeting for approval of draft notices of Shareholders and Creditors meeting as directed by the NCLT for the Shareholders and Creditors	
7	Filing of Draft Scheme of Amalgamation & Arrangement with the Registrar of Companies - Physically & Electronically through Form GNL-1. Filing of draft scheme with Income Tax department, sectoral regulators seeking objections, if any.	
8	Calling and Convening Meeting of Members and Creditors	
	•	Dispatch of Notice and Explanatory Statement (as per Rule 6) in Form No. CAA.2 to each member/creditor of the Companies atleast 1 month before date fixed for meeting;
	•	Advertisement of such notice in Form No. CAA.2 in newspapers (1 English and 1 vernacular), on company website at least 1 month before date fixed for meeting;
	•	Dispatch of Notice and Explanatory Statement in Form No. CAA.3 to prescribed Statutory Authorities (RD, ROC, IT, SEBI, Official Liquidator, RBI, etc.) forthwith after notice is sent to members and creditors with a time frame of 30 days to make any representation to the NCLT and Company;
	•	Filing of Affidavit of Service by Chairperson of the Meeting with the NCLT along with copy of advertisements published, acknowledgement of dispatch of notices to Members, Creditors, Statutory Authorities at least 7 days before the date of meeting stating that all directions w.r.t. notices and advertisements have been complied with;
	•	Convening of Meeting(s) as per the Order and passing Resolutions for approval of the Scheme with such majority as required under the Companies Act, 2013;
	•	Filing of Chairman's Report by the Chairperson of the Meeting in Form No. CAA.4 with the NCLT within 3 days of the conclusion of meeting or such other days as directed by the Tribunal
	•	Application for in-principle approval for listing of new securities can also be applied at this stage.

Step	Broad Process for scheme involving a listed company	
9	Petitioning the NCLT and Obtaining Final Order	
	•	Once the Scheme has been agreed by the members and creditors, the Companies shall file a petition in Form No. CAA.5 with the NCLT for sanction of scheme, within 7 days of filing of Chairman's report
	•	Admission of Petition for fixing the date of final hearing – NCLT
	•	Response to Notice received from the Registrar of Companies, Regional Director and Official Liquidator and follow-up with them
	•	Advertisement for Petition to be advertised in the same newspapers as the notice in Form No. CAA.2 was advertised at least 10 days prior to the scheduled hearing & Filing of Affidavit of Service
	•	Obtain approval of RBI and all other sectoral regulators as applicable.
	•	NCLT shall pass an Final Order on the petition in Form No. CAA.7
10	Post Final Order compliances	
	•	Stamp duty Adjudication as per the State Stamp Duty Acts;
	•	On receipt of Certified Copies of the Final Order, the Company shall file Certified Copy of Order with the ROC within 30 days of its receipt in Form INC-28 along with Acknowledgement of payment of Fees to RD and OL for the companies;
	•	Allotment and credit of Shares to shareholders pursuant to the Scheme of Amalgamation and Arrangement;
	•	Application to Stock Exchanges for Listing of New Equity Shares issued as consideration;
	•	Intimation to Stakeholders w.r.t. effectiveness of Scheme of Amalgamation and Arrangement.

Eligibility and Process for effectuating a Fast-Track M&A through a scheme of arrangement

Fast track merger route is eligible for (a) merger between two or more small company(ies) or (b) merger between a holding company and its wholly owned subsidiary. Section 2(85) of the Companies Act, 2013 defines Small Company as below:

"small company" means a company, other than a public company,—

(i) paid-up share capital of which does not exceed fifty lakh rupees or such higher amount as may be prescribed which shall not be more than ten crore rupees; and

(ii) turnover of which as per profit and loss account for the immediately preceding financial year does not exceed two crore rupees or such higher amount as may be prescribed which shall not be more than one hundred crore rupees

***Provided that** nothing in this clause shall apply to —*

(A) a holding company or a subsidiary company;

(B) a company registered under section 8; or

(C) a company or body corporate governed by any special Act;

Fast Track merger does not involve NCLT approval but post the approval of the board of directors of the company, notice would be sent to the registrar of companies and official liquidator inviting objections/suggestions to scheme. An objective threshold of approval from at least 90% shareholders and 90% creditors (value) would be required. This threshold is higher than the approval threshold required in case of a normal NCLT-route merger being that of majority of shareholder(s) and/or creditor(s) present and validly voting and representing ¾ in value. The broad process for scheme under Fast-Track Route is envisaged as below:

Step	Broad Process for scheme under Fast-Track Route	
1	Conceptualisation stage and pre-board meeting preparations	
	•	Evaluation of transaction structure and review of all aspects before taking final decision on M&A involving a scheme of arrangement.
	•	Review of relevant documents and preparation of project activity plan basis of the shortlisted option.
	•	Preparation and finalisation of Scheme of Amalgamation / Arrangement.
	•	Complete valuation of the companies and obtain valuation reports from Registered Valuer Obtain Fairness Opinion from a merchant banker.
	•	Preparation of secretarial documents in relation to calling of a board meeting.
2	Filing of Notice of the proposed Scheme with the ROC and OL or persons affected by the scheme in Form No. CAA.9 for inviting their objections/suggestions to the Scheme along with Proof of Dispatch to the Persons affected by the Scheme	
3	Filing of Declaration of Solvency by all the Companies with the Registrar of Companies in Form No. CAA.10 after 30 days of Filing CAA-9 as above along with Balance Sheets	
4	Drafting of Notices of Meeting of Members, Creditors along with Explanatory Statement as per Rule 6 of CAA Rules, 2016;	
5	Convene the Board Meeting for approval of draft notices of Shareholders and Creditors meeting and determination of Record Date (latest possible) for the Shareholders and Creditors	
6	Convening Extra Ordinary General Meeting of Members and Obtaining Written Consent from the Creditors for the approval of Scheme	
7	Filing of Approved Scheme along with results of the Meeting and Written Consent from Creditors in Form CAA.11 with RD, ROC, OL for obtaining their approval - Physically + Electronically through Form GNL-1 within 7 days of the conclusion of the Meeting	
8	In case there are no objections on the Scheme, the Central Government through RD shall pass the Final Order in Form No. CAA.12	
9	Stamp Duty Adjudication on RD Order	
10	Filing of the Final order with the ROC in Form INC-28 within 30 days of receipt of Final order	
11	Intimation to Stakeholders w.r.t. effectiveness of Scheme of Amalgamation and Arrangement	

Nuances involving companies whose securities are listed and traded on recognised stock exchanges

Securities and Exchange Board of India (Listing Obligation & Disclosure Requirements), 2015 **('Listing Regulations')** more specifically Regulations 11 and 37 govern the requirements applicable to listed companies. Regulation 11 of the Listing Regulations, *inter alia*, provides that any scheme

of arrangement / amalgamation / merger / reconstruction / reduction of capital etc. to be presented to any Court or Tribunal does not in any way violate, override or limit the provisions of securities laws or requirements of the Stock Exchanges. Regulation 37 of Listing Regulations provides that the listed entities desirous of undertaking scheme of arrangement or involved in a scheme of arrangement shall file the draft scheme with Stock Exchange(s) for obtaining Observation Letter or No-objection Letter (which shall be valid for period of six months), before filing such scheme with any court or Tribunal.

In order to effectively implement the compliance under above regulations, SEBI issued Circular No. CFD/DIL3/CIR/2017/21 dated March 10, 2017 laying down the framework for Schemes of Arrangement by Listed Entities and Relaxation under Rule 19(7) of the Securities Contracts (Regulation) Rules, 1957. Certain amendments were also effectuated to this circular via Circular CFD/DIL3/CIR/2018 issued on January 3, 2018. The broad requirements under this circular which are peculiar to listed companies are as below:

a. ***Applicability of the requirements:*** All schemes filed by companies whose securities are listed on a stock exchange except schemes which solely provides for merger of a wholly owned subsidiary or its division with the parent company. However, even under such exempted cases, draft schemes shall be filed with the stock exchanges for the purpose of disclosures and the stock exchanges shall disseminate the scheme documents on their websites.

b. ***Choosing of designated stock exchange:*** Listed companies have a choice to choose one of the stock exchanges having nationwide trading terminal on which its securities are traded as a designated stock exchange. The listed company shall before filing the scheme with the NCLT obtain approval from the designated stock exchange. The designated stock exchange shall inturn obtain comments/consent of SEBI.

c. ***Disclosure in relation to unlisted entities being a party to the scheme:*** In schemes involving unlisted entities and listed company, the listed company is required to disclose in the explanatory statement or notice or proposal accompanying resolution to be passed sent to the shareholders, all applicable information pertaining to the unlisted entity/ies involved in the scheme in the format specified for abridged prospectus. The accuracy and adequacy of such disclosures shall be certified by a SEBI Registered Merchant Banker after following the due diligence process. Such disclosures shall also be submitted to the Stock Exchanges for uploading on their websites.

d. ***Additional disclosures in explanatory statement sent to shareholders:*** In addition to the above, the listed company shall ensure the following additional details are sent as part of the explanatory statement to shareholders:

- Observation letter received from stock exchanges
- Pre-and post arrangement capital structure
- Fairness opinion obtained from merchant banker on valuation of assets\shares done by the independent chartered accountant

e. ***Disclosure on websites and redressal of complaints:*** Immediately upon filing of the Draft Scheme of arrangement with the stock exchanges, the listed entity shall disclose the draft scheme of arrangement and related documents on its website. The Listed entity shall submit to stock exchanges a 'Report on Complaints' which shall contain the details of complaints/ comments received by it on the draft scheme from various sources (complaints/ comments written directly to the listed

entity or forwarded to it by the stock exchanges/SEBI) prior to obtaining observation letter from Stock Exchanges on Draft Scheme.

f. ***Public shareholder approval for the scheme:*** As an anti-abuse measure, in certain cases, the circular mandates approval of public shareholders as a pre-requisite for passing of the scheme. i.e the Scheme of arrangement shall be acted upon only if the votes cast by the public shareholders in favour of the proposal are more than the number of votes cast by the public shareholders against. Such a requirement in applicable in five instances as mentioned in the circular. In case the scheme is not covered under the five instances, a certificate of the auditor duly approved by the board to this effect shall obtained and hosted on the website.

Valuation under schemes of amalgamations and arrangements

The Companies Act, 2013, more specifically section 247 therein introduces the concept of 'registered valuers'. Where any valuation is required to be made in respect of any property, stocks, shares, debentures, securities or goodwill or any other assets or net worth of a company or its liabilities under the provision of the Companies Act, 2013, it shall be valued by a person having such qualifications and experience, registered as a valuer and being a member of an organisation recognised, in such manner, on such terms and conditions as may be prescribed. Such a valuer would be appointed by the audit committee or in its absence by the Board of Directors of that company.

Subsequently, the Ministry of Corporate Affairs has notified Companies (Registered Valuers & Valuation) Rules, 2017, wherein detailed framework and provisions governing registered valuers have been prescribed. The rules are currently in their transitory implementation phase and will come into full effect from October, 2018. Until such time, an independent merchant banker registered with the Securities and Exchange Board of India or an independent chartered accountant in practice having a minimum experience of ten years shall be regarded as registered valuers.

Typically, schemes of amalgamation and arrangement require a swap ratio to be determined basis on a valuation exercise performed on both the transacting companies. Such a swap ratio is certified by the registered valuer. The Companies Act, 2013 also makes it mandatory that notice of meeting to discuss the scheme of amalgamation/arrangement must be accompanied by valuation report. Further, in case of listed companies in addition to the valuation report issued by the registered valuer, a merchant banker registered with SEBI shall issue a fairness opinion on the derived swap ratio.

In case of schemes involving foreign companies, valuation of the foreign company shall be conducted by valuers who are members of a recognised professional body in the jurisdiction of the transferee company and further that such valuation is in accordance with internationally accepted principles on accounting and valuation. A declaration to this effect shall be attached with the application made to Reserve Bank of India for obtaining its approval.

Conclusion

As briefly discussed in this article and also under the various other articles under this publication, the landscape of M&As is India is fairly contemporary and also equally evolving with modern-day realities. While a lot can be desired in relation to the timeframe involved for implementation of a M&A transaction in India, the other aspects of an enabling legal framework are very much in place. The Companies Act, 2013 provided the much desired shot-in-the-arm for upgrading the M&A architecture in the India context. The coming years hold a lot of promise for the growth of Indian economy and having the M&A framework in place will certainly play its role in managing the growth going forward.

CA Jinesh Shah, CA Devarsh Patel &
CA Hardik Shah

Cross Border Merger

The wave of Mergers & Acquisitions has started in latter half of the 1990 and has continued in the till this time. It is now becoming a mega activity due to globalisation as both the value of deals and the number of deals have surged that is why the current M&A activity is far from being a unique phenomenon. The cross border deal activity has also seen an increase despite global shakeups, such as Brexit and policy uncertainty in the US that impacted global currencies and capital markets.

Emerging market firms have become strong contenders in the Cross Border Acquisition Market. Initially they were targets for acquisitions by developed country acquirers. In the last decade, they have turned acquirers, expanding their presence in the global scenario by acquiring firms from both emerging and developed markets.

Under the erstwhile Companies Act, 1956 (1956 Act), whilst it was possible for a Foreign Company to merge with an Indian Company (inbound merger), it was not possible for an Indian Company to merge with a Foreign Company (outbound merger) within the court sanctioned merger framework set out under Indian corporate law.

The provisions with respect to compromises, arrangements and amalgamations are contained in Sections 230 to 240 of Chapter XV of the Companies Act, 2013. The lawmakers, for the first time have introduced the provisions with respect to merger or amalgamation of an Indian Company with a Foreign Company. The enabling provision in this regard is a significant step taken by the Government help companies having global presence restructure their operations. At the same time, Reserve Bank of India (RBI) also issued draft regulations setting out the conditions for obtaining 'deemed' approval from the RBI for cross border mergers. Now, companies in India desirous of merging with a Foreign Company may do so in specified jurisdictions. However certain tax provisions on merger with Foreign Company (which is taxable) need more clarity.

Following are some of the analysis on cross border mergers from point of views of Companies Act, 2013 and rules thereunder, FEMA / RBI regulations and Income-tax Act 1961:

Companies Act, 2013

Section 234 of Companies Act, 2013 was brought into force with effect from 13th April, 2017.

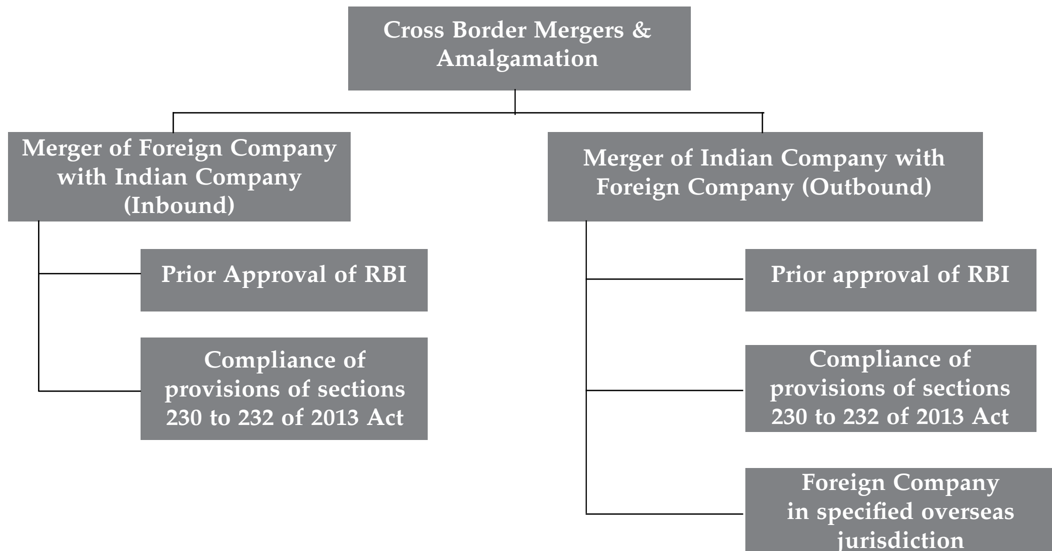
MCA also notified Companies (Compromises, Arrangements and Amalgamations) Amendment Rules, 2017[1] **("Rules 2017')** by inserting Rule 25A enabling Merger or Amalgamation of Company with a Foreign Company and vice versa.

In light of the above-mentioned amendments, 2013 Act currently allows both inbound and outbound cross border mergers.

However, such cross border mergers would entail two primary conditions:

(i) Requirement for the prior approval of Reserve Bank of India (RBI)

(ii) Specified overseas jurisdictions where such cross border mergers and amalgamations of Indian Companies would be permitted.



Sub-rule (2) of Rule 25A of Rules 2017 enables merger of an Indian Company into the Foreign Company incorporated in 'specified jurisdiction' as mentioned below:

(a) Jurisdiction whose security market regulator is a signatory to International Organisation of Securities Commission's **(IOSCO)** Multilateral Memorandum of Understanding or Bilateral Memorandum of Understanding with SEBI

(b) Jurisdiction which is not identified in the public statement of Financial Action Task Force **(FATF)** as:

  a. Jurisdiction having a strategic Anti-Money Laundering,

  b. Jurisdiction combating the financing of Terrorism deficiencies to which counter measures apply,

  c. Jurisdiction that has not made significant progress in addressing the deficiencies or

  d. Jurisdiction that has not committed to an action plan developed with FATF to address the deficiencies.

(c) Jurisdiction whose Central Bank is a member of Bank of International Settlements **(BIS)**

It can observed that currently, by virtue of rule 25A of Rules 2017, tax-friendly jurisdictions such as Bermuda, the British Virgin Islands, Cayman

1. MCA Notification No. GST 368 (E) dated 13th April, 2017

Islands, Isle of Man, Jersey, Luxembourg, Mauritius and Switzerland fall within the list of notified jurisdictions as they are signatories to the **"IOSCO MoU"**[2]. Further, Dubai, Singapore and Mauritius, which are preferred jurisdictions for routing investment in India, have "bilateral MoUs" with SEBI[3] and fall within the list of notified jurisdictions.

Key countries like the USA, UK, Russia, Germany, France, Japan, China, Singapore, Mauritius, etc. will fall within the definition of eligible jurisdictions.

FEMA / RBI Preview on cross border merger

In order to facilitate approval for cross border mergers, RBI has proposed Foreign Exchange Management (Cross Border Merger) Regulations, 2017[4] **('Draft RBI Regulation, 2017')**, which set out the conditions to be complied with to obtain its approval. It is expected that the final set of regulations will be notified shortly.

RBI has proposed these draft RBI Regulations 2017 in order to address the issues that may arise when an Indian Company and a Foreign Company enter into Scheme of merger, demerger, amalgamation, or rearrangement. These Regulations stipulate conditions that should be adhered to by the companies involved in the Scheme.

RBI has provided certain definitions which *inter alia* include cross border merger, Foreign Company and Resultant Company.

As per RBI Regulations 2017, Cross border merger means any merger, demerger, amalgamation or arrangement between Indian companies and foreign companies in accordance with the Co. Rules. However, the Section 234 of 2013 Act permitting outbound mergers from India, specifically discusses mergers and does not use the term "compromise/ arrangement" leading to an element of argument that whether outbound demergers will be permitted under the provisions of section 234 of the Act, 2013.

In the outset, definition of "Foreign Company" under Draft RBI regulations 2017 and under 2013 Act means any Company or body corporate incorporated outside India regardless of whether it has place of business in India.

The Draft RBI Regulation 2017 has been drafted in relating to merger, demerger, amalgamation and arrangement between Indian companies and foreign companies.

Following are some of the key highlights of the recent RBI draft regulations governing cross border mergers for its deemed approval

For inbound mergers

The following applies to cross border mergers where the resultant Company is Indian Company:

- Issue or transfer of security by Indian Company to a person resident outside India shall be compliance with FEMA (Transfer or issue of security by a person resident outside India) Regulation, 2000 (i.e., FEMA 20)
- Existing borrowings of the Foreign Company from overseas sources that becomes borrowing of Indian Company should confirm to Foreign borrowing norms or Foreign Exchange Management (Guarantee) Regulations 2000 as applicable
- Pursuant to merger, Indian Company may acquire / hold / Transfer any assets outside India shall adhere to the Foreign Exchange Management Act, 1999 or rules or regulations framed thereunder (FEMA).

2. https://www.iosco.org/about/?subSection=mmou&subSection1=signatories
3. https://www.sebi.gov.in/sebi_data/internationalAffr/IA_BilMoU.html
4. RBI draft rules *vide* Notification No. FEMA. _____ /2017-RB read with press release dated April 26, 2017 (2016-2017/2909)

For outbound mergers

The following applies to cross border merger where resulting Company is Foreign Company:

- An Indian resident may acquire or hold securities of the Foreign Company in accordance with the applicable Indian Foreign exchange regulations.
- The resultant Foreign Company shall be liable to reply any outstanding borrowings of the Indian Company as per the Scheme sanctioned by National Company Law Tribunal.
- Resultant Foreign Company may acquire, hold and transfer any asset or security in India, provided it is permitted to do so under the provisions of relevant Indian Foreign exchange regulations.

In case of contravention of FEMA provisions

Under both the Inbound and outbound merger, if assets or securities held by resultant Company is in contravention of the provisions of FEMA, the resultant Company would be required to sell the said assets/securities within 180 days from the sanction of the merger scheme or sale proceeds to be repatriated to India or outside India as the case may be. This may entail unattractive tax and stamp duty implications and also involve penalty on account of violation of FEMA regulations.

Valuation

- **Under Draft RBI Regulation 2017:** For the purpose of cross border merger as per Draft RBI Regulation 2017, the valuation of Indian Company and Foreign Company should be in accordance with internationally accepted pricing methodology for valuation of shares on arms' lengh basis which is duly certified by Chartered Accountant / Public Accountant / Merchant Banker authorised to do in either jurisdiction.
- **Under Rules 2017:** As per Sub-rule (2) of Rule 25A of Rules 2017 requires Transferee Company to ensure that valuation is conducted by the valuers who are members of a recognised professional body of jurisdiction of Transferee Company and valuation should be in accordance with internationally accepted principles on accounting and valuation. Declaration to this effect shall be enclosed with application made to RBI for obtaining its approval. Sub Rule (1) of rule 25A of Rules 2017 apply only in case of outbound merger i.e. when Indian Company merges into Foreign Company.

All Cross border mergers transaction undertaken in accordance with above regulations would not be required to file applications to seek approval with the RBI and shall be considered as deemed approval of RBI.

Income-tax Act, 1961

The Income Tax Act, 1961 (ITA), at present, contains exemption in case of tax neural mergers subject to compliance of certain conditions which are as under:

- All assets and liabilities of the transferor entity become the assets and liabilities of the transferee Company, and
- At least 75% in value of the shareholders of the transferor entity (other than shares already held by transferee entity) become shareholders of the transferee Company by way of amalgamation

While in the past inbound mergers have generally been implemented for consideration in the form of shares, the 2013 Act provisions also permit payment of consideration in the form of depository receipts and cash. Where the consideration on mergers is discharged in the form of depository receipts or cash, such mergers may not remain income-tax neutral. In the absence of specific tax provisions, the

tax implications on the merging Company and shareholders remain ambiguous.

As regards merger of Foreign Company into Indian Company, in case it does not have any assets situated in India, there may be no tax implications in India. Similarly, in the hands of shareholders, there would be no capital gains implications on transfer of shares of the merger of Foreign Company in India unless the shareholders are Indian tax residents or such shares derive their value substantially from assets in India (resulting in the trigger of indirect transfer provisions under the Indian tax laws). In case such a transaction may be taxable in the hands of shareholders, the capital gains would logically be computed based on the fair value of the shares of the merged Company received as consideration.

The brief summary of Income Tax implications under different forms of amalgamation / arrangement are under.

A. Merger of Indian Companies

In India, mergers of Indian Companies are exempt from tax for all parties (subject to prescribed conditions mentioned above) which are as under:

In the hands of Transferor Company	Capital gains arising upon transfer of capital assets to the Transferee Company;
In the hands of shareholders of Transferor Company	Capital gains arising upon exchange of shares of the Transferor Company for the shares in the Transferee Company.

B. Inbound mergers (Merger of Foreign Company with Indian Company):

Under section 47(vi) of the ITA, exemption has been provided to Transferor Company (i.e., Foreign Company) for any transfer of capital assets to Indian Transferee Company pursuant to Scheme of amalgamation.

A similar tax exemption has also been provided to the shareholders of the Transferor Company under Section 47(vii) of ITA where shares of the Transferor Company are transferred in consideration for the issue of shares in the Transferee Indian Company.

Taxability in the hands of Foreign Company and its shareholders in case of Demerger of from Foreign Company into Indian Company need to be evaluated in the light of current provisions of the ITA.

C. Outbound mergers (Merger of Indian Company with Foreign Company)

Under ITA, there are no specific provisions providing exemption in case of merger of Indian Company with Foreign Company. Consequently, the capital gains arising from these mergers may result in tax liabilities in the hands of the shareholders of the Transferor Company as well as in the hands of Indian Transferor Company.

In the absence of any specific exemption, taxation of outbound mergers may be more complex than that of inbound mergers because the defence available in the case of inbound mergers that the merging Company is not an Indian Company or the shareholders are not Indian residents may not be available for outbound mergers. Nevertheless, non-resident shareholders of the merged Indian Company may be able to claim exemption under the relevant tax treaty benefits, as applicable. In the outset, tax neutral status as provided to inbound mergers should also be accorded to outbound mergers to simplify and facilitate corporate reorganisation.

D. Overseas Corporate Restructuring by way of Merger / Demerger:

I. **Direct transfer of investment in Indian Company on account of merger of two Foreign Companies:** As per provisions of Section 47(via) of ITA, transfer of shares of Indian Company pursuant to merger of

two Foreign Companies would be exempt subject to the following conditions:

– At least 25% of shareholders of Foreign Transferor Company continue to remain shareholders of Foreign Transferee Company; and

– The transfer does not attract capital gains tax in the country where Foreign Transferor Company is incorporated.

However, under the ITA, there is no exemption prescribed on capital gains arising in India in the hands of the shareholders of Foreign Transferor Company (having investment in Indian Company) on account of merger with another Foreign Transferee Company.

II. **Direct transfer of capital assets being shares of Indian Company on account of Demerger of undertaking of Foreign Company into another Foreign Company:** As per provisions of Section 47(vic) of ITA, transfer of Indian capital assets being shares of Indian Company are transferred from one Foreign Company into another Foreign Company by way of demerger would be exempt subject to the following conditions:

– At least 75% of shareholders of Demerged Foreign Company continue to remain shareholders of Resulting Foreign Company; and

– The transfer does not attract capital gains tax in the country where demerged Foreign Company is incorporated.

Similarly like in case of merger, there is no exemption prescribed on capital gains arising in India in the hands of the shareholders of Demerged Foreign Company on account of Demerger from one Demerged Foreign Company with another Resulting Foreign Company.

III. **Indirect transfer of capital asset being shares of Indian Company on account of merger of two Foreign Companies:** Keeping in line with the exemption prescribed under section 47(via) of ITA, for a direct transfer pursuant to a merger of two Foreign Companies, an exemption was also prescribed under section 47(viab) of ITA for capital gains arising on transfer of capital assets being shares of Foreign Company (FCo) which derives directly or indirectly its substantial value from shares of Indian Company on account of merger of Foreign Holding Company (FCo1) with another Foreign Company (FCo2) subject to following conditions are complied with:

a) At least 25% of the shareholders of the Foreign Transferor Company (FCo1) continue to remain shareholders of the Foreign Transferee Company (FCo2); and

b) The transfer does not attract capital gains tax in the country in which the Foreign Transferor Company (FCo1) is incorporated.

However, in this case as well, there were no exemption provided to the shareholders of Foreign Transferor Company.

IV. **Indirect transfer of capital asset being shares of Indian Company on account of Demerger of undertaking of one Foreign Company into another Foreign Company:** Keeping in line with the exemption prescribed under section 47(vic) of ITA, an exemption was also prescribed under section 47(vicc) of ITA for capital gains arising on transfer of capital assets being shares of Foreign Company which derives directly or indirectly its substantial value from shares of Indian Company held by Demerged Foreign Company into another Resulting Foreign Company subject to following conditions are complied with:

a) Atleast 75% value of the shareholders of the Demerged Foreign Company continue to remain shareholders of the Resulting Foreign Company; and

b) The transfer does not attract capital gains tax in the country in which the Demerged Foreign Company is incorporated.

However, in this case as well, there were no exemption provided to the shareholders of such Demerged Foreign Company.

Effectively, in all scenarios, we see that while exemptions have been provided for merging companies, whether such merger results in a direct or indirect transfer, there is no exemption provided for shareholders of such transferor / demerged companies. Thus, an overseas merger may result in Indian capital gains tax for such shareholders, under the indirect transfer provisions, subject to the provisions of the relevant Double Taxation Avoidance Agreement (DTAA).

Given the intricacies involved, India's tax laws need to be realigned to exempt shareholders from any taxes that may arise in an outbound merger. One can be hopeful that the income tax provisions may be modified in line with the new regulations above.

It is important for the Government of India to come out with further clarifications and amendments keeping in mind the practical implications of a cross border merger. While the regulations issued by the RBI are currently only in draft form, we hope that necessary clarifications will come to light when the cross border regulations are (hopefully) notified by the RBI.

There are certain Open issues which require certain clarity:

- **Lack of clarity on cross border demergers:** Section 234 of 2013 Act lead to a conclusion that demergers between Indian Company and Foreign Company are disallowed, the objective behind the new provisions is to lay down a forward looking law to facilitate cross border mergers. As a result, there is lack of clarity over the question of permissibility of a Foreign Company demerging its business undertaking to an Indian Company or vice versa under the 2013 Act.

- **Merger of Foreign LLP with Indian Company:** As per definition of "Foreign companies" in the 2013 Act includes bodies incorporated outside India. Given that the definition of "body corporate" under section 2(d) of the Limited Liability Partnership Act, 2008, includes an Limited Liability Partnership (LLP) incorporated outside India. It need to be evaluated that, whether Foreign LLPs can be merged into Indian Company or not.

- **Fast-track overseas mergers:** While Section 234 of 2013 Act provides merger of an Indian Company with a Foreign Company, the scope of this section has been restricted to Rule 25A of Rules 2017. It only refers to compliance with Sections 230 to 232 of the Act and makes it mandatory for the transferee Company to file an application before the NCLT without availing fast track process provided under Section 233 of the Act. Due to which it does not allow a wholly-owned Foreign subsidiary to merge with its Indian holding Company or Merger of wholly-owned Indian subsidiary with its Foreign parent Company.

- Pursuant to merger of Foreign Company into Indian Company, Grandfathering of investment into Indian Company in the hands of shareholders of Foreign Company would be a challenge at the time of availing certain treaty benefits mentioned in some countries.

- In case of merger of Indian Company into Foreign Company, operations of Indian Company could be considered as 'Permanent Establishment' of Foreign Company in India and Income tax authorities can consider higher rate of taxation on such Indian Branch need to be seen.
- If Foreign Company has various subsidiaries in India and pursuant to merger of Foreign Company into Indian Company, all the remaining Indian investments of Foreign Company would be transferred to Indian Company which could be considered as 'downstream investment' in India and accordingly downstream investment guidelines may require to be followed

If above open issue can be clarified sooner, the cross border merger can become a tool for India Inc to raise funds abroad, thus becoming truly multinational companies.

Although there remain a few issues as highlighted above, cross border mergers will present an additional structuring avenue for undertaking corporate transactions in an efficient and flexible manner. Further, such a move should improve the accessibility of companies to access capital in overseas market. However, considering the involvement of multiple agencies and laws (primarily RBI and NCLT in India, and the competent authority, if applicable, and the laws of the relevant foreign jurisdiction), the timelines and implementation will have to be calibrated in order to achieve the commercial objective.

Conclusion

In light of the new cross border regime, the path to pursue group restructuring exercises and to make Indian companies more globally relevant and competitive is clearer than before. Indian companies seeking a global platform are most likely to benefit, and can further unlock global potential and reach through mergers with foreign companies.

All in all, the provisions of the 2013 Act read together with the draft regulations will allow companies to expand their business and integrate globally with ease. These provisions can also provide an exit to foreign group companies with Indian subsidiaries by allowing such subsidiaries to merge with their foreign parent entity as opposed to undergoing the rigorous process of liquidation.

It is important that MCA and RBI analyse the available knowledge internationally on implementation of legal framework for regulating cross border mergers and fine-tune the domestic legal framework. One can be cautiously optimistic that cross border mergers may turn out to be an efficiency enhancing avenue for corporates in India.

Take care ! Beware of everything that is untrue; stick to truth and we shall succeed, may be slowly, but surely. Work on as if I never existed. Work as if on each of you depended the whole work.

— *Swami Vivekananda*

CA Sanjeev Shah & CS Abdullah Fakih

Restrictions on 2-tier subsidiaries – A mixed bag!

This article deals with the restrictions on having multi-layered subsidiary companies under the Companies Act, 2013, exemptions available to certain classes of companies, practical challenges that may be faced due to the restrictions and expected impact on future M&As.

Background

The Companies Act, 2013 (2013 Act) was enacted with the aim to facilitate more business-friendly corporate regulations, improve corporate governance norms, enhance accountability on the part of corporates and auditors, raise levels of transparency and protect the interests of investors, particularly small investors. The 2013 Act enhances self-regulation, encourages corporate democracy and virtually eliminates matters requiring Government approvals.

One of the objectives of the 2013 Act is to prevent money laundering. With this objective in mind, restrictions have been imposed on companies' ability to set-up multi-layer subsidiaries and investment companies.

Section 186(1) of the 2013 Act states that investments cannot be made through more than two layers of investment companies, subject to the following exceptions:

- Where a company acquires any other company incorporated in a country outside India if such other company has investment subsidiaries beyond two layers as per the laws of such country;
- A subsidiary company may have any investment subsidiary for the purposes of meeting the requirements under any law for the time being in force.

The explanation to section 186(1) states that the expression "investment company" means a company whose principal business is the acquisition of shares, debentures or other securities.

Section 186(1) of the 2013 Act was notified with effect from 1st April, 2014.

Section 2(87) of the 2013 Act, defines "subsidiary company". The *proviso* to the definition prohibits prescribed class or classes of "holding companies" from having layers of subsidiaries beyond prescribed numbers. As per the explanation (d) to section 2(87) "layer" in relation to a holding company means its subsidiary or subsidiaries. The said *proviso* was notified to be effective from 20th September 2017.

Companies Law Committee Report

On multi-layer subsidiaries

Companies Law Committee (CLC) noted that the limit on having layers of subsidiaries beyond the

prescribed numbers were included in the 2013 Act to address practices of creating subsidiaries aimed at making it difficult to trace the source of funds and their ultimate use, and reduce the usage of multiple layers of structuring for siphoning off funds. The said provisions were incorporated in the wake of various reported scams. In this regard, CLC also noted that the J. J. Irani Committee Report on Company Law recommended that the new Companies Act should not impose severe restrictions on corporate structuring, as these prescriptions would put Indian companies at a disadvantage *vis-à-vis* their international counterparts. The report stated, *"therefore, we are of the view that there may not be any restriction to a company having any number of subsidiaries, or to such subsidiaries having further subsidiaries."* The J. J. Irani Committee Report also noted that *proper disclosures accompanied by mandatory consolidation of financial statements should address the concern attendant to the lack of transparency in holding-subsidiary structure.* The J. J. Irani Committee Report had also recognised that siphoning off of funds could take place through other routes, and therefore, imposing a blanket restriction on the number of layers of subsidiaries may not be the best way to deal with the concern.

A perusal of the Parliamentary Standing Committee Report on the Companies Bill, 2012 (Standing Committee Report) also reveals that stakeholders had represented before the Committee that imposing restrictions on layers could be construed as restrictive for conduct of businesses. In addition, at another place in the Standing Committee Report, it was proposed to introduce a register of beneficial owners of a company, which would address the need to know the ultimate beneficial owners in complex corporate structures.

The CLC, therefore, felt that the *proviso* to Section 2(87) was likely to have a substantial bearing on the functioning, structuring and the ability of companies to raise funds and hence recommended that the said proviso be omitted from the 2013 Act.

On multi-layer investment companies

CLC observed that the layering restrictions on investment companies under Section 186(1) may become too obtrusive and impractical in the modern business world. Regulatory concerns arising out of earlier scams were also noted. CLC noted that while companies that became a subsidiary of another investment company due to any corporate action such as the non-subscription of a rights issue from the layering requirements, etc. could be exempted, it would not address the core issue that there may be several legitimate business justifications for use of a multi-layered structure, and such restriction hampers the ability of a company to structure its business. CLC felt that sufficient safeguards have been built into the oversight mechanism of SEBI and stock exchanges, and the recommendations on beneficial ownership register requirements should dispel regulatory concerns.

Accordingly, in line with the above recommendations of CLC, the Companies (Amendment) Bill, 2016 had proposed to omit the restrictions on number of layers of subsidiaries as well as restrictions on having more than two-layers of investment companies.

Subsequently, in view of media reports of misuse of multiple layers of companies, where shell companies are created for diversion of funds for money laundering, the Government decided, in June 2017, to retain these provisions and placed a draft notification of the rules to be prescribed under section 2(87) for public comments.

After receiving comments from the public, MCA has, on 20th September 2017, notified the proviso to section 2(87) as well as issued the Companies (Restriction on Number of Layers) Rules, 2017 (the Rules).

The Rules prescribe companies not to have more than two layers of subsidiaries, subject to certain exceptions.

Salient features of the Rules

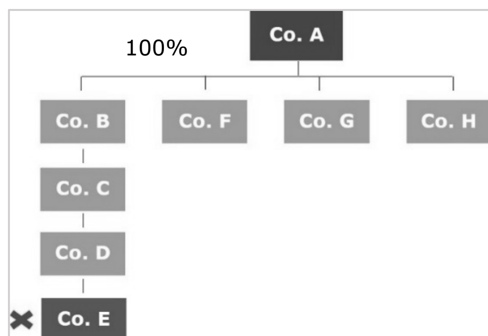
On and from 20th September 2017, no company shall have more than two layers of subsidiaries. However, the following are exceptions to this rule:

- A company may acquire a company incorporated outside India with subsidiaries beyond two layers as per the local laws of such country.

  It may be noted that above excludes only "acquisition" of existing companies outside India and does not talk about setting-up a newly-incorporated entity as a subsidiary outside India.

- In computing the number of layers, one layer which consists of one or more wholly-owned subsidiary (WOS) or subsidiaries shall not be taken into account.

Illustration:



If Co. A is the holding company, it can have one WOS (Co. B) or subsidiaries (Co. F, Co. G and Co. H). Co. B in turn can have up to two-step-down subsidiaries or layers of subsidiaries i.e. Co. C and Co. D. However, Co. D cannot have any subsidiary (Co. E). There is no restriction on Co. B having fellow subsidiaries which are directly held by Co. A, i.e. Co. F, Co. G, Co. H and so on. Similarly Co. F, Co. G and Co. H may have up to two layers of step-down subsidiaries.

- The following classes of holding companies are exempted from the applicability of the Rules:
  - Banking companies
  - Systemically Important Non-Banking Financial Companies (NBFC-SI) registered with the Reserve Bank of India
  - Insurance companies
  - Government companies

It may be observed that no exemptions have been given under the Rules to Housing Finance Companies, Core Investment Companies (CICs) which are not systemically important.

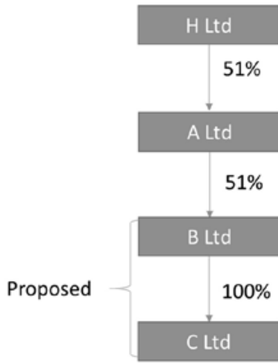
- Existing companies having more than two-layers of subsidiaries as on 20th September 2017 are required to ensure the following:
  - File a return in the prescribed form with the Registrar of Companies within 150 days of 20th September 2017;
  - Shall not have any additional layer of subsidiaries over and above the existing layers on or after 20 September 2017; and
  - In case one or more layers of subsidiaries are reduced by such companies subsequent to the Rules being notified, the number of layers permissible shall not be more than:-
  - Number of layers after such reduction; or
  - Two layers;

  whichever is more.

It is pertinent to note that the existing restrictions under section 186(1) of the 2013 Act from making investment companies through not more than two layers of investment companies would continue to apply and there is no change in the same after introduction of the Rules.

Exemption of WOS – at which layer?

A question could arise whether the exemption of not counting WOS can be at a layer not immediately following the layer of the holding company. This is explained in below illustration:



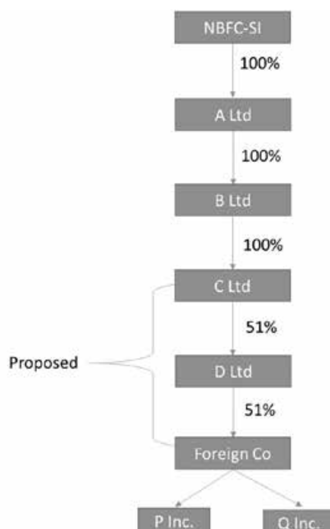
H Ltd. has a subsidiary A Ltd. which in turn has a subsidiary B Ltd. Now B Ltd. proposes to form a WOS, C Ltd. Can H Ltd. avail the exemption for the layer represented by C Ltd.?

Since C Ltd. will not be treated as WOS of H Ltd., H Ltd. cannot avail the exemption, and in fact, B Ltd. cannot form / acquire C Ltd.

Some practical challenges

In light of the Rules, let us examine the workability of certain structures:

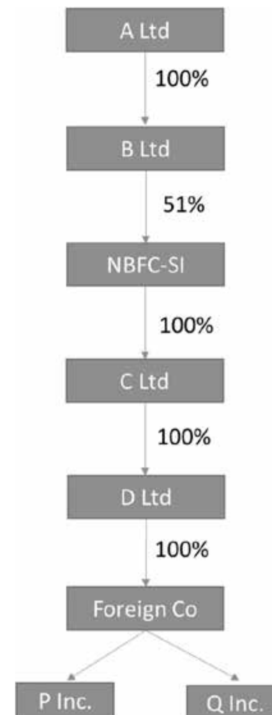
Case 1



Question: An NBFC-SI has a WOS viz., A Ltd. which in turn has B Ltd. as its WOS. B Ltd. has a WOS C Ltd. C Ltd. desires to incorporate a subsidiary D Ltd. which would acquire a Foreign Co. Is the incorporation of D Ltd. and acquisition of existing Foreign Co. (which already has subsidiaries abroad) allowed under the Rules?

Response: NBFC-SI is exempt from the Rules, i.e., there is no limit on the number of layers of subsidiaries it can incorporate. However, the rule also needs to be examined at the level of A Ltd. Since one layer of WOS is exempt, investment of A Ltd. in B Ltd. would be exempt from the two-layer rules. Further, B Ltd.'s investment into C Ltd. will be regarded as one layer of subsidiary for A Ltd. Further, setting up of D Ltd. by C Ltd. would be possible as it will result into just two layers. The question would be whether D Ltd. can acquire Foreign Co.? In light of specific conditional exemption given to companies incorporated outside India, it is possible to incorporate D Ltd. and acquire Foreign company under D Ltd.

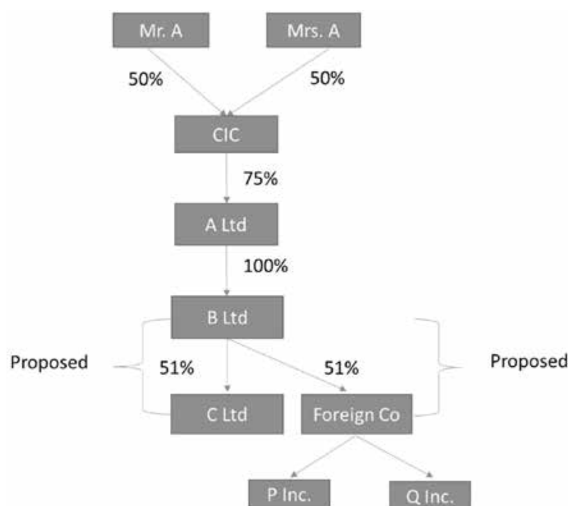
Case 2



Question: A Ltd. is an existing company and proposes to incorporate companies as shown above. The question is till which layer will investment be permitted under the Rules?

Response: For A Ltd., investment in B Ltd. would be not be reckoned for one layer as it is a WOS. B Ltd. can form NBFC-SI (1st layer counted for A Ltd.) and NBFC-SI can have C Ltd. (2nd layer counted for A Ltd.). Now even if NBFC-SI is permitted to have any layers of subsidiaries, since, A Ltd. has exhausted 2 layers, incorporation of D Ltd. by C Ltd. would not be permissible as it would end up in A Ltd. having three layers of subsidiaries. Subsequently, the question of D Ltd. acquiring Foreign co. does not arise.

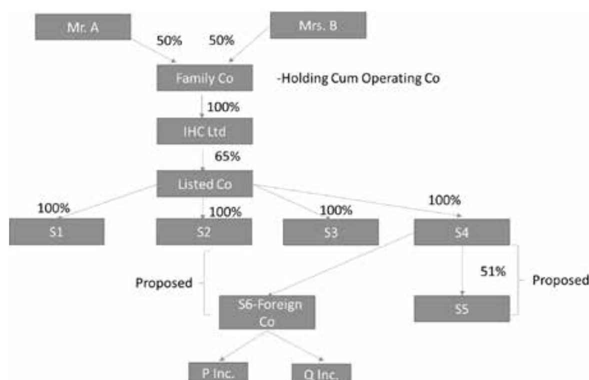
Case 3



Question: Husband and wife, Mr. A and Mrs. A hold 50% each in CIC (exempt from registration with RBI). CIC has a subsidiary A Ltd. which in turn has a WOS B Ltd. B Ltd. now proposes to acquire C Ltd. and a Foreign Co. Is the incorporation of C Ltd. and Foreign Co. permitted under the Rules?

Response: CIC does not have any WOS. Further, CIC does not enjoy exemption from having any layers of subsidiaries since CIC is not registered with RBI. Hence, for CIC, investment up to two layers, i.e. up to B Ltd. is permissible. Incorporation / acquisition of C Ltd. is not permitted. However, acquisition of Foreign Co. would be permissible, in light of specific conditional exemption given to companies incorporated outside India.

Case 4



Given the above structure, can S4 have step down subsidiary in S5 and S6?

Response: Investment in IHC Ltd. will be exempt as one layer of WOS for Family Co. Further, investments by IHC Ltd. in Listed Co. and further investments by Listed Co. into S1, S2, S3 and S4 is permissible as it is within two layers. The proposed investment by S4 in S5 will not be permissible as it would result into 3rd layer of subsidiary for Family Co. However, investment by S4 in S6-Foreign Co. would be possible in light of specific conditional exemption given to companies incorporated outside India. So Listed Co. will be impacted for further growth through layers below S4 in India due to its ultimate parent (Family Co.) already exhausting the limit of two layers.

Future M&A activities impacted by two layer rule

M&A transactions typically involve creation of subsidiaries and the Rules are expected to throw a spanner into the works when it comes to use of multi-layered entities for M&A.

It is also important to see all layers of subsidiaries in the target entity (third party) by the acquirer during the due diligence process, if transaction (acquisition / takeover / amalgamation etc.) of target entity would result into the acquirer ending up having more than two layers of subsidiaries post consummation of the transaction.

The Rules would also pose challenges when it comes to certain industry sectors, viz., infrastructure, real estate etc. where creation of Special Purpose Vehicles (SPVs) and multi-layered structures is a common practice to ring fence the holding company from any liabilities that may arise due to failure of any project or to meet statutory requirements or to attract a project-specific investor.

Further, any scheme of arrangement giving rise to more than two layers of subsidiaries would pose a challenge in getting approval of the National Company Law Tribunal (NCLT), as the NCLT does not have powers to approve a scheme by disregarding the express prohibition under the proviso to section 2(87) read with the Rules.

Penalty for non-compliance

- In case of contravention of the Rules, the company and every officer of the company who is in default is punishable with fine up to ₹ 10,000 and in case of continuing default, with a further fine up to ₹ 1,000 per day of default.
- There is no penalty prescribed for contravention of section 2(87) of the Companies Act, 2013. Hence, in the event of a contravention, it will attract the provisions of section 450 of the Companies Act, 2013 which states that the company and every officer of the company who is in default will be punishable with fine up to ₹ 10,000 and in case of a continuing default, with a further fine up to ₹ 1,000 per day of default.
- In case a company contravenes the provisions of section 186, the company shall be punishable with fine which shall be at least ₹ 25,000 but which may extend to ₹ 5,00,000 and every officer of the company who is in default shall be punishable with imprisonment for a term up to 2 years and with fine which shall be at least ₹ 25,000 but may extend up to ₹ 1,00,000.

Conclusion

Thanks to the grand-fathering provisions under the Rules, corporate structures existing on 20 September 2017 would not have to be dismantled. However, any new structure envisaged on or after 20th September, 2017 will have to comply with the Rules.

The cap on layers of subsidiaries is expected to keep a check on usage of multiple layers of holding-subsidiary structures for siphoning off / routing of funds. The Rules may pose significant challenges in M&A activities especially when it comes to inorganic growth, as companies will have to structure the acquisitions accordingly, which may have implications under tax and other regulations.

Source

1. *Notification G.S.R. 1176(E) and Notification S.O. 3086(E) dated 20 September, 2017 issued by MCA*

2. *Report of the Companies Law Committee issued in February, 2016.*

CA Amrish Shah, CA Vinit Desai &
CA Pankti Shah

Income tax provisions for M&A

Corporate restructuring and consolidation of operations including mergers, demergers and slump sale have become a common aspect of corporate strategy for organisations worldwide. Such reorganisations could have host of consequences which need to be factored in. Accordingly, it is important to understand the income tax implications of such restructuring/ sale.

Amalgamation

The term 'merger' typically indicates unification of two entities into a single entity.

The Income-tax Act, 1961 (the Act) defines '**Amalgamation**' to mean the merger of one or more companies with another company or the merger of two or more companies to form one company in such a manner that –

a) All the assets and liabilities of the Amalgamating Company(s) become the assets and liabilities of the Amalgamated Company; and

b) Shareholders holding not less than 75% in value of the shares in the Amalgamating Company(s) (other than shares already held immediately before the amalgamation by the Amalgamated Company(s) or its subsidiary or its nominee) become the shareholders of the Amalgamated Company by virtue of the Amalgamation.

'Amalgamating Company' means company or companies which are getting merged and **'Amalgamated Company'** means the company with which the amalgamating companies merge or the company which is formed after merger. The corporate identity of the Amalgamating Company ceases to exist after amalgamation.

The benefits/concessions under the Act shall be available to Amalgamating/ Amalgamated Company and their respective shareholders only when conditions, mentioned hereinabove, are satisfied.

Key tax implications of a tax neutral amalgamation

In the hands of the Amalgamating Company

The Act provides an exemption from capital gains tax for any transfer of capital asset in a scheme of amalgamation, where the Amalgamated Company is an Indian company. Judicial precedents[1] suggest that a business undertaking is also a 'Capital Asset'.

1 *Cooper vs. Union of India [1970] 40 Comp Cas 325 (SC)*

Similarly, capital gains on transfer of shares, in a scheme of amalgamation in an Indian company / foreign company which derives its value substantially from shares of an Indian company by the amalgamating foreign company to the amalgamated foreign company, is exempt provided at least 25% of the shareholders of the amalgamating foreign company continue to remain the shareholders of the amalgamated foreign company and there is no capital gains tax in the country in which the amalgamating foreign company is incorporated. Where a wholly-owned subsidiary company amalgamates into its holding company, the transfer shall be exempt from capital gains tax though the above condition is not satisfied.[2]

In the hands of shareholders of the Amalgamating Company

The Act provides an exemption from capital gains tax for transfer of shares in the Amalgamating Company, if the shareholders receive shares in the Amalgamated Company as consideration and the Amalgamated Company is an Indian company. The Gujarat High Court[3] has held that exemption from capital gains tax would apply only when the consideration is received by the shareholders in the form of shares and not combination of shares, bonds, debentures or cash for that matter. Once the transaction is exempt, provisions relating to deeming of fair market value as sale consideration, in case of inadequacy/ unascertainability/ indeterminability etc., should not apply.

It may be noted that there is no specific exemption provided for capital gains arising to a non-resident shareholder on transfer of shares in foreign amalgamating company (deriving substantial value from India) against issue of shares by foreign amalgamated company.

The cost of acquisition of the shares of the Amalgamated Company would be equal to the cost of acquisition of the shares of the Amalgamating Company and the period of holding of shares of the Amalgamated Company will include the period for which the shares in the Amalgamating Company were held by the shareholder.

There may arise a question with respect to indexation benefit for computing capital gains on sale of shares in Amalgamated Company, as to whether the Cost Inflation Index (CII) for the year of acquisition of shares of the Amalgamated Company is to be considered or CII for the year of acquisition of shares of the Amalgamating Company is to be considered. In this regard, it may be noted that the Bombay High Court[4], on the issue of gift of shares held that CII of the year of acquisition of shares by previous owner has to be considered. Extending the same analogy, CII of the year in which shares were acquired in Amalgamating Company could be considered in case of receipt of shares on amalgamation.

In the hands of Amalgamated Company

The cost of the capital asset transferred to the Amalgamated Company, pursuant to amalgamation will be the same as it would have been to the Amalgamating Company, if the amalgamation had not taken place. The Written Down Value (WDV) of the block of assets transferred by the Amalgamating Company shall be regarded as the WDV of the block for the Amalgamated Company.

The depreciation with respect to eligible assets for the year of amalgamation will be

2 *DIT vs. Hoechst GMBH [2007] 208 CTR 197 (AAR)*

3 *CIT vs. Gautam Sarabhai Trust [1988] 173 ITR 216 (Guj)*

4 *CIT vs. Manjula Shah (2011) 16 taxmann 42 (Bom)*

apportioned between the Amalgamating Company and Amalgamated Company in the ratio of number of days of usage of those assets by the respective companies.

It may be noted that the Finance Bill, 2018 has proposed to widen the definition of "accumulated profit" to include, the accumulated profits, whether capitalised or not of the Amalgamating Company on the date of amalgamation. Thus for computing dividend tax on any future distributions, the same needs to be considered.

Carry forward and set-off losses

The Act provides for the transfer of accumulated business loss/unabsorbed Depreciation (UAD) upon amalgamation of –

– A company owning an industrial undertaking or a ship or a hotel,

– A banking company;

– One or more public sector companies engaged in operations of aircraft

Provided the following conditions are fulfilled. –

– The Amalgamating Company is engaged in the business, in which the accumulated loss occurred or depreciation remains unabsorbed, for at least 3 years;

– The Amalgamating Company continuously holds as on the date of amalgamation at least 75% of the book value of the fixed assets held by it 2 years prior to the date of amalgamation;

– The Amalgamated Company continuously holds at least 75% of the book value of the fixed assets and continues the business of the Amalgamating Company for a minimum period of 5 years;

– Amalgamated Company to furnish certificate in Form 62, to the Assessing Officer; and

– Amalgamated Company owning an industrial undertaking should achieve the level of production of at least 50% of the installed capacity within 4 years of amalgamation and continue to maintain the same up to 5 years from amalgamation.

Industrial undertaking means an undertaking engaged in manufacture or processing of goods, manufacture of computer software, generation or distribution of power or provision of telecom services.

Amalgamated Company can carry forward and set-off the accumulated business losses of the Amalgamating Company for a period of 8 years from the year in which amalgamation takes place. If the above conditions are not fulfilled, the benefits claimed, would be taxed in the hands of the Amalgamated Company in the year of default.

Depreciation claim on goodwill acquired on amalgamation

The Supreme Court in the case of Smifs Securities[5] has held that goodwill acquired on amalgamation being the excess of consideration paid over the net value of the assets acquired is an intangible asset eligible for depreciation. Thus, depending upon facts, Amalgamated Company could explore claiming depreciation on goodwill, if any arising on amalgamation.

Demerger

Demerger indicates split or division of the business of a company. The Act defines demerger to mean a transfer that fulfils all the conditions mentioned below:

5 *CIT vs. Smifs Securities Ltd. [TS-639-SC-2012]*

- Transfer is pursuant to a scheme of arrangement under Sections 230-232 of the Companies Act, 2013;
- All the assets of the undertaking and liabilities relatable to the undertaking immediately before the demerger are transferred to the Resulting Company at their book values (any revaluation should be ignored) on a going concern basis;
- The Resulting Company issues shares to the shareholders of the Demerged Company on a proportionate basis, except where the Resulting Company itself is a shareholder of the Demerged Company;
- The shareholders holding at least 75% in value of the shares in the Demerged Company (other than shares already held therein immediately before the demerger by a nominee for, the Resulting Company or its subsidiary) becomes the shareholders of the Resulting Company by virtue of demerger;
- The demerger is in accordance with the conditions, if any, notified by the Central Government. However, until date no such conditions are notified.

Undertaking includes any part of an undertaking, or a unit or division of an undertaking or a business activity undertaken as a whole but does not include individual asset or liabilities or any combination thereof not constituting a business activity.

Since the provisions are not clear, a question could arise as to whether the retained business/assets of the Demerged Company should also qualify as 'Undertaking' even though there is no specific requirement *per se*. This becomes even more relevant post GAAR provisions coming into effect.

"Demerged Company" means the company whose undertaking is being transferred pursuant to demerger. **"Resulting Company"** is the company to which the undertaking of the Demerged Company is transferred.

Transfer of Liabilities in demerger

The following liabilities of the Demerged Company will be transferred to the Resulting Company upon demerger –

- All liabilities arising out of activities of the undertaking;
- Specific loans or borrowings (including debentures) pertaining to the undertaking;
- General or multipurpose borrowings of the Demerged Company shall be transferred in the same proportion in which the value of the asset transferred bears to the total value of assets of the Demerged Company immediately before demerger.

Pursuant to introduction of Ind AS, it has now become essential that the accounting treatment specified under the Act and that under Ind AS remains aligned.

Key tax implications of a tax neutral demerger

In the hands of the Demerged Company

The Act provides an exemption from capital gains tax on transfer of capital assets pursuant to a scheme of demerger by a Demerged Company to the Resulting Company being an Indian company. The WDV of the block of assets of the Demerged Company will be reduced by the amount of WDV of the assets transferred to the Resulting Company.

Once the transaction is exempt, provisions relating to deeming of fair market value as sale consideration, in case of inadequacy/unascertainibility/indeterminibility, should not apply.

Depreciation on assets transferred will be apportioned between the Demerged Company and Resulting Company in the ratio of number of days of usage of those assets by the respective companies.

Capital gains on transfer of shares in Indian company/foreign company deriving its value substantially from shares of an Indian company, as a result of demerger of the demerged foreign company to resulting foreign company shall be exempt provided shareholders holding at least 75% in value of shares of Demerged Company continue to remain the shareholders of resulting foreign company and there is no capital gains tax in the country in which demerged foreign company is incorporated.

In the hands of shareholders of the Demerged/Resulting Company

Issue of shares to the shareholders of the Demerged Company, by the Resulting Company is exempt from capital gains tax provided the Resulting Company is an Indian company. The period for which the shares were held in the Demerged Company shall also be considered while computing period of holding for shares in Resulting Company. The cost of acquisition of shares of Resulting Company shall be the amount that bears to cost of acquisition of shares held by the assessee in the Demerged Company in the same proportion as the net book value of the assets transferred bears to the net worth of the Demerged Company. The cost of acquisition of original shares in the Demerged Company shall be deemed to have been reduced by the amount arrived at for the cost of acquisition of shares in the Resulting Company.

It may be noted that there is no specific exemption provided for capital gains arising to a non-resident shareholder on transfer of shares in foreign Demerged Company (deriving substantial value from India) against issue of shares by foreign Resulting Company.

Implications in the hands of the Resulting Company

The cost of the transferred capital asset to the Resulting Company shall be the same as the cost to the Demerged Company. The WDV of the block of assets acquired by Resulting Company will be the WDV of such assets in the hands of Demerged Company.

Depreciation shall be apportioned between the Demerged Company and Resulting Company in the ratio of number of days for which those assets were respectively used by them. The aggregate depreciation available in the previous year shall not exceed the depreciation calculated at the prescribed rates, as if the demerger had not taken place.

Carry Forward and set-off losses

The accumulated business loss and UAD of the Demerged Company will be transferred to the Resulting Company as under –

– Loss or UAD directly relatable to the undertaking will be transferred to the Resulting Company;

– Loss or UAD not directly relatable to the undertaking will be transferred to the Resulting Company in proportion in which the asset of the undertaking have been retained by the Demerged Company and transferred to the Resulting Company;

  A question could arise, whether for this split, asset means gross assets or net of liabilities.

The accumulated loss or UAD will be allowed to be carried forward by the Resulting Company for the balance number of years for which the Demerged Company would have carried forward.

Other common provisions applicable to Amalgamation and Demerger

Deduction available under tax benefits/ holiday

In lieu of the amendment to Section 80IA and CBDT Circular[6] the tax holiday benefit could be denied to the Amalgamated Company/ Demerged Company. However, it may be argued that the benefit of Section 80IA may be available to Amalgamated/ Demerged Company as Section 80IA was only clarificatory in nature and the said tax holiday was available even prior to insertion of the said section.

Similar amendment restricting the transfer of tax holiday benefit was not made in any other sections other than Section 80IA. Thus, tax holiday benefits available under such sections may be availed by the Amalgamated/ Resulting Company.

Amortisation of amalgamation/demerger expenses

Expenditure incurred in connection with amalgamation/demerger is allowed to be claimed as deduction over 5 successive years, beginning with the previous year in which the amalgamation/ demerger takes place.

Section 10(38)

Finance Bill, 2018 proposes to tax long term capital gains in excess of INR 1 lakh, arising on transfer of listed shares on which STT is paid at the time of acquisition and transfer (amongst other conditions), at the rate of 10%. However, a benefit of cost step-up based on fair value as on 31st January 2018 will be available subject to certain conditions. Currently it is not clear whether such step-up will be available for shares received on merger/ demerger completed post 31st January 2018.

Carry forward and set-off losses in case of change in shareholding of a closely-held company

Section 79 of the Act restricts carry forward and set-off losses in the hands of a closely-held company, if the shares of such company carrying at least 51% of voting power are not **beneficially** held by persons who beneficially held such shares on the last day of the previous year in which the loss was incurred. However, the said provisions are not applicable to carry forward of UAD. Thus, changes in shareholding of Amalgamated/ Resulting Company on account of issue of shares need to be monitored to see the impact on tax losses.

The above provisions shall not apply in case of change in shareholding of an Indian subsidiary of foreign company as a result of amalgamation or demerger of foreign company, subject to the condition that minimum 51% of shareholders of transferor foreign company continue to remain shareholders of the transferee foreign company.

Implications on book losses under Minimum Alternate Tax (MAT) and MAT Credit

While not specifically provided in law, depending on the accounting treatment, if book loss and depreciation is a part of profit and loss balance transferred, the book loss and depreciation of the Amalgamating Company may be deemed to be the book loss and depreciation of the Amalgamated Company while calculating book profit for computing MAT.

The Act does not specifically provide that MAT credit should be transferred on amalgamation. On a plain reading of MAT credit provision, it seems that MAT credit is required to be availed by the same person who initially paid MAT. However, the

6 CBDT Circular No. 3 dated 12th March 2008

Mumbai Tribunal[7] held that on amalgamation all the properties including credit for taxes of the Amalgamating Company become the property of the Amalgamated Company. Accordingly, MAT credit could be transferred to Amalgamated Company.

Applicability of Section 56(2)(x) in the hands of shareholders

Receipt of shares by the shareholders in transferee company pursuant to amalgamation/demerger is specifically exempt from provisions taxing gifts under the Income Tax Act.

Key implications of a non-tax neutral amalgamation/demerger i.e. non-compliance with definition of amalgamation/ demerger

Prima facie, it appears that specific exemption from capital gains provided in the Act shall not be available to transferor company.

However, a view may be explored that for a transaction to be subject to capital gains, there must be transfer of a capital asset and consideration must be received by the transferor. Upon amalgamation/demerger, the shares of the transferee company are issued to the shareholders of the transferor company, and no consideration is accrued to/ received by the transferor company. Therefore, in the absence of any consideration, it may be argued that there is no tax implication in the hands of the transferor company. Further, as the cost of acquisition and cost of improvement of the undertaking cannot be ascertained, the computation mechanism fails and therefore, could not be subject to tax. However, this view may be subject to litigation.

Recently Delhi High Court in case of Salora International[8] ruled that merely because part of the consideration for the transfer was paid to the shareholders of the Amalgamating Company, by issue of fully paid-up shares, it could not be said that the same could not be stated to have been 'received or accruing' in favour of the Amalgamating Company. If the transferor is entitled to the consideration, then the same must be taken into account for the purposes of computation of capital gains.

The revenue authorities may apply the provisions of Section 50B and consider the transfer as slump sale. However, one may argue that the provisions of Section 50B apply only to a transfer as a result of sale, and that transfer pursuant to a scheme of arrangement is not a sale.[9] The provisions of slump sale should not apply to such transfers.[10]

The transferee company will neither be eligible to carry forward accumulated business losses, UAD nor claim tax holiday/benefits available to transferor company.

However, the transferee company could explore to allocate the consideration to depreciable asset and claim depreciation thereon instead of claiming the depreciation on WDV as in the books of the transferee company.

The shareholders of the transferor company may be liable to capital gains tax on the difference between the fair value of the consideration received and the cost of the shares. However, in case of demerger, a view may be taken that as there is no sale, exchange, relinquishment or extinguishment of rights in the share by the shareholder in demerger, there is no 'transfer'.

7 *SKOL Breweries Ltd vs. ACIT [2008] (28 ITATINDIA 998)(Mum.)*

8 *CIT vs. Salora International Ltd [2016] 386 ITR 580 (Delhi)*

9 *Oudh Sugar Mills Ltd vs. ITO [1990] 35 ITD 76 (Bom.)*

10 *Avaya Global Connect Ltd vs. ACIT [2008] 26 SOT 397 (Mum.)*

As far as amalgamation is concerned, the Supreme Court in Grace Collis[11] held that amalgamation results in 'extinguishment' of rights of shareholders in the amalgamating company and hence results in 'transfer' being liable to tax.

Slump Sale

Prior to the insertion of Section 2(42C), courts have held that slump sale is a sale of a business on a going concern basis where *lump sum* price cannot be attributed to individual assets or liabilities.

The concept of 'slump sale' was incorporated by the Finance Act, 1999 when Section 2(42C) was inserted defining the term 'slump sale' as transfer of one or more undertaking(s) as a result of sale for a *lump sum* consideration without values being assigned to the individual assets and liabilities. Further, determination of the value of an asset or liability for the payment of stamp duty shall not be regarded as assignment of values to individual assets and liabilities.

The mechanism for computation of capital gains arising on slump sale is provided in the Act wherein the difference between sale consideration and the net worth of the undertaking is chargeable to tax.

Net worth is the difference between the aggregate value of total assets of the undertaking and the value of its liabilities as appearing in books of account. The aggregate value of total assets is the sum total of WDV in case of depreciable assets and the book value in case of other assets.

The benefit of indexation is not available in the case of slump sale and the profit or gain on slump sale is regarded as long-term or short-term depending upon the period of holding of the undertaking being transferred.

The Supreme Court in case of B C Srinivasa Setty[12] held that no capital gains tax should arise on the transfer of an asset if the cost of acquisition is unascertainable. The same was followed by the Mumbai Tribunal in Bharat Bijlee[13] which was later confirmed by the Mumbai High Court. The issue was relating to concept of 'slump exchange' and its taxability. In the instant case it was held that the transfer of an undertaking in exchange for issue of preference shares and debentures was a case of slump exchange and not sale. Consequently, Section 50B is not applicable to slump exchange and in the absence of any specific computation provision, the computation mechanism fails and accordingly the gain on transfer of the undertaking was not taxable.

Carry forward of business losses and UAD

In the absence of any specific provisions for carry forward of business loss and UAD, the business loss and UAD pertaining to the undertaking may not be transferred pursuant to a slump sale but retained with the transferor.

Transfer of assets with negative net worth

There is nothing in the law to suggest the mechanism for computing the capital gains where the net worth is a positive or a negative number.

In case of Zuari Industries[14], the Mumbai Tribunal held that where the net worth is negative, the cost of acquisition shall be nil. Accordingly, in such case only the sale consideration shall be chargeable to capital gains tax.

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11 *Grace Collis vs. CIT [2001] 248 ITR 323 (SC)*

12 *B. C. Srinivasa Setty (1981) 128 ITR 294 (SC)*

13 *Bharat Bijlee Ltd. vs. CIT [2014] 365 ITR 258 (Bombay)*

14 *Zuari Industries Ltd. vs. ACIT (2008) 298 ITR 97 (Mum.)*

However, in case of Summit Securities[15], the Mumbai Tribunal held that negative net worth of the undertaking transferred *via* slump sale should be added to the sale consideration for the purposes of determining the capital gains as the net worth is defined to mean the difference between the value of assets and liabilities, the result of which can be positive or negative.

Sections 50C and 56(2)(viia)/(x)

Section 50C which deems stamp duty value as sale consideration, applies to transfer of capital asset being land or building or both and not any other capital asset. The same may not apply to computation of capital gains under slump sale which is governed by Section 50B, although land and building may form a part of the undertaking being transferred *via* slump sale. Similarly, Section 56(2)(viia)/(x) dealing with taxation in hands of recipient for receiving assets for inadequate consideration may not apply to a business transfer.

Slump sale vs. Itemised Sale

It may be important to evaluate if the business transfer is a slump sale and not itemised sale, as itemised sale may have other consequences which may be unintended. For instance, Section 50C and Section 56(2)(viia)/(x) explained above, may apply if specified assets are part of business being transferred on an itemised sale basis.

No Objection Certificate

As per Section 281 of the Act, during the pendency of any proceeding under the Act, any transfer of assets by way of sale, exchange, gift or whatsoever to other person shall be void if the prior approval from the income tax authorities in the form of tax clearance certificate is not obtained.

However, it may be relevant to note that in case of amalgamation/demerger/slump sale, the business as a whole is transferred and there is no transfer of individual assets. Accordingly, one may evaluate if a view may be taken that as there is a transfer of an undertaking forming a part of the business and individual assets are not being transferred, a no objection certificate from the tax authorities may not be required.

Liability of the transferor falling on the transferee

The Act provides that in case tax liability, for the year of succession up to date of succession and preceding year, cannot be recovered from predecessor, revenue authorities could recover the same from successor. This may be relevant for demerger as well as slump sale.

Any action of merger and demerger involves interaction of several provisions of the Act as multiple stakeholders are involved. This article has attempted to provide a generic overview of key applicable provisions which need to be borne in mind while evaluating amalgamation/demerger/slump sale.

15 *DCIT vs. Summit Securities Ltd (2012) 135 ITD 99 (Mum)(SB)*

CA Hiten Kotak & CA Yogesh Dharnidharka

Mergers & Acquisitions involving Listed Entities

In order to bring more transparency and protect the interest of public, more particularly the minority shareholders, the Securities & Exchange Board of India (SEBI) has laid down regulations/ guidelines to be followed by the listed entities in case of any merger/amalgamation, demerger or any such corporate action. This include compliance procedures, disclosure requirements, obtaining approval of stock exchanges, obtaining approval from majority of the public shareholders, etc.

SEBI has laid out the regulatory framework for scheme of amalgamation/ arrangement in Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements) Regulations, 2015 ["SEBI LODR Regulations"] and has also issued various circulars[1] thereto. The key requirements under such regulations are discussed herein below:

A) SEBI LODR Regulations

1. Pre Board Meeting Disclosure

The listed entity is required to give prior intimation to stock exchange about the meeting of the board of directors at least 2 working days in advance in specified matters such as proposal for buy-back, declaration of dividend etc. However, matters such as merger/ demerger/ acquisition/sale of unit proposed to be approved in the board meeting is not explicitly provided and hence, one may take a view that no prior intimation is required in cases where there are other agenda items to be discussed by the board.

2. Post Board Meeting Disclosure

2.1 On approval of the merger/demerger/ acquisition/sale or disposal of unit by the board of the company, the listed entity is required to disclose such event to the stock exchange within 24 hours from the occurrence of such event.

1. CFD/DIL3/CIR/2017/21 dated March 10, 2017
CIR/IMD/DF/50/2017 dated May 26, 2017
CFD/DIL3/CIR/2017/105 dated September 21, 2017
CFD/DIL3/CIR/2018/2 dated January 3, 2018
CFD/DIL1/CIR/P/2018/011 dated January 19, 2018

2.2 The disclosures required to be made by a listed entity are as under:

Acquisition	a. Name of the target entity, details in brief such as size, turnover etc.; b. Whether the acquisition falls within related party transaction(s) and whether the promoter/ promoter group/ group companies have any interest in the entity being acquired. If yes, nature of interest and details thereof and if done at 'arm's length'; c. Industry to which the entity being acquired belongs; d. Objects and effects of acquisition such as disclosure of reasons for acquisition of target entity, if business of acquirer is different from target; e. Disclosure of reasons for acquisition of target entity, if its business is outside the main line of business of the listed entity; f. Brief details of any Governmental or regulatory approvals required for the acquisition; g. Indicative time period for completion of the acquisition; h Nature of consideration – cash consideration or share swap and details of the same; i. Nature of consideration – whether cash consideration or share swap and details of the same; j. Cost of acquisition or the price at which the shares are acquired; k. Percentage of shareholding / control acquired and / or number of shares acquired; l. Brief background about the entity acquired in terms of products/line of business acquired, date of incorporation, history of last 3 years turnover
Amalgamation/ Merger	a. Name of the entity(ies) forming part of the amalgamation/merger, details in brief such as, size, turnover etc.; b. Whether the acquisition falls within related party transaction(s). If yes, nature of interest and details thereof and if done at 'arm's length'; c. Area of business of the entity(ies); d. Rationale for amalgamation/merger; e. In case of cash consideration – amount or otherwise share exchange ratio; f. Brief details of change in shareholding pattern (if any) of listed entity
De-Merger	a. Brief details of the division(s) to be demerged; b. Turnover of the demerged division in amount and as percentage to the total turnover of the listed entity in the immediately preceding financial year / based on financials of the last financial year; c. Rationale for demerger;

	d. Brief details of change in shareholding pattern (if any) of all entities; e. In case of cash consideration – amount or otherwise share exchange ratio; f. Whether listing would be sought for the resulting entity.
Sale of disposal of unit(s) or division(s) or subsidiary of the listed entity	a. Amount and percentage of the turnover or revenue or income and net worth contributed by such unit or division of the listed entity during the last financial year; b. Date on which the agreement for sale has been entered into; c. Expected date of completion of sale/disposal; d. Consideration received from such sale/disposal; e. Brief details of buyers and whether any of the buyers belong to the promoter/ promoter group/group companies. If yes, details thereof; f. Whether the transaction would fall within related party transactions. If yes, whether the same is done at 'arm's length'; g. Additionally, in case of a slump sale, indicative disclosures provided for amalgamation/merger, shall be disclosed by the listed entity with respect to such slump sale.

3. Key conditions for Scheme of arrangement/ amalgamation

3.1 The scheme of arrangement / amalgamation / merger / reconstruction / reduction of capital etc. presented to Tribunal should not in any way violate, override or limit the provisions of securities law or requirements of the stock exchange(s);

3.2 Before the Scheme is filed with Tribunal, a listed entity is required to comply with the requirements prescribed under SEBI LODR Regulations and first file a draft scheme with the stock exchange(s) for obtaining observation letter or no-objection letter as per SEBI LODR Regulations;

3.3 Once the observation/no-objection letter is issued, a listed entity shall file the Scheme with the Tribunal within a period of 6 months. The listed entity should ensure that observation made by SEBI/Stock Exchange are incorporated in the Scheme before the same is filed with the Tribunal;

3.4 Pricing guidelines as per SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009 ("ICDR Regulations") to be complied with in case the Scheme involves allotment of shares only to a select group of shareholders or shareholders of unlisted companies;

3.5 Approval of majority of the public shareholders to the Scheme through e-voting in the following cases:

– Where additional shares have been allotted to Promoter / Promoter Group, Related Parties of Promoter / Promoter Group, Associates of Promoter / Promoter Group, Subsidiary/(s) of Promoter / Promoter Group of the listed entity;

– Where the Scheme of Arrangement involves the listed entity and any other entity involving Promoter / Promoter Group, Related Parties of Promoter / Promoter Group, Associates of Promoter / Promoter Group, Subsidiary/(s) of Promoter / Promoter Group;

– Where the parent listed entity has acquired, either directly or indirectly,

the equity shares of the subsidiary from any of the shareholders of the subsidiary who may be Promoter / Promoter Group, Related Parties of Promoter / Promoter Group, Associates of Promoter / Promoter Group, Subsidiary/(s) of Promoter / Promoter Group of the parent listed entity, and if that subsidiary is being merged with the parent listed entity under the Scheme;

– Where the scheme involving merger of an unlisted entity results in reduction in the voting share of pre-scheme public shareholders of listed entity in the transferee / resulting company by more than 5% of the total capital of the merged entity;

– Where the scheme involves transfer of whole or substantially the whole of the undertaking (i.e. twenty per cent or more of value of the company in terms of consolidated net worth or consolidated total income during previous financial year) of the listed entity and the consideration for such transfer is not in the form of listed equity shares.

3.6 In case of a scheme between listed and unlisted entities, the listed entity to provide information pertaining to the unlisted entities in the abridged prospectus as per ICDR Regulations which shall be certified by a SEBI Registered Merchant Banker;

3.7 The percentage of shareholding of pre-scheme public shareholders of the listed entity and the Qualified Institutional Buyers of the unlisted entity, in the post scheme shareholding pattern of the "merged" company on a fully diluted basis shall not be less than 25%. In case this condition is not complied with, the following conditions are required to be satisfied:

– *The entity has a valuation in excess of ₹ 1,600 crore as per the valuation report;*

– *The value of post-scheme shareholding of public shareholders of the listed entity in the transferee entity is not less than ₹ 400 crore;*

– *At least ten per cent of the post-scheme paid-up share capital of the transferee entity comprises of shares allotted to the public shareholders of the transferor entity.*

4. Additional conditions for NCRPS (Non-Convertible Redeemable Preference Shares)/NCDs (Non-Convertible Debentures) issued pursuant to the Scheme

4.1 A listed entity may seek listing of NCPRS/ NCDs only if the listed entity is a part of the scheme and the listed entity has its securities listed on the stock exchange and the said NCRPS/ NCDs are issued to the holder of the securities of the listed entity. Such scenarios may broadly include the following:

(a) A listed entity, which has listed its specified securities, (demerged entity) demerges a unit and transfers the same to another entity (resultant entity), and the resultant entity issues NCRPS/NCDs to the holders of the specified securities of listed entity (i.e. demerged entity) as a consideration under the scheme of arrangement;

(b) A listed entity, which has listed its specified securities, (amalgamating entity) is merged with another entity (amalgamated entity), and the amalgamated entity issues NCRPS/NCDs to the holders of the specified securities of listed entity (i.e. amalgamating entity) as a consideration under the scheme of arrangement.

4.2 Only the NCRPS/NCDs issued to the holders of listed specified securities, *vide* the scheme of arrangement, would be eligible for seeking listing;

4.3 Additionally, terms of issue of NCRPS/ NCDs by listed entities are as under:

– Minimum tenure of the NCRPS / NCDs shall be one year;

– Valuation report to include valuation of NCRPS / NCDs;

– Minimum such credit rating, if any, specified for public issue of NCRPS under SEBI (Issue and Listing of Non-Convertible Redeemable Preference Shares) Regulations, 2013 or for public issue of NCDs in terms of SEBI (Issue and Listing of Debt Securities) Regulations, 2008, as the case may be by a credit rating agency registered with SEBI;

– All NCRPS / NCDs to be issued in dematerialised form only

4.4 Additional disclosures to be made in the Scheme:

– Face value & Price

– Dividend / Coupon such as terms of payment and frequency etc.

– Credit Rating

– Tenure / Maturity

– Redemption – Terms of redemption, date, amount, redemption premium/discount etc.

– Other terms of instruments

B) Valuation report and Fairness Opinion

1. All listed entities undertaking a scheme of arrangement / amalgamation are required to submit a valuation report to SEBI from an Independent Chartered Accountant specifying the share exchange ratio. However, where there is no change in the shareholding pattern of the listed entity / resultant company, the valuation report is not required.

Illustration of 'no change in shareholding pattern':

In case a listed entity ("entity A") demerges a unit and makes it a separate company ("entity B");

o if the shareholding of entity B is comprised only of the shareholders of entity A; and

o if the shareholding pattern of entity B is the same as in entity A; and

o every shareholder in entity B holds equity shares in the same proportion as held in entity A before the demerger

A 'change in the shareholding pattern' means:

– Change in the proportion of shareholding of any of the existing shareholders of the listed entity in the resultant company; or

– New shareholder being allotted equity shares of the resultant company; or

– Existing shareholder exiting the company pursuant to the Scheme of Arrangement

2. In addition to the valuation report, the listed entity is also required to obtain a Fairness Opinion by an Independent SEBI Registered Merchant Banker on the valuation of assets/ shares done by the valuer for the listed entity and unlisted entity stating that the share exchange ratio as per valuation report is fair and reasonable;

3. As per the recent circular issued by SEBI on January 3, 2018, the chartered accountant and the merchant banker shall not be treated as independent in case of existence of any material conflict of interest among themselves or with the company, including that of common directorships or partnerships.

C) Cases where filings are not required

The provisions of the SEBI Circular which lays down the detailed requirements to be complied with by listed entities while undertaking schemes of arrangement shall not apply to

schemes which solely provides for merger of a wholly owned subsidiary or its division with the parent company.

However, such draft schemes shall be filed with the stock exchanges for the purpose of disclosures and the stock exchanges shall disseminate the scheme documents on their websites.

D) Key elements to be kept in mind for filing with stock exchange and other requirements

In order to maintain uniformity and strengthen control over the applications required by the listed entities seeking approval for scheme of amalgamation/ arrangement, SEBI rolled out a Master Checklist for Scheme of Amalgamation/ Arrangement/ Demerger, etc. as per Regulation 37 of SEBI LODR Regulations. In addition to this, the stock exchanges (i.e. BSE Limited and National Stock Exchange of India Limited) have also prescribed a list of documents required to be submitted with them for obtaining approval under Regulation 37 of SEBI LODR Regulations.

List of documents to be filed with the stock exchanges:

1. Board Resolution:

   It should contain the following matters:

   a. Approving the Draft Scheme (merger/demerger);

   b. Taking on record the report of the Audit Committee recommending the draft Scheme;

   c. Adopting the valuation report of an Independent Chartered Accountant;

   d. Adopting the fairness opinion by an Independent SEBI registered Merchant Banker;

   e. In case the approval of majority of the public shareholders is not required, a certificate from a statutory auditor stating the reasons thereof shall be taken on record;

   f. Identification of a designated stock exchange for the purpose of co-ordinating with SEBI;

   g. Taking on record the certificate from the statutory auditor confirming the compliance of the Accounting Standards

2. Draft Scheme of Amalgamation/ Arrangement;

3. Valuation report from the Independent Chartered Accountant along with the workings thereof;

4. Audit Committee Report;

5. Fairness opinion by Merchant Banker;

6. Shareholding pattern of all companies involved (pre & post Amalgamation/ Arrangement):

   a. For listed companies – Format under Regulation 31 of SEBI LODR Regulations

   b. For unlisted companies – No format has been prescribed. However, details such as name of the shareholders, shares held, percentage holding, etc. to be disclosed

7. Audited Financials of the transferee/ resulting and transferor/demerged companies for the last 3 financial years. Care should be taken that such financials should not be more than 6 months old as on the date of filing the scheme with the stock exchange.

   Additionally, in case of listed companies, the audited / unaudited financials for the latest quarter along with Limited Review Report of the auditor is also required;

8. Statutory Auditor's Certificate confirming the compliance of the accounting treatment as per the format prescribed by SEBI. In case the sectoral regulatory authorities have prescribed norms for companies for accounting treatment of items in the financial statements contained in the scheme, the requirements of the regulatory authorities shall prevail.

9. Detailed Compliance Report certifying that the draft scheme of arrangement involving the entities does not, in any way violate, override or limit the provisions of securities laws or requirements of the Stock Exchange(s) and the same is in compliance with the applicable provisions of SEBI LODR Regulations, including the following:

   a. *SEBI LODR Regulations – Corporate Governance requirements*

      i. Regulation 17: Board of Directors (duties and responsibilities)

      ii. Regulation 18: Audit Committee (formation, composition and role)

      iii. Regulation 19: Nomination and remuneration (formation, composition and role)

      iv. Regulation 20: Stakeholders Relationship Committee (formation, composition and role)

      v. Regulation 21: Risk Management Committee (formation, composition and role)

      vi. Regulation 22: Vigil Mechanism

      vii. Regulation 23: Related Party Transactions (materiality, approvals and disclosures)

      viii. Regulation 24: Corporate governance requirements with respect to subsidiary of listed entity

      ix. Regulation 25: Obligations with respect to independent directors

      x. Regulation 26: Obligations with respect to employees including senior management, key managerial persons, directors and promoters

      xi. Regulation 27: Other corporate governance requirements such as quarterly compliance report on corporate governance including requirements as specified in Part E of Schedule II of SEBI LODR Regulations

   b. *Regulation 11 of SEBI LODR Regulations – Compliance with securities laws*

   c. *Requirements of the SEBI Circular*

   d. *Certificate from the managing director/ chief financial officer that the accounting treatment provided in the Scheme is in compliance with Accounting Standard as applicable to a listed entity;*

10. If approval from Public shareholders through e-voting is not applicable then following is required to be submitted:

    a. An undertaking certified by the auditor clearly stating the reasons for non-applicability of the same

    b. Certified copy of Board of Director's resolution approving the aforesaid auditor certificate

11. Brief details of the transferee/resulting and transferor/demerged companies as per prescribed format including the following:

a. Name

b. Date of incorporation

c. Registered address

d. Brief particulars of the scheme

e. Rationale for the scheme

f. Date of board resolution approving the Scheme

g. Date of Audit Committee meeting approving the Scheme

h. Appointed date

i. Networth details – Pre and post

j. Method of valuation

k. Exchange Ratio

12. Networth certificate from a Chartered Accountant together with related workings pre and post scheme for the transferee and / or resulting company.

 'Networth' for the purpose of certificate to be submitted to National Stock Exchange of India Limited – Equity Share Capital plus Free Reserves minus miscellaneous expenditure written off.

 'Networth' for the purpose of BSE Limited has not been defined.

13. In case of allotment of shares to selected group of shareholders/shareholders of unlisted companies, pricing certificate from statutory auditor of the listed entity as per ICDR Regulations;

14. Capital evolution details of the transferee/ resulting and transferor/demerged companies such as date of issue of shares, number of shares issued, issue price, type of issue (IPO/FPO) etc. from the date of incorporation;

15. Confirmation by the Managing Director/ Company Secretary as per format prescribed;

16. In case of demerger wherein a division of a listed company is hived off into an unlisted company or where listed company is getting merged with an unlisted company, following additional documents are required with BSE Limited:

 a. Clarification as to what will be listing status of the Resulting/ Transferee Company/ies

 b. Details of Assets and Liabilities of the Demerged division that are being transferred

 c. Confirmation from the Managing Director/ Company Secretary, that:

  i. There will be no change in Share Capital of the resulting/ transferee company till the listing of the equity shares of the company on BSE Limited.

  ii. The shares allotted by the resulting company pursuant to the Scheme shall remain frozen in the depositories system till listing/trading permission is given by the designated stock exchange.

 d. Confirmation by the Managing Director/ Company Secretary of the resulting/transferee company on the letter head of resulting company as per format prescribed;

 e. Percentage of Net Worth of the company, that is being transferred in the form of demerged undertaking and percentage wise contribution of the Demerged division to the total turnover and income of the company in **the last two years** as per the format prescribed

17. Complaint Report to be submitted within 7 days of expiry of 21 days from the date of uploading of Draft Scheme and

related documents on the website of stock exchanges providing the details such as number of complaints received, no. of complaints resolved etc.

All the above documents should be serially numbered, signed, stamped and certified by the authorised signatory of the company.

Other requirements

1. The listed entity shall also comply with the following requirements:

   a. In case of merger of an unlisted company or a division of unlisted company with the listed transferee company, the transferee company should have a minimum paid-up capital of ₹ 3 crore post scheme of arrangement / amalgamation

   b. In case a listed company merges with an unlisted company or division of a listed company is hived off into an unlisted company and the unlisted company applies for listing, the transferee / resulting company should have a minimum paid-up capital of ₹ 3 crore post scheme of amalgamation / arrangement.

2. No requirement to obtain an 'in-principle' approval from recognised stock exchange for securities to be issued pursuant to the scheme of arrangement approved by the Tribunal for which the listed entity has already obtained 'No-Objection Letter'.

3. Listed entity to give notice at least 7 working days in advance (excluding the date of intimation and the record date) to stock exchange of record date for issuance of securities pursuant to the scheme.

Recent Developments

In support of the vision of a digital India, SEBI *vide* its Circular CFD/DIL1/CIR/P/2018/011 dated January 19, 2018 introduced the *'Online Filing System for Offer Documents, Schemes of Arrangement, Takeovers and Buybacks'.*

Such online filing along with the physical filing of documents shall continue till March 31, 2018.

Thereafter, from April 1, 2018 physical filing of the aforesaid documents shall be discontinued and only online filing will be accepted.

Conclusion

In order to conclude, we can say that regulations made under SEBI laws for merger / demerger/ acquisition have evolved over a period of time to protect the interest of stakeholders. The clarifications issued by SEBI from time to time is a welcome move.

What we think, that our body becomes.

Everything is manufactured by thought, and thus we are the manufacturers of our own lives.

We alone are responsible for whatever we do.

— *Swami Vivekananda*

CA Anil Talreja & CA Soniya Vyas

Uncertainty continues to loom over Indirect Transfer Taxation Regime

Expectations on clarity of indirect transfer taxation regime have fallen flat with the Finance Bill, 2018 remaining silent on the issues faced with respect to the extant provisions. With the result, the ambiguity around certain aspects of the law in this relation would continue.

Background

Indirect transfer related taxation witnessed its evolution post the most talked about Supreme Court decision in the case of Vodafone, in 2012. As per the said judgment, in order to trigger taxation in India, the capital asset should be situated in India. The Apex Court held that shares of a foreign company should be considered as not being situated in India. Accordingly, the transaction of transfer of shares of a foreign company between two foreign companies was held not to be subjected to tax in India.

Introduction of the law

In the Finance Act, 2012, the provisions of section 9(1)(i) of the Income-tax Act, 1961 (the Act) were widened with retrospective effect from assessment year 1962-63. As per the amended section, an asset or a capital asset being any share or interest in a company or entity registered outside India, shall be deemed to be situated in India provided the share or interest derives, directly or indirectly, its value substantially from the assets located in India. Further, this was introduced as a clarification meant to be effective with retrospective effect from 1st April, 1961.

Developments in indirect transfer taxation regime

While the law was laid down, its application was yet to be determined due to absence of a structured regime. The Finance Act, 2015 made amendments to introduce certain clarification whereby the mechanism of evaluating indirect transfer provisions was laid down. Further, it was clarified that the value of an asset shall be the fair market value as on the specified date, of such asset without reduction of liabilities, if any. Exceptions were also brought in for small shareholders holding up to 5% stake indirectly in the Indian assets. The Finance Act had likewise introduced exemption on transfer of foreign shares of a foreign company which derives substantial value from India pursuant to an amalgamation or a demerger subject to fulfilment of certain conditions.

After much deliberation and representations by various stakeholders, the Government in 2017 announced an exemption to the investors of Category I and II Foreign Portfolio Investors

(FPI) from the rigours of indirect transfer provisions with retrospective effect from 2012. This move provided the needed respite to the foreign investors.

During the journey of the evolution of the law, the CBDT was intimated of the apprehensions expressed on the construct of the law which could lead to bringing dividends declared overseas, to be also covered under indirect transfer provisions. The CBDT then issued clarifications to state that dividends distributed by a foreign company in respect of shares which derive substantial value from India, would not be deemed to accrue or arise in India. This was a welcome step to avoid unnecessary harassment to the overseas investors.

In 2016, based on various queries received by the CBDT about the scope of indirect transfer provisions, a working group was created to examine the issues as raised by the stakeholders. In consideration of the comments, certain clarifications were released. Multiple concerns were raised by various stakeholders post the issue of clarifications and the same was kept in abeyance.

Practical challenges faced by foreign investors having investments in India

1. Trigger of indirect transfer provisions post exit from Indian portfolio company

One of the most crucial challenges that needed immediate attention is the taxation trigger on upstreaming of funds by the foreign investors (not being investors in Category I and II FPIs) post exit (whether partial or complete) from the portfolio company in India. The trigger of the provisions of indirect transfer arises on account of examination of specified date. The definitions of specified date as it stands today is the date of the last close of financial statements or the date of transfer of share or interest in the foreign entity where the value of assets in such entity increases by 15% from the last balance sheet date.

Let's take an example to understand this in detail.

The foreign investor exits the Indian company say on 24th March, 2017 and it upstreams funds to its parent on 29th March, 2017. The said company maintains financial statements on a calendar year basis i.e. latest balance sheet date would be 31st December, 2016. As per the specified date definition, if the value of assets of the foreign company do not increase by more than 15% up to 28th March, 2017, then the specified date would be 31st December, 2016. Accordingly, upstreaming of funds are caught under indirect transfer tax.

The Finance Minister had mentioned in his Budget speech that indirect transfer provisions should not apply on up streaming of funds post exit from India investments. This was however not seen in the fine print of Finance Act, 2017. Later, the CBDT released a clarification on 7th November, 2017 the applicability of indirect transfer provisions on redemption of share or interest outside India which is relevant to foreign investors indirectly having investment in Category I and II Alternative Investment Funds (AIFs) or a Venture Capital Fund (collectively referred to as specified funds). As per the clarification released, no income under indirect transfer provisions should accrue on account of redemption of share or interest held indirectly in the specified funds if such income accrues as a consequence of transfer of shares of securities held in India by the specified funds. This benefit is subject to cases where proceeds of redemption or buyback arising to the non-resident investor does not exceed the pro-rata share of the non-resident in the total consideration realised by the specified funds from the said transfer of shares or securities in India.

While this is definitely helpful, it needs to be noted that majority investments in India are covered under foreign direct investment (FDI) route and the applicability of the clarification is limited to cover specified funds only. Further, the clarification released is limited to the consideration that was received in India when the specified funds had sold their investments in India.

While certain steps have been taken by the Government to rationalise the effects of the indirect transfer provisions to entice foreign investors, majority investors still remain affected by the provisions with no relief. In the age of globalisation, multiple layered structures spread across countries are not an uncommon feature. The extant provisions are so broad in their ambit that unintendedly they also cover any transfer at an overseas level by the company, which has indirect holdings in India deriving substantial value. Let's understand this by way of an example. Company A in country X holds investments in India, China, Sri Lanka and Japan. The shares of Company A derive substantial value from India. Company A tenders its shares to its parent entity to repatriate funds pursuant to an exit from its investment in China. This redemption of shares by Company A would trigger indirect transfer in India and subject the income earned by the parent entity to tax in India. Resultantly, the parent entity would have to undertake compliances in India and the Indian company would also have to file Form 49D. Accordingly, the provisions of indirect transfer are significantly harsh in such cases. Further, the investor's indirectly holding stake in specified funds would also get caught in this abovementioned example since the exemption is restricted to income repatriated post exit from India by the specified funds.

Given the complexities and unintended taxation triggers, exceptions to the applicability of indirect transfer provisions were expected in Budget 2018. However, there is no mention of any change in the existing regime either in the Budget speech (as was in the last year) or in the fine print of the Finance Bill 2018. This issue would continue to haunt foreign investors thereby making upstreaming of funds more challenging. Indirect transfer implications would need to be considered with every transfer undertaken at an overseas level. It is not sure how far it is practically possible and how Indian entities would be able to track transactions which they are expected to report as per the provisions of the Act.

2. Valuation report to be sought for evaluating indirect transfer provisions

The Income-tax Rules, 1962 (the rules) relating to the indirect transfer provisions were introduced in June 2016 which among other things, prescribed for a method for examining whether the share or interest of a foreign entity derives substantial value in India. The said rules prescribe undertaking the exercise of valuation of such share or interest on the specified date. Additionally, the rules also prescribe considering the audited balance sheet for an Indian company valuation and certified / audited balance sheet for the valuation of a foreign company, as on the specified date. As we understand, the specified date is the last balance sheet date or the date of transfer, if the value of the assets of the said foreign entity increases by 15% from the last balance sheet date. The requirement of getting balance sheet audited as on the specified date to evaluate the tests of indirect transfer enhances challenges in practically concluding the transactions as commercially planned.

As we are aware, any payments to a non-resident which are subject to tax in India are required to comply with the withholding tax provisions i.e. prior to booking liability or releasing the payment to the non-resident, tax is required to be withheld. Only once the tax payments are made, can the transaction be said to be concluded.

The rules state that for calculation of substantial value, the audited / certified financial statements as on the specified date should be considered Resultantly, the transferor is required to conduct audit on the accounts as on the said specified date. This requirement of audited financials for understanding the value of the Indian company is highly onerous. It is recommended that the Government should consider easing this requirement. Instead of audited / certified financial statements, management accounts as on the specified date may be considered as on the transaction date in order to facilitate timely closure. Government may consider adding a time period within which the companies need to get the accounts finalised and audited as on the specified date and pay the remaining tax if, any with the Government treasury as per prescribed norms.

Additionally, at present the provisions of section 9(1)(i) of the Act, envisages a situation that all the companies holding shares or interest in a foreign company indirectly deriving value from multiple jurisdictions apart from India. However, there could also be scenarios where the overseas company indirectly holds only assets situated in India.

In addition, let's consider a situation where an underlying investment of overseas company is indirectly situated 100% in India. In such a scenario, since rationally 100% of the value is derived from India, undertaking a valuation report exercise could be highly cumbersome and not add value to the database already available. Absence of any exclusion of such cases could hurt the investors and also cause them to comply with daunting task of completing the relevant India filings. This would be a common feature in case of funds which are set up with a focus of investing in India as a jurisdiction and would surely be in the list of their pain points. It would be useful if the valuation report requirement is done away with in such cases and a more practical approach is sought by the Central Government.

3. Filing of Form 49D by the Indian company with respect to indirect transfer triggering transactions

As per the provisions of the Act, onus is cast on the Indian portfolio company to furnish prescribed particulars in Form 49D in order to make disclosure of the transactions covered under indirect transfer provisions. Presently, the Indian companies are facing numerous challenges to comply with the said reporting. Firstly, awareness that an overseas transaction has triggered an indirect transfer getting triggered is the key. Unless the transactions concluded by the overseas entities / shareholders are not disclosed, Indian company would not be in a position to comply with the provisions of the Act to make appropriate filings. Accordingly, meeting the deadline for filing the Form 49D with the desired disclosures may be difficult.

In case where the indirect transfer trigger has also resulted in change in control and management, then Form 49D required to be filed within 90 days of the date of the transaction. Complying with so many requirements within the prescribed time limit could result in practical issues. Further, in case the Indian company is provided with the information after the due date would result in penal proceedings against the Indian company.

Additionally, the particulars of the said Form 49D are also quite elaborate and request for details which may be difficult to fetch; e.g. the audited / certified financial statements of an entity from Cayman Islands as on the specified date are required to be furnished by the seller. There could be a practical hindrance of providing details of value of assets based on audited / certified financial statements etc. in case there is no requirement

of getting accounts audited / certified in the home country. However Form 49D mandates disclosures as per audited / certified financial statements.

Another issue is the number of entities which are required to file the Form 49D with respect to one transaction. Currently, the rules prescribed give an option to file a consolidated Form 49D by group entities. Only those companies which are subsidiary companies of the foreign shareholder would get classified under "Group Company". Say for example, a PE investor holds shares in six portfolio companies in India, not being a subsidiary and 3 companies which get classified as subsidiary companies. In case of subsidiary companies, out of three, one can be nominated to file a Form 49D on behalf of other two entities. However, other 6 companies would be required to individually file Form 49D furnishing the details prescribed as per the Act. In which case, while not only the Indian company needs to comply but every company is required to seek information from the foreign shareholder with respect to transactions triggering an indirect transfer. This has resulted in making the compliances burdensome for the foreign shareholder.

Additionally, the penalty provisions are very stringent on the Indian company for not complying with the lawful requirement. As per the Act, the levy of penalty is 2% of the transaction value or INR 5 lakh, whichever is higher. The base threshold of INR 5 lakh for penalty is not commensurate with the size of investments as is generally observed in market practice for any investments, i.e. strategic investment or a portfolio investment by a private equity player. Therefore, penalty provisions could result in hefty liabilities should there be any miss on Form 49D filing by the Indian company. Further, while the levy of penalty is subject to the discretion of the tax officers, there is no specific mention of a grace period in case the prescribed deadline is not met. Hence, it becomes imperative to ensure timely compliances. It also needs to be considered that in case any particulars are erroneously furnished in Form 49D, there is no mechanism to rectify the same. Accordingly, the Indian company would be required to re-file the same. This could cause a challenge on which date to be considered for filing the Form 49D.

In case the later one was filed after the relevant due date passed and the first Form 49D filed is not considered, there could be huge penal implications of the same depending on the transaction value. Therefore one would need to be extremely cautious while completing the Form 49D in order to avoid such issues.

4. Applicability of deeming fictions to indirect transfer covered transaction

Two new sections were inserted in the Budget 2017 under the Act namely, sections 50CA and 56(2)(x). We are aware that 50CA has been enacted to monitor transactions of unquoted securities undertaken at a value lower than the fair value of the shares sold. The provisions of this section are applicable in the hands of the seller of shares. Further 56(2)(x) has been inserted to replace the earlier section 56(2)(viia) and the same is much wider in its applicability.

Provisions of section 50CA deems to replace the value of sale consideration with the fair market value computed as per the rules prescribed if the same is higher than the commercially agreed sale consideration. Further, the provisions of section 56(2)(x) are wide enough to take in its ambit the transactions undertaken by the overseas investor where the said investor is receiving shares.

Presently, there is no clarity on whether a transaction which is tested for indirect transfer taxation is also required to be evaluated from

the perspective of the sections 50CA and 56(2)(x). As both these sections are recently introduced, there are no precedents for the same. This has resulted in different views or approaches taken with respect to the said sections. Where a view is taken that there should be no implications under section 50CA or section 56(2)(x), it would be required to be substantiated to the tax authorities that the said provisions are not applicable as there is no specific mention of there being a carve-out for transactions which result in an indirect transfer in India. This could lead to litigation and the resolution of the position taken could take its own time.

However, if overseas investor takes a view that both these sections should not be applicable in the case of a transaction triggering indirect transfer, there would be additional compliances which needs to be considered. The rules for computing the fair market value for both these sections are overlapping. As per the rules prescribed, all assets except land, building, investments and jewellery needs to be valued at book value. As regards land and buildings, they need to be valued at the stamp value of the property. Jewellery needs to be valued at the fair market value and investments in other companies need to be valued as per the rules as applicable to shareholder company.

Let's assume that a foreign company has acquired shares of another foreign company which has subsidiaries across the globe, who in turn have multiple subsidiaries at a local level. Applying the rules prescribed for understanding the fair market value could be extremely difficult since one would need to understand fair value of the land or building if that company holds real estate. Further, having the circle rate of the property owned by the foreign company may not be possible since the overseas law would be different from India. Additionally, computing the value of investments could be going in circles if there are multiple subsidiaries spread all across. Moreover, in case where the overseas investor is a buyer, it would need to depend on the seller for the valuation of the underlying shares. In a situation where both parties take a contrary stand on the applicability of indirect transfer, it would be practically challenging, especially for the buyer, to have the desired information.

5. Issues in group restructuring at an overseas level

Indirect transfer provisions are too wide to cover group restructurings at an overseas level. Therefore any merger or demerger for example could result triggering indirect transfer provisions.

The Finance Act, 2015 which had brought certain amendments in the Act relating to indirect transfer provisions including expansion in the situations / transactions which would not be considered as a transfer under section 47 of the Act. As per the amended section, transfer of a capital asset being shares of a foreign company by one company to another in the case of an amalgamation would not be considered as a transfer if at least 25% of the shareholders of the amalgamating foreign company continue to remain shareholders in the amalgamated company and such transfer also does not attract capital gains taxation in the country where amalgamating company is incorporated. A provision was also introduced with respect to demerger where transfer of a capital asset being shares of a foreign company are transferred to another foreign company should not be considered as a taxable event if at least 75% of the shareholders of the demerged company continue to remain the same as the resulting company and the said transaction should not attract tax on capital gains in the country in which the demerged company is incorporated.

As per the existing exemptions granted under section 47 of the Act, the event of transfer of shares of a foreign company pursuant to demerger or amalgamation are covered. However, similar exemption is not granted to the shareholders of the said amalgamating or demerged company. Thereby resulting in taxation in their hands. This has created concerns for genuine transactions under group restructuring having indirect investments in India. Various representations had already been made in this regard with expectations of relief being visible in Budget 2018. However, this issue still remains open and certainly adds to the concerns of the overseas investors contemplating internal group restructuring.

Way forward to ease the indirect transfer issues

Indirect transfer tax provisions have raised the bar of burdensome compliances for the genuine foreign investors. Following changes would be welcome in the existing provisions to iron out issues faced in complying with the said provisions:

a. Exemption to the shareholders on transfer of shares or interest as a result of upstreaming of funds pursuant to exit. This is a serious issue causing frustration to the overseas investors as there is multiple taxation at every upstreaming of funds until such step where the shares or interest transferred at an overseas level derive value from investments in India. Adequate clarity needs to be given that indirect transfer provisions should not trigger pursuant to upstreaming of funds at all levels on account of exit from a jurisdiction other than India. Accordingly, there should be no compliances as well to be undertaken with respect to the same.

b. It may be considered to value the shares based on the management accounts on the date of transfer and may be revisited later once the certified accounts are ready. Any additional tax liability payable on account figures being updated after review should not be liable to interest for late payment of tax. Further, a requirement from obtaining a valuation report may be considered to be relaxed in a situation where 100 per cent of the value of overseas shares are derived from India.

c. With a step to simply the compliances, the Indian Government may consider filing one Form 49D by all the Indian companies where an indirect transfer needs to be reported. This would be useful to avoid unnecessary penal implications in the hands of Indian company and ease of process for the foreign investor.

d. Granting relaxation to indirect transfer triggering transactions from the deeming fictions created by sections 50CA and 56(2)(x) of the Act. This step would ease the issues around the valuation rules which require humungous data especially where the company structure is complex.

e. Restructuring of investor group at an overseas level should be exempt from indirect transfer provisions. Relaxation should be granted to not only amalgamation or demerger transactions but also other transactions which result in indirect transfer for example a slump sale or slump exchange.

The Government has taken various measures to project India as a business friendly jurisdiction including various regulatory reforms which were much awaited. More is expected by the investors to ease the rigours of the provisions and rationalise compliances in order to promote foreign investment in India.

CA Naresh Ajwani

Tax Planning versus GAAR – In relation to Mergers and Acquisitions (M&As)

1. Background and focus of this article

Mergers and Acquisitions (M&As) is a generic term for rearrangements of business. It includes demergers and transfers. In this article I have used the term **"rearrangements"**. For certain kinds of rearrangements, the Income-tax Act provides certain reliefs. Taking advantage of the same is a *bona fide* tax planning if it is undertaken in a *bona fide* manner and as per rules. There is however a thin line of demarcation between tax planning and tax avoidance. What guidelines can be considered to distinguish tax planning and tax evasion? This will be the focus of the article. The details of rearrangements have been discussed in separate articles by other authors. Hence these are not discussed here.

2. Tax planning / Tax avoidance / Tax evasion

2.1 There are a plethora of judgments on this subject. Supreme Court has observed in the decisions of *Azadi Bachao Andolan (263 ITR 706)* and *Vodafone (341 ITR 1)* that without specific anti-avoidance provisions in the law, a person is free to plan his affairs. If the Government wants, they can provide for anti-avoidance provisions in the law. At the same time, there are other decisions where the Court has given importance to substance. Colourable devices are not accepted as tax planning. (e.g. *McDowell decision - 154 ITR 148)*. In some cases, Court has also pierced the corporate veil.

2.2 Broadly, tax reduction can be divided into 3 categories.

One is **"tax mitigation"** which involves legal measures with substance to save taxes (e.g. setting up a new unit in SEZ or an amalgamation as defined u/s. 2(1B)). We may call this as **tax planning** or **tax mitigation**. This is acceptable even after GAAR has come into force.

Second is **"tax evasion"** where the transactions are outright sham, or are concealed. This is not covered by GAAR as existing jurisprudence is sufficient to cover tax evasion / sham transactions.

The third is **"tax avoidance"** which involves use of legal steps resulting in tax reduction, which steps would not have been undertaken if there was no tax reduction. This kind of tax avoidance planning are sought to be covered by GAAR.

2.3 With GAAR, there is no difference between tax evasion and tax avoidance. All transactions which have implications for avoiding income-tax, can be under the scanner of GAAR. At the same time all tax saving transactions cannot be considered under

GAAR. A tax relief provided by the Government cannot be a matter of GAAR scrutiny if the relief has been claimed in a *bona fide* manner and as per law. GAAR is meant to apply to transactions which are *prima facie* legal, but do not have commercial substance and result in tax reduction.

2.4 There are various methods to avoid income-tax inappropriately. Broadly these are as under:

i) **Use of tax relief provisions for one transaction** – If an income-tax provision provides relief on certain transactions, the section itself contains the conditions which must be fulfilled to claim the relief (e.g. for merger). For claiming relief for such transaction, fulfill the conditions in form and not in spirit. If one follows the conditions in form, and yet escapes tax, GAAR can apply.

   Investors can take advantage of the exemptions to achieve some other purposes. For example, if a loss making company merges into a profit making company, the income-tax goes down. Before the merger, the loss of one company could not have been set off against profit of another company as the two companies are separate persons. Is the merger driven for business considerations or only for obtaining tax advantage? This is an issue where now GAAR can come into play. If GAAR is applicable, then the relief sought to be obtained will be nullified. The problem will be more in case of rearrangements within group companies / entities. Establishment of commercial reasons is the key to avoid GAAR. See another illustration in para 7 below.

ii) **Series of transactions** – To claim tax relief, a series of transactions may be required to be undertaken. Each transaction by itself may be all right and entitled to a relief. However taken as a whole, the transactions may be devoid of commercial substance. GAAR can apply to such transactions. (Illustration is given in para 8 below).

iii) **Claim relief by claiming an incorrect fact** – The tax relief will be obtained if the revenue department does not become aware of the correct fact. If the incorrect fact comes to light, the tax relief will be denied. GAAR or SAAR may not even be required.

iv) **Claim relief by claiming the fact to be true based only on form** – E.g. If a Mauritius company invests in India, India-Mauritius DTA relief is claimed. Later it comes to light that while formally the Mauritius company is the investor, in substance the investor is a US company. Mauritius company is not operated like a company. In such cases, tax relief can be denied. This involves fact finding and interpretation. Here also GAAR or SAAR may not even be required. (e.g. In the Advance ruling of *AB Mauritius - No. 1128 of 2011*; ruling dated 8-11-2017 – it was held that AB Mauritius was not operated like a company. It was the US company which was the real shareholder.) (See para 10 for more details.)

A combination of above methods or any other methods may be used. GAAR involves finding the facts and real purpose, rather than interpretation. Legal interpretation is important when there is a matter of law. Therefore in this article, illustrations have been used to explain the subject instead of too much legal jargon.

3. Incomes on rearrangements which can be covered under GAAR

Mergers and demergers are undertaken to rearrange business affairs. There can be several reasons such as change in business environment, regulatory laws, for deriving more

benefit, joining with someone, separating from someone, etc. A businessman takes a view on the arrangement.

Any rearrangement involves income-tax consideration on account of transfer of capital assets from one person / entity to another. There could be other incomes such as dividend or interest. GAAR can apply to all incomes and not just capital gain relief.

Let us look at the basic provisions of GAAR.

4. Basic provisions of GAAR

The basic provisions of GAAR have been dealt with in details in the CTC journal of October 2017. Here the key provisions are discussed.

4.1 GAAR applies when the arrangement is an **Impermissible Avoidance Arrangement** (IAA). An arrangement will be considered as IAA, if both the conditions are met:

i) The main purpose is a tax benefit, and

ii) There is a tainted element (any one of the four). (This is discussed in para 4.2 below.)

Rule 10U(1)(a) has provided that if the tax benefit is ₹ 3 crores or less, then GAAR will not apply. CBDT has stated in its Circular No. 7 dated 27-1-2017 in answer to question 14 that benefit has to be seen "assessment year specific". It means that if the benefit during the specific year is ₹ 3 crores or less, GAAR will not apply.

4.2 Tainted Element test

Section 96(1) refers to four tainted elements which an arrangement should have to be considered as IAA. These are as under:

i) creates rights, or obligations, which are not ordinarily created between persons dealing at arm's length.

ii) results, directly or indirectly, in the misuse, or abuse, of the provisions of this Act.

iii) lacks commercial substance or is deemed to lack commercial substance under section 97, in whole or in part.

iv) is entered into, or carried out, by means, or in a manner, which are not ordinarily employed for *bona fide* purposes.

The above are alternative tests and not cumulative tests. Satisfaction of any one is sufficient to consider a transaction as IAA.

One of the most important tests is **"Lacking commercial substance"**. It has been defined in section 97. A transaction will be considered to be lacking in commercial substance if:

i) substance and effect of the arrangement differs from the form.

ii) it involves round tripped finance, accommodating party, transactions cancelling each other, it disguises value, location, source, ownership or control of funds.

iii) it involves the location of an asset or a transaction or residence of any party which is without any substantial commercial purpose other than obtaining a tax benefit.

iv) it does not have a significant effect upon the business risks or net cash flows of any party to the arrangement apart from the tax benefit.

Round tripped finance, accommodating party, etc. have been defined further. These are not discussed here.

The essence is that are there *bona fide* reasons or commercial reasons for undertaking a transaction? If yes, GAAR will not apply.

4.3 SAAR versus GAAR:

It is accepted that Specific Anti-Avoidance Rules (SAAR) and General Anti-Avoidance Rules (GAAR) can co-exist together. Just because a SAAR is satisfied, it does not mean GAAR cannot be applied. Shome Committee's suggestion that – where SAAR is satisfied, GAAR should not apply – has not been accepted.

5. Exemption for rearrangements

For corporate restructuring, the Income-tax Act provides for various reliefs. These are mainly under section 47. The reliefs are broadly:

i) To Indian companies which transfer their assets in amalgamation or demerger.

ii) To Shareholders of such Indian amalgamated and demerged companies.

iii) To foreign companies who transfer shares of Indian companies in an amalgamation or demerger of two or more foreign companies.

iv) To shares of foreign company in a foreign amalgamation or demerger which are covered under Indirect transfer provision under explanation 5 to Section 9(1)(i). Kindly note that the relief is extended to amalgamated or demerged foreign companies (transferors) only. The relief is not extended to shareholders of such foreign amalgamating / demerged companies.

v) To capital assets in case of conversion of firm / proprietary concern into a company, or a company into LLP.

vi) To transfer of capital assets between Holding and Subsidiary company, if the transferee is an Indian company.

Apart from the above, there are reliefs for banks, co-operative banks and others.

If one follows the conditions prescribed for the above reliefs, there will be no tax. Thus there is a tax benefit. These reliefs are specifically provided. Hence normally GAAR cannot apply.

These are coupled with exemption being provided under Section 56(2)(x), clause (IX) in the proviso. In case of merger and demerger, the transfer has to take place at book value for tax purposes. Usually the fair value of assets would be higher. In this situation, the transferee (who acquires the assets) can be liable to tax on the difference between fair value and book value. However a specific exemption has been provided. In Finance Bill 2018, exemption under section 56 has been extended for transfers amongst holding and subsidiary companies. (It may be noted that Section 56 still does not include all transactions which are exempt under section 47.)

Considering the provisions for transferor and transferee, the intention is clear that specified rearrangements are sought to be exempt completely.

However a person can use a combination of these sections to achieve a position where there is no tax. Let us see more details in the subsequent paragraphs.

6. Arrangement

An arrangement can be a transaction, or a series of transactions, or just a step in a transaction.

In what manner can a person avoid tax when specific exemptions have been given? Primarily under two situations:

i) where the conditions prescribed for rearrangement are complied with only in form.

ii) where a series of rearrangement transactions are undertaken, which results in the tax saving at the end of the series; but if the transactions in the series had not been undertaken, there would have been tax payable.

Let us consider some illustrations below.

7. Preference shares in case of demerger – conditions for relief followed only in form

Under Section 2(19AA), in case of a demerger, the resulting company is required to issue shares to the shareholders of demerged company.

The shares can be equity shares of preference shares. Thus the demerged company's

shareholders can get preference shares. These preference shares can be redeemed after a few years.

Is this demerger transaction exempt from tax on capital gains?

It will be interesting to consider the decision of *Uma Enterprises (P) Ltd. (67 taxmann.com 227 Rajasthan High Court)*. In this case, the land was transferred in a demerger to the resulting company. The shareholders were issued preference shares. The Court held that the issue of preference shares showed that the transaction was essentially sale of land. However it was designed as a demerger. In such a situation, the exemption was not available. In the case of *Wood Polymer Ltd. (109 ITR 177 Gujarat High Court)*, the decision was rendered on similar lines. Both the above decisions were rendered on the facts of the case.

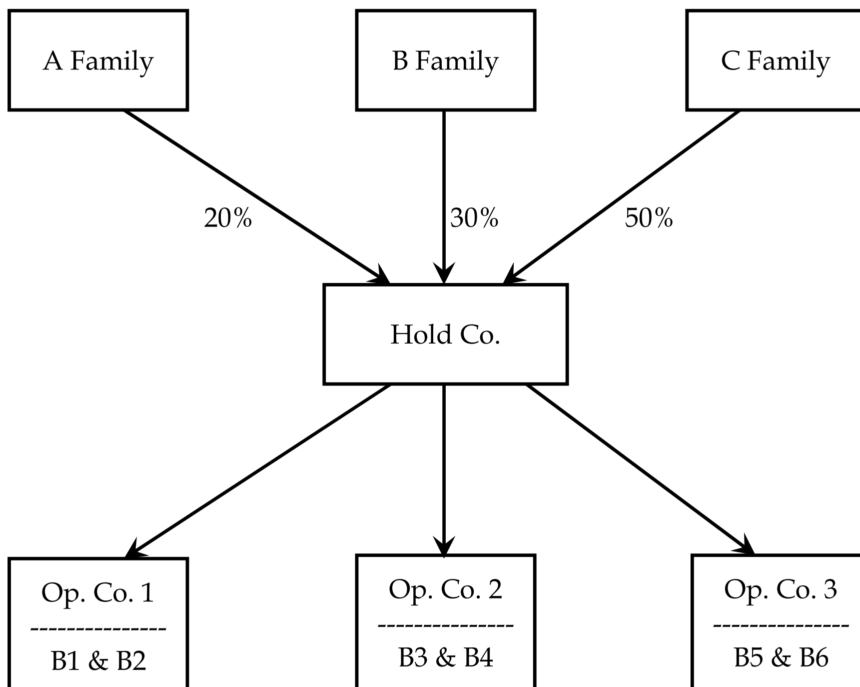
This leads to a situation where if the transaction is essentially a sale, but is disguised as demerger, then the exemption itself may not be available. Here there is no need for GAAR. Under the provisions of rearrangement itself, the exemption can be denied. With GAAR, it is easier to deny the exemption.

The rearrangements can be approved by the Court or now by the National Company Law Tribunal (NCLT). If the tax consideration in an arrangement has been considered adequately by the court or the NCLT, then GAAR will not apply. (See answer to question no. 8 of the CBDT Circular No. 7 dated 27-1-2017).

8. Family arrangement – series of transactions to obtain tax relief

8.1 Let us consider an illustration

There are 3 families whose members own shares of operating companies. However instead of holding the shares personally, they hold the shares through their personal holding companies. The ownership structure is given below:



[B1, B2, B3, B4, B5 & B6 are different businesses.]

There is no alignment between the businesses which are managed by the families, and the ownership of those businesses. The families have decided to transfer the businesses to the families which manage the same. The families' desires are:

A family will hold B1 & B3.

B family will hold B2 & B4.

C family will hold B5 & B6.

8.2 Before going into details, let us briefly see what a family arrangement is

Family arrangement is a British concept where the UK Courts permitted division of assets within the family members to bring peace and harmony within the family. Even potential disputes were considered as a valid reason for family arrangements. Family arrangements are not considered as transfers that are liable to income tax. There is no law *per se*. It is a Court made law.

The concept has been accepted by the Indian Courts.

However the exemption from transfer is **available to individual family members**. It is not available to entities which are held by families.

8.3 In the above case, as the holdings of the families are through a holding company, the following steps are proposed

i) The operating companies are first merged into the holding company. With this, the operating businesses become the businesses of the holding company.

ii) Each family sets up a personal holding company. E.g. A family sets up A Holding company.

iii) The respective businesses are demerged into the personal holding companies of the family which wants to manage the businesses. E.g., B1 and B3 are demerged into A Holding company.

iv) In the personal Holding companies, other family members are also allotted shares as required u/s. 2(19AA). For example, in A Holding company, B and C family members will be allotted shares.

v) Subsequently, the shares in each other's companies will be exchanged in a family arrangement.

Each family is supposed to get 1/3rd of the total value of combined value of all businesses (B1 to B6). The fair value of each business is different. Some families may get more value and some may get less. Therefore any surplus or deficit in value of businesses which the families get, will be settled in cash.

In this manner the families will get the businesses to be managed by them.

The above arrangement involves merger, demerger, and family arrangement.

Will this be appropriate under GAAR?

Can it be argued that the overarching objective is family arrangement? However as the holding is through the holding companies, the families had to undertake this exercise. Therefore there is no tax avoidance *per se*.

8.4 The department can take a stand that on the following lines

i) Family arrangement is available to individuals.

ii) The holding is not by individuals but by holding company. Hence family arrangement relief is not available to the company.

iii) Therefore these three steps have been entered into to avoid tax.

iv) Each step is valid and exempt from tax. However collectively it is designed to fall within "family arrangement" whereas

actually the families are not entitled to "family arrangement" relief.

v) Under section 96(1) the above arrangement:

- creates rights, or obligations, which are not ordinarily created between persons dealing at arm's length. [If the groups were not families, they would not have merged only to demerge later.]
- results, directly or indirectly, in the misuse, or abuse, of the provisions of this Act. [It is abuse of relief provisions for rearrangement.]
- lacks commercial substance or is deemed to lack commercial substance under section 97, in whole or in part. [There is no commercial reason to merge, demerge, and split - other than to obtain tax relief. Normally people will sell business to each other.]

vi) Hence it is an Impermissible Avoidance Arrangement (IAA).

8.5 The above is an illustration of using a series of tax exempt transactions to achieve the objective of tax avoidance, which if it had been undertaken directly (without the multiple steps), there would have been a tax payable.

In my view, GAAR can apply.

9. Shome Committee

Shome Committee has given a few examples of rearrangement. It had recommended that GAAR should not apply to certain transactions. These have not been accepted by the Government. Hence these remain open issues. The main reasons for not invoking GAAR in the examples are:

- The arrangement is under a Court order.
- There are specific anti-avoidance measures.
- The taxpayer has a choice of arranging the sequence of transactions.
- The taxpayer has a choice of achieving tax efficiency.

Briefly the examples pertaining to rearrangements as discussed in the Committee report are as under:

9.1 Example 2A – An Indian company has a foreign holding company. The foreign holding company has downstream operating companies (outside India). The operating companies declare dividends which are parked in the holding company.

After a few years, instead of declaring a dividend, the holding company is merged with the Indian company. The committee has suggested that there is a specific exemption for merger. Hence GAAR should not apply. The tax payer has a choice of deciding on the timing of the activity.

9.2 Example 3 – Merger of a loss making company with a profit making company should not be a cause of applicability of GAAR. The ITA provides for specific anti-avoidance provisions.

9.3 Example 3A – Merger of profit making company with a loss making company does not have specific anti-avoidance provisions. However as it will under the High Court order, GAAR should not be applied.

9.4 Example 13 – An Indian company say ICO1 is held by another Indian company ICO2.

ICO2 is held by FCO1 and FCO2 (foreign companies in offshore centre - say Mauritius). India-Mauritius DTA gives taxation rights for capital gains only to Mauritius and Mauritius does not tax capital gains. (The Committee report is of 2012. Subsequently, the DTA has been amended to provide that India can tax the capital gain earned by Mauritian companies.)

ICO2 was liquidated without Court consent. Assets of ICO2 (including shares of ICO1) were transferred to FCO1 and FCO2.

FCO1 and FCO2 sold the shares of ICO1 to NCO incorporated in Mauritius. No capital gain tax was paid by FCO1 and FCO2 due to the DTA.

Can GAAR apply?

The committee suggests as under:

If the above route was not adopted then the alternatives could be:

i) NCO could acquire shares of ICO2 from FCO1 and FCO2.

ICO2 is liquidated. Thus NCO becomes shareholder ICO1.

No tax is payable on transfer. Tax on dividend on reserves of ICO2 is payable.

ii) ICO2 sells shares in ICO1 to NCO.

Then ICO2 is liquidated.

Tax is payable on capital gains of ICO2. Tax on dividend on reserves of ICO2 is also payable.

Shome Committee suggests that taxpayer can arrange the affairs in a tax efficient manner. Hence GAAR cannot be invoked.

9.5 Example 27 - An Indian holding company Holdco borrows ₹ 10 crore for acquisition of shares of Subco which then became subsidiary of Holdco.

Holdco and Subco amalgamate so that the interest payable on the monies borrowed to acquire the shares can be deducted in computing the income from the business of the amalgamated company.

The committee suggests that the borrowing by Holdco followed by the amalgamation by Subco is not abusive. GAAR cannot apply in the case of merger which is carried out under the orders of High Court. (CBDT Circular 7 dated 27-1-2017 in answer to question no. 8 has stated that <u>if the court or the NCLT has considered the tax issue adequately</u>, then GAAR will not apply. Just because the Court / NCLT has approved the merger, it does not mean GAAR will not apply.)

10. Grandfathering

Grandfathering means preserving reliefs for old transactions. Under Rule 10UDA(1)(d), GAAR rules will not apply to any income from transfer of investments (i.e., capital gains) if the investments are made before 1-4-2017.

Investments means any assets which are held for earning incomes like dividend, interest, rent, appreciation, etc. Loan or lease transactions will not be covered by "investments". (See answer to question 6 in Circular No. 7 dated 27-1-2017.)

Hence in any transaction, if any investment has been acquired prior to 1-4-2017, and there is a capital gains, then GAAR will not apply. Even if the transaction is considered as IAA, to the extent of capital gains, GAAR will not apply. Regular provisions will apply.

Example

A Mauritius company has made investment in an Indian company prior to 1-4-2017. It sells the shares before 1-4-2019 and earns capital gains. Will it be eligible for capital gains relief as per India-Mauritius DTA? (Under the DTA, capital gain earned up to 31-3-2019 is chargeable to tax @ 50% of normal tax).

This becomes very interesting considering the recent Advance Rulings in the case of ***AB Holdings, Mauritius-II (AAR 1129 of 2011)***. The Authority has given a ruling that the benefit of India-Mauritius DTA will be available.

However in the case of ***AB Mauritius (AAR 1128 of 2011)***, the Authority held that Mauritius company was not the true owner. It acquired the shares from the US companies. The consideration was paid by acquiring the liability of the US company. The liability was subsequently cancelled. Thus there was no flow of funds.

Further, the board of Mauritius company came to know of the transaction after about a year. Hence Mauritius company was the benami owner of the US companies. It was the US companies which earned the gain. Hence India-Mauritius DTA could not be applied.

Thus normally the grandfathering relief will be available. However where the transaction itself is not a *bona fide* transaction, one has to first determine the correct transaction. To the correct transaction, grandfathering can be applied. To determine whether the transaction is *bona fide* or not, there is no need of GAAR. The existing jurisprudence permits the lifting of corporate veil, ignoring sham transaction, etc.

11. DTA and MLI

11.1 OECD and G20 countries have come out with Base Erosion and Profit Shifting (BEPS) actions. Under these, Multilateral Instrument (MLI) has been signed. Once the ratification process is over, the MLI will amend several hundred DTAs with one instrument.

The MLI provides amongst other things, a Principal Purpose Test (PPT). PPT is akin to GAAR. It provides that if one of the principal purposes of a transaction is to avail DTA relief, the DTA will not apply.

11.2 How will **PPT and GAAR** interact? There is a view that if a person crosses the hurdle of PPT, DTA relief will apply. If the DTA applies, GAAR cannot apply.

However if one reads the OECD commentary, and section 90(2A) of the ITA, even if one satisfies the DTA, but GAAR is not satisfied, the DTA relief will not be available. Relevant extracts of OECD commentary are reproduced below:

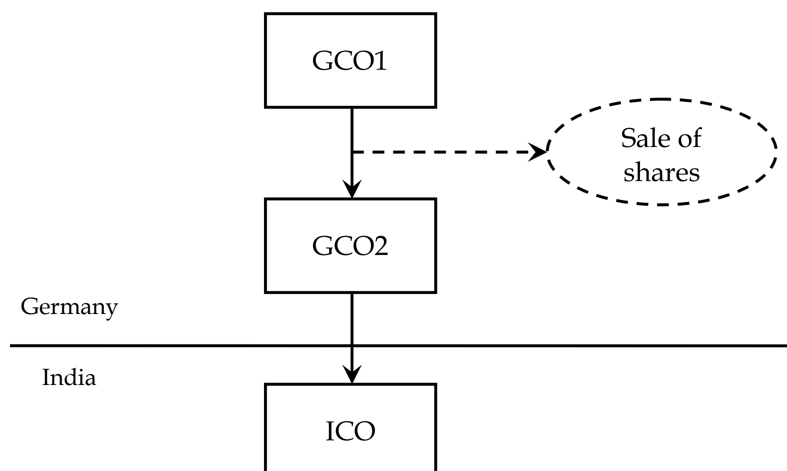
> ***Addressing tax avoidance through domestic anti-abuse rules and judicial doctrines***
>
> ***66. Domestic anti-abuse rules and judicial doctrines may also be used to address transactions and arrangements entered into for the purpose of obtaining treaty benefits in inappropriate circumstances. These rules and doctrines may also address situations where transactions or arrangements are entered into for the purpose of abusing both domestic laws and tax conventions.***
>
> ***67. For these reasons, domestic anti-abuse rules and judicial doctrines play an important role in preventing treaty benefits from being granted in inappropriate circumstances. The application of such domestic anti-abuse rules and doctrines, however, raises the issue of possible conflicts with treaty provisions, in particular where treaty provisions are relied upon in order to facilitate the abuse of domestic law provisions (e.g. where it is claimed that treaty provisions protect the taxpayer from the application of certain domestic anti-abuse rules). This issue is discussed below in relation to specific legislative anti-abuse rules, general legislative anti-abuse rules and judicial doctrines.***

It should be noted that PPT is only for applicability of DTA. For applicability of ITA, one needs to satisfy GAAR. Let us consider an illustration.

11.3 Illustration

A German company (GCO1) holds shares of another German company (GCO2). GCO1 is held by German residents. I understand that if a German company sells shares of another corporation, 95% of the gain is exempt from tax.

GCO2 invests in an India subsidiary company ICO. A chart is given below:



The company decides to dispose of the investment in ICO. However instead of selling shares of ICO, GCO1 sells shares of GCO2.

Under the ITA, assume that the gain is covered by Indirect Transfer Provisions (Explanation 5 to Section 9(1)(i)). Hence under the ITA, the capital gain is liable to tax.

Will it be taxable under the India-Germany DTA?

Under the DTA, the gain will be covered by Article 13(5). It will not be covered by Article 13(4) as ICO shares are not being sold. What are being sold are the shares of GCO2. As no other clause of Article 13 covers it, it is taxable only in Germany as per Article 13(5). It is a settled principle that ITA or DTA whichever is more beneficial, will apply.

Prima facie GCO2 is a proper German company. It is being held by GCO1 which is held by German residents. Hence there is no question of treaty shopping. Whether GCO1 had invested or GCO2 had invested, both are entitled to the DTA relief. Hence under the PPT, it will be difficult to state that the principal purpose of investment by GCO2 was to take advantage of DTA relief.

In such situation, can GAAR apply? The answer will depend on facts of the matter. Consider two situations below.

i) GCO2 is a proper operating company. It has factory, people, etc. It has investments in India as well as other countries. In that case, it will be difficult to state that GCO2 has been formed without commercial substance. The tainted elements will not apply. GAAR cannot apply. GCO2 will not be liable to tax in India.

ii) GCO2 is only a holding company. Main investment is in India. Other investments are small. In this case, it may be possible to state that there was no commercial purpose for investing from GCO2. GAAR may apply and GCO1 may be considered as the true investor. In that case, gain can be taxed in India.

11.4 Thus a factual exercise has to be carried out. If the person is able to claim the DTA relief by coming out of PPT test, it may be very difficult to apply GAAR. However legally, PPT and GAAR both can apply.

12. Summary

In essence, the substance of the matter is that one should be able to establish that there are sound commercial reasons for undertaking a transaction. If commercial reasons cannot be established then SAAR and GAAR both can apply.

CA Prashant Deshpande, CA Gagan Agarwal
& CA Aditi Maheshwari

GST in M&A

Overview of GST

Introduction of Goods and Services Tax (GST) from 1st July, 2017 has overhauled the complex and multiple indirect taxes that were levied on different products, services and activities, across various stages of supply chain. GST has brought in efficiencies in business by reducing cascading effect of multiple taxes.

This paradigm shift in taxation in India has brought changes in almost all the business operations in the nation. The changes are not restricted at the transactional level but have also resulted in playing a major role in unleashing greater investment opportunities. The opportunities can be encashed either by way of a greenfield investment (i.e. investment by setting up new projects or entities) or a brownfield investment by way of acquiring other entities or businesses through mergers and acquisitions (M&A).

GST has a dual role to play here - while it has fostered M&A transactions, it also has some very specific implications on the M&A transactions. While the impact of GST on M&A transactions is discussed in detail in the subsequent paragraphs, let us first have a look at the key differences in the Indirect Tax regime pre and post GST.

Key Differences in the Indirect Tax Regime pre and post GST

Introduction of GST has played an instrumental role in changing the way business is done in India by bringing in more efficiencies. The key changes in the indirect taxation system as regards taxability due to the implementation of GST are mentioned below.

Indirect Taxes in India

In the erstwhile regime of indirect taxes in India, there were separate laws for separate activities. The erstwhile taxes along with their taxability under the GST law have been listed below:

Sr. No.	Tax	Taxable event	Levy by	GST levied by	Taxable event under GST
1	Customs Duty	Import	Centre	Centre	Import
2	Excise Duty	Manufacturing of goods	Centre	Centre and States	Taxable event is Supply under GST
3	Service Tax	Provision of service	Centre		
4	Central Sales Tax ('CST')	Inter-State sale	Centre		
5	Value Added Tax ('VAT')	Sale within State	State		

Tax Rates

In the indirect taxation system prevalent in India prior to 1st July 2017, tax was levied at each stage separately by the Centre and the State, at varying rates, on the full value of the goods. This led to multiple taxes being levied on the same commodity at different tax rates making tax administration cumbersome.

Under the GST regime, tax is be levied only on the value added at each stage. It is a single tax (collected at multiple points) with a full set-off available for the taxes paid earlier in the value chain.

Further, the Government has with the recommendation of the GST Council finalised four GST slab rates at 5%, 12%, 18% and 28% for different goods and services.

Under **0%** tax rate, essential commodities such as food grains, rice, and wheat are included. The first slab is **5%** tax rate, under which mass consumption products are included such as mustard oil, tea & spices. Processed food has been included in the **12%** slab rate. The third slab is **18%** tax rate, under which consumer goods have been included such as toothpaste, refrigerator & smartphones etc. Luxury items and other sin goods like cards, tobacco and aerated drinks have been kept in the **28%** tax slab rate. Most of the demerit goods are liable to GST cess over and above the existing rate of tax.

Further, it is pertinent to note that the Government is constantly pruning the list of goods and services under the 28% slab rates so as to ultimately reduce the burden of GST on end consumers.

Compliances under GST – Have they really become easier?

Type of Taxpayer	Compliances under earlier regime	Compliances under GST Regime	Increase or Decrease in Compliance Burden
Service provider providing services in multiple states	Option of centralised registration (i.e., 2 half yearly returns to be filed with monthly payments)	Registration and returns to be filed monthly in every State where services are provided (i.e. 3 returns every month along with monthly payment in every State	Increase
Manufacturers having factories in multiple states	Excise and sales tax registration and monthly returns in every state	Single registration and 3 monthly returns in every state	Increase
Trader	Sales Tax registration and monthly returns in every State	Single registration and 3 monthly returns in every State	Increase

As can be seen from above, for all the three class of taxpayers (i.e. service providers, manufacturers and traders), there is an increase in the compliance burden. Under GST, all the class of taxpayers are now required to file 3 monthly returns (i.e., GSTR-1 providing details of outward supplies, GSTR-2 providing details of all inward supplies and GSTR-3 is a consolidated return of outward and inward supplies). In addition to the said returns, a summary return in Form 3B is required to be filed every month and an Annual Return is required to be filed every year.

However, in November 2017, the GST Council announced that GSTR-2 and GSTR-3 returns are not required to be filed for the time being since the timelines to file those returns are being worked out by a separate committee. Further, in January 2018, it has been informed that a consolidated monthly

return may be required to be filed by all types of taxpayers. The modalities are being worked out by the Council which is likely to be announced in due course of time.

Easing of tax burden and seamless flow of credit

The integration of tax laws in GST is expected to reduce the tax burden on the taxpayer. GST is a single tax (collected at multiple points) with a full set-off available for the taxes paid earlier in the value chain. Thus, the final consumer bears only the GST charged by the last dealer in the supply chain with set-off benefits at all the previous stages. This brings transparency and eliminates cascading.

Until 30th June, 2017, taxes on inter-state supply of goods accrued to the originating State. Thus, the taxes levied on inter-state supply was not available as credit to the receiver of goods, thus hindering the inter-state movement of goods. However, under GST, this situation is tackled by levying IGST, which accrues to the Centre and is then allocated by the Centre to the State where the goods/services are consumed.

Impact of GST in Mergers & Acquisitions

As GST has impacted structuring of various M&A transactions in India, it is essential to understand the implications of GST on the types of M&A transactions. Largely, the indirect tax implications of a transaction of transfer of business vary depending upon the manner in which the transaction is undertaken, as substantiated by the documentary evidences, intention and conduct of the parties to the transaction and facts & circumstances of each case.

GST implication on the sale/ transfer of securities

One of the most commonly resorted to methods of acquisition is by share acquisition. In this case, the ownership/ business of the Company is acquired by transfer of shares to the acquirer.

In the erstwhile tax regime, State VAT laws excluded securities from the definition of 'goods' and hence, securities were not liable to VAT. Contrary to this, service tax law had specifically included 'securities' under the definition of 'goods'. By considering them as goods, securities were kept outside the ambit of service tax. Accordingly, transfer of securities were not liable to either Service tax or VAT.

Under the GST law as well, securities have been specifically excluded from the definition of goods as well as services, thus ensuring no tax is levied on the sale of securities. This practice is in line with the global practices.

GST implication on Slump Sale

Under the erstwhile indirect tax regime, the implication of transfer of a business as a going concern including transfer of whole unit or a business division was not well-defined as most of the State VAT laws were silent on the applicability of VAT on the transfer of business. However, the Courts have consistently held that transfer of a business as a whole on a going concern basis would not be liable to sales tax or VAT since such sale cannot be equated to the sale of movable goods liable to sales tax or VAT. Moreover, the activity of transfer of business on a going concern basis had been specifically exempted under Entry 37 of Service Tax mega exemption Notification No. 25/2012 dated 20th June, 2012.

The position remains unchanged under the GST law as well. Sale of business on a going concern basis is not considered to be a supply in the course of business. Further, business does not qualify as goods under the GST law and hence GST cannot be levied upon the sale of business or an undertaking treating it as a supply of goods. In addition to the above, Notification No. 12/2017 Central Tax (Rate) dated 28th June 2017 specifically exempts services by way of transfer of a going concern as a whole or an independent

part thereof. It is clear from the above that GST is not applicable on a slump sale transaction i.e., the transfer of business on a going concern basis.

GST implication on Itemised/ Piecemeal Sale

An itemised sale is the sale by way of transfer of specific assets and liabilities of a business by assigning a specific value to each item. This type of sale involves the disposal of key or selected business assets. Sale of separately identifiable and individually valued assets and liabilities was subject to the levy of VAT/ CST under the earlier indirect tax regime. The definition of goods included movable assets and intangibles including patents, trademarks, copyrights, etc. Nonetheless, the purchaser of the assets could avail input tax credit of VAT charged by the seller, subject to fulfilment of certain prescribed conditions.

Similarly, under the GST law as well, transaction of itemised/piecemeal sale is treated as a supply transaction, the rationale being that the individual assets being transferred are covered within the ambit of the definition of goods. Thus, GST is leviable on the transfer of business by way of itemised sale.

Historical Tax Liabilities

By virtue of the specific provision of VAT laws in various States, the historical tax liabilities and obligations of the business proposed to be transferred remain and travel with the business itself. These provisions made the acquirer, a party to liability or obligation of the transferor, by virtue of principle of joint and several liabilities.

Further, under the Central Excise and Service Tax Law, while the transferee was not jointly and severally liable for the tax liabilities of the transferor, however, by virtue of Section 11 of the Central Excise Act, 1944 and Section 87 of the Finance Act, 1994, where any duty / tax was recoverable from the transferor and the business was transferred, such duty / tax could be recovered by attaching the goods in custody or possession of the transferee.

The provisions in the GST law have been aligned to the erstwhile VAT laws i.e., joint and several responsibility of the transferor and transferee in case of historical liability (whether determined prior to the transfer of business or thereafter) of the business transferred as per Section 85 of the Central GST law. This indicates that statutorily, the buyer will be equally liable as the seller and hence, it will be extremely essential for the buyer to be aware about the quantum of tax exposure/ liabilities being inherited along with the business.

Personal liability of directors

Under the erstwhile service tax law, in case of evasion of service tax or other specified offences under section 78A of the Finance Act, 1994, any director and other officers in charge of, and responsible to the Company for the conduct of business and knowingly concerned with the contravention were liable to penalty up to INR 1 lakh. In addition, for the above offences exceeding specified monetary threshold (INR 200 lakhs), there was a provision for punishment by way of imprisonment between six months to seven years.

There are significant changes brought in the GST law as regards personal liability of the directors. Section 89 of the GST law provides that if any tax, interest or penalty cannot be recovered from a private company, it can be recovered jointly and severally from the directors of the company during the period of liability, unless directors can prove that there is no gross neglect on their part. Further, Section 137 provides that in case of offences by companies, every person in charge of, and responsible to the Company for the conduct of business of the Company as well as the Company shall be punished. Further, as per Section 132, for specified offences, there is a provision for punishment by way of imprisonment between six months to five years depending on the quantum of offence.

As can be seen from above, the provisions in GST as regards the personal liability of director are far more stringent than any other law subsumed under GST.

Unutilised Tax Credit

Unutilised tax credit means the amount of tax credit (pertaining to the transferred business) claimed but remaining unutilized in the hands of transferor at the time of business transfer.

Most of the State VAT laws had specific provisions that allowed transfer of VAT credit to the buyer of the business. Similarly, the CENVAT Credit Rules, 2004 also permitted transfer of unutilised CENVAT credit to the transferee in case of transfer of business. However, for transferring of CENVAT credit, it was mandatory to transfer the liabilities of the business and also the inputs and capital goods on which such credit is taken.

Section 18(3) of the GST law also permits transfer of unutilised GST credit to the transferor in the case of transfer of a business. Also, similar to the erstwhile regime, the transfer of credit is subject to the condition that the liability of the business are also transferred along with the assets. Further, Rule 41 of the GST Rules prescribes Form ITC-02 which is required to be submitted by the transferor furnishing complete details of sale, merger, demerger, amalgamation, etc., along with the details of unutilised input tax credit lying in the hands to the transferee. The transferee is required to accept the details so furnished by the transferor on the common GST portal.

Inter-Company transactions during intervening period

Intervening period refers to the period between the appointed date (i.e., date from which business of the transferor vests with the transferee) and the effective date (i.e. when the Court order is submitted to the Registrar of Companies, in cases involving transfer of business through a Court scheme).

Technically, in case of an amalgamation or merger with retrospective effect, two companies should be considered as a single entity from the appointed date and thus any transaction of goods and services between the appointed date and effective date should be considered as transaction with oneself.

However, in the erstwhile tax (service tax) regime where there was no specific provision in the law prescribing the leviability of service tax in specific situations of provision of services between the transferor and transferee during the intervening period. Based on various decisions by the Court, taxpayers adopted a position that transactions between the transferor and transferee during the intervening period should be considered as transactions between the same entities and hence not liable to service tax. Further, the VAT implication on a sale transaction between the transferor and transferee during the intervening period varied from State to State. VAT laws of many States had a specific provision wherein the transferor and transferee are treated as separate entities till the effective date and hence, subjected to VAT.

The inconsistency between VAT laws and service tax law in this matter has been put to rest under GST. According to Section 87 of the GST law, two or more companies are treated as distinct companies up to the date of the court order, implying that the transactions between them during the intervening period are liable to GST.

Conclusion

Though the position for most of the aspects remain unchanged, the GST law has majorly addressed most of the concerns of the M&A transactions thus bringing in greater clarity on the taxability of business transfer from an indirect tax perspective.

Sanjay Buch, *Advocate & Solicitor*

Key aspects in drafting of scheme of arrangement – It's an art not a copy paste job

Business restructuring may be achieved by a variety of modes, such by entering into a Scheme of Arrangement for a Merger or a Demerger. Each of these modes has its own advantages and disadvantages and must be selected keeping in mind the objectives to be achieved. At the initial stage itself while considering an appropriate mode and before drafting a Scheme of Arrangement (including Amalgamation or a Demerger) one has to consider a variety of factors including financial and commercial justification besides the legal angle.

In *Hindustan Lever vs. State of Maharashtra*[1] the Supreme Court held as follows:

> *"The transfer of assets and liabilities takes effect by an order of the Court. The order also provides for passing of consideration from the transferee company to the shareholders of the transferor company. The consideration for sale in a transaction like this is the shares. The share exchange ratio is decided on the basis of number of factors including the value of net assets of the transferor and transferee company. To arrive at this figure of net assets the liabilities have to be set off against the gross value of the assets. The share value is fixed. The properties belong to the company and the company belongs to the shareholders. Once the shareholders of the transferee company receive the consideration it would be deemed as if the owner has received the consideration."*

It was also held in the same case that a Scheme of Arrangement is nothing but a "Contract" between the Shareholders and the companies involved in the merger or a demerger. Hence, a well drafted scheme has to have all such covenants and obligations that are capable of being performed and enforced by and between he parties as any other agreement or contract would have.

Drafting is an art and not a cut, copy, paste job since one cannot apply a formula of **"ONE SIZE FITS ALL"** facts and circumstances of all commercial arrangements may differ. Before drafting a Scheme, it would be thus necessary to seek information and details that can be built or factored in the legal document that would take a final shape.

Broad Drafting Checklist for Mergers

- Examine whether a Forward Merger or a Reverse Merger is more beneficial: the factors to be considered are tax benefits, listing, etc.

1 AIR (2004) SC 326

- Ensure that the main objects or the incidental objects of the Memorandum of Association contain the power to amalgamate.
- Ensure that the Scheme does not violate, override or circumscribe the provisions of securities laws or the stock exchange requirements.
- Consider whether the merger would be covered under the Competition Act and hence, one which requires the permission of the Competition Commission.
- Valuation of shares for fixing the Share Exchange Ratio should be obtained and studied.
- Fairness Report from a Merchant Banker on the Valuation Report in the case of Listed Companies should be obtained and studied.
- Accounting Treatment contained in the Schemes is in compliance with all the applicable Accounting Standards.
- Listed Companies will have to comply with the requirements of SEBI Circulars (10th March, 2017) which lays down various procedures for obtaining SEBI's permission. These include, obtaining shareholders' approval through postal ballot and e-Voting in certain cases, e.g., where the promoters would be issued additional shares under the Scheme, where related parties are involved in the Scheme, etc.

Factors to be considered while drafting a Scheme of Arrangement

1. Ascertain shareholding pattern of the companies pre- and post-Amalgamation / Arrangement. It may be noted that all the shares allotted to the unlisted transferor company shall be classified under promoter's category.
2. Ascertain Category wise list of shareholders holding more than 0.5% in each of the companies.
3. Ascertain Capital evolution details of the listed and unlisted companies.
4. Seek details of capital issued but not listed in the listed company(ies), if any, with reasons for the same.
5. Seek details of name and addresses of all allottees with number of shares to be allotted, in respect of unlisted transferor companies.
6. Seek details of number of shareholders in each of the companies.
7. Seek financial details (Annual Reports) of the transferor and transferee company for last 3 years.
8. Seek details of provisional Net Worth (excluding revaluation reserve) certificate of the transferee company pre- and post-amalgamation.
9. Seek details of directors and promoters of the transferor and transferee company pre- and post-amalgamation and clarification regarding change in management control if any.
10. Seek details about the cross holdings between the companies, if any.
11. Whether companies forming part of scheme are sensitive sectors categories companies?
12. Whether any of the companies are listed on any stock exchange?
13. Whether any NRI/foreign stake in the Companies?
14. Whether the companies or its directors have contravened any provisions of Act?
15. Whether valuation report submitted, if so share exchange ratio is as per report and accounting principles?

16. Whether transfer of employees and their interest needs to be protected?
17. Whether Accounting Treatment clause is as per AS-14/IND-AS 103 and the same is in tune with provisions of the Companies Act, 2013?
18. Whether meeting of class of shareholders/ creditors is required to be conducted?
19. Whether details of related party transactions are furnished?
20. Whether consideration is made in cash other than of shares?
21. Whether provisions of buy back is attracted?
22. Whether any reduction of share capital is involved?
23. Whether authorised share capital of Transferee Company is sufficient?
24. Whether any foreign entity is involved and necessary approvals obtained?
25. Whether compliance of FEMA/RBI Guidelines has been done?
26. Whether any qualification has been made by Statutory Auditor?
27. Whether a listed company is merging with an unlisted company?
28. Whether the promoters holding in listed company is increased?
29. Whether the interest of creditors and shareholders needs to be adequately protected?
30. Whether the arrangement proposed is fair and reasonable and in the interest of all the stakeholders?
31. Whether the Scheme of Arrangement will be in consonance with public interest?

Legal and statutory factors to be considered

- Income-tax impact on the Companies and their shareholders, e.g., capital gains on the transfer, set-off of losses and depreciation, transfer of deduction, cost of assets to the transferee, etc.
- Stamp duty, e.g., levy, concessions, etc.
- Companies Act provisions; (Sections 230 to 240);
- Competition Law provisions;
- Conditions, if any prescribed by SEBI/ BSE/NSE while granting an NOC on draft Scheme;
- SEBI Takeover Regulations and SEBI DIP Guidelines;
- Listing Agreement provisions and procedural requirements;
- FEMA and FIPB Policies;
- Goods & Services Tax Provisions;
- Transfer of Licences under EPCG (Export Promotion Council Guarantee) Scheme, Project Import Regulations, etc.
- Transfer of Tenancies/ assignments of industrial and commercial leases under Rent Control and other local Laws/ Policies;
- Labour law implications, e.g., Govt. permission for closure of a unit with more than 100 workers;
- Permissions required under contractual agreements, e.g., lenders, Govt. Ministries in case of infrastructure / telecom projects, etc.;
- Transfer of environmental licences; and
- Accounting implications of a particular method.

Having due regards to all the above factors, a Scheme should cover all the following clauses on a case-to-case basis

1. Definitions of important terms such as Appointed Date, Effective Date, Record Date for issue of shares, and "Undertaking" that is sought to be transferred and merged etc.
2. Background, capital, history, etc. of the Transferor and Transferee Company;
3. Commercial Justification and Rationale of the Scheme;
4. Amalgamation of Transferor with Transferee Company and vesting of its undertaking, assets and liabilities in the Transferee Company. Reduction of capital, if any, of the Transferee;
5. Issue of securities, etc., by Transferee to shareholders of Transferor, Share Exchange Ratio, Valuation Report, etc.
6. Increase in Authorised Capital of Transferee, if required;
7. The date from when the Scheme comes into operation;
8. Accounting treatment of the amalgamation by the Transferee;
9. All contracts, deeds, bonds, instruments, executed by the Transferor to be binding on and enforceable against the Transferee;
10. All legal proceedings, by or against the Transferor to be binding on and enforceable against the Transferee;
11. Transferee to carry on Transferor' business until the effective date;
12. Applications to relevant Authorities including NCLT for their approval;
13. All employees of Transferor to become the employees of Transferee;
14. No dividends, bonus, rights, further shares to be issued by either company without prior approval of the other company;
15. The approvals / sanctions upon which the Scheme is conditional and effect of non-receipt of such approvals;
16. Sharing of merger costs and expenses;
17. Change of Board of Directors of Transferee, if any;
18. Vesting of Undertaking /Properties and Dissolution without Winding-Up of Transferor;
19. Change of name and registered office of the Transferee, if applicable
20. Consolidation of the Authorized Share Capital;
21. Reduction of capital if any;

Additional Drafting Checklist for Demergers

- Ensure that what is being demerged is an undertaking as per the Income-tax Act or else the tax benefits may be jeopardised;
- Decide whether the Resulting Company would be a New Company or an Existing Company;
- Reduction in capital of the demerged company;
- Accounting adjustments, if any;
- Resulting Company to take over the assets and liabilities of the demerged company; and
- Allotment of the securities to the shareholders of the Transferor Company.

Major items that require attention under Section 230 of the Companies Act, 2013 while drafting the Scheme and the Explanatory Statement

Section 230 of the 2013 Act provides for detailed disclosures to be made, one of the disclosures also mandates the applicant to disclose whether the scheme contains a reduction of capital or a corporate debt restructuring.

The applicant who desires to restructure a corporate debt has to provide a report by auditors on the position of liquidity and also as to whether the corporate debt restructuring is in line with the guidelines provided by the Reserve Bank of India.

The extensive disclosures are in addition to the disclosures required by section 393 of the 1956 Act. The intent of increased disclosures is to ensure transparency and empower stakeholders by allowing them to take informed decisions.

Introduction of voting by way of postal ballot (in addition to a Court convened meeting), which will ensure larger public participation, the concept of dispensation by providing a threshold for the dispensation of creditors meetings are a welcome measures.

The 2013 Act also requires that notices be sent to various statutory authorities with regard to a scheme, arrangement or restructuring. This measure may evoke mixed reactions but is aimed to invite the participation of various regulators to assist the Tribunal to take an informed decision.

The new section also enables the takeover of listed companies through a scheme of compromise or arrangement and places emphasis on the pricing guidelines which the Securities and Exchange Board of India would prescribe ensuring that uniformity in law is maintained.

Approval by majority in number representing 3/4th in value of the creditors or members or class thereof present and voting either in person or by proxy or by postal ballot.

All material facts relating to company, such as latest financial position of the company, the latest auditor's report on the accounts of the company, the pendency of any investigation or proceedings against the company; (ii) Reduction of share capital of the company, if any, included in the compromise or arrangement; iii) Any scheme of corporate debt restructuring consented to by not less than 75% of secured creditors in value, including –

(i) a creditor's responsibility statement in the prescribed form;

(ii) safeguards for the protection of other secured and unsecured creditors;

(iii) report by the auditor that the fund requirements of the company after the corporate debt restructuring as approved shall conform to the liquidity test based upon the estimates provided to them by the Board;

(iv) where the company proposes to adopt the corporate debt restructuring guidelines specified by the Reserve Bank of India, a statement to that effect; and

(v) a valuation report in respect of the shares and the property and all assets, tangible and intangible, movable and immovable, of the company by a Registered Valuer (w.e.f. 1st September, 2018);

(vi) valuation Report to be given to the shareholders / creditors / debenture holders along with the notice convening meeting;

(vii) notice convening meetings shall be sent to all shareholders / creditors / debenture holders of the company individually at the address registered with the company;

(viii) notice to be served to the Central Govt., Income Tax Authorities, RBI, SEBI, the

Registrar, respective stock exchanges, Official Liquidator, Competition Commission of India, if necessary, and such other sectoral regulators or authorities;

(ix) the notice and other documents shall also be placed on the website of the company, if any, and in case of listed company, these documents shall be sent to the Securities and Exchange Board and Stock Exchange where the securities of the companies are listed, for placing on their website and shall also be published in the newspapers in such manner as may be prescribed;

(x) section 232 of the 2013 Act prohibits the maintenance of the treasury stock. The norm and practice of indirectly holding investments through intermediaries like a private trust is now prohibited and cannot be structured by companies;

(xi) importance on compliance with accounting standards and of providing liquidity to the shareholders is rightly placed;

(xii) exit options which were structured through selective capital reduction petitions have now found support through the provisions of this section wherein on merger of a listed company with an unlisted company, the exit option to shareholders through a pre-determined formula or valuation can be given.

Section 234 enables, facilitates and provides legal sanctity to structure cross-border amalgamations between Indian Companies and Foreign Companies. This new section also facilitates the merger of an Indian Transferor Company with a Foreign Transferee Company. Foreign Company, may with prior approval of Reserve Bank of India, merge into Indian Company or *vice versa*. The consideration for merger can be in the form of Cash and / or Depository Receipts or partly in Cash and partly in Depository Receipts. This would apply to Foreign Companies in jurisdictions as notified by the Central Government.

Section 240: The liability in respect of offences committed by the officers of the Transferor Company prior to its merger, amalgamation or acquisition shall be liable for the offence committed post-merger, amalgamation or acquisition.

Ensure that the Scheme does not in any way violate or override or circumscribe the provisions of the Companies Act, 2013 SEBI Act, 1992, the Securities Contracts (Regulation) Act, 1956, the Depositories Act, 1956, the Rules, regulations and guidelines made under these Acts, and the provisions of the clauses of the SEBI LODR/ Listing Agreement or the requirements of the Stock Exchanges.

A well-crafted Scheme would stand the test of scrutiny before all stakeholders, including the Regulators and Judiciary.

If a man with an ideal makes a thousand mistakes, I am sure that the man without an ideal makes fifty thousand. Therefore, it is better to have an ideal.

— *Swami Vivekananda*

This world is the great gymnasium where we come to make ourselves strong.

— *Swami Vivekananda*

Dr. Anup P. Shah, *Chartered Accountant*

Stamp Duty – Ignore at your own Peril

Introduction

"To Stamp or not to Stamp is always the question!".

Stamp duty is a significant cost which must be reckoned while entering into an immovable property transaction. Stamp duty is also the second most important source of revenue for the Maharashtra Government after GST. Maharashtra has the infamous distinction of covering the maximum number of instruments under the ambit of the stamp duty net.

History Lessons First

Stamp Act is a revenue statute since it raises taxes for the Government. In *Hindustan Steel Ltd. vs. Dalip Construction Company, 1969 SCR (3) 796,* the Supreme Court held that the Stamp Act is a fiscal measure enacted to secure revenue for the State on certain classes of instruments; it is not enacted to arm a litigant with a weapon of technicality to meet the case of his opponent. The stringent provisions of the Act are conceived in the interest of the revenue. However, interestingly it is both the subject of the Central and the State Government. This dichotomy exists because of a provision in the Constitution of India. Often a question arises, which Act applies – ***The Indian Stamp Act, 1899 or The Maharashtra Stamp Act, 1958?***

Article 246 of the Constitution divides the law making powers between the Centre and the State. Power to make laws in respect of all items enumerated in List I in the Seventh Schedule to the Constitution vest exclusively with the Parliament (known as *the Union List*) while for those items enumerated in List II vest with the State Government (known as *the State List*). However, items enumerated in List III represent *the Concurrent List* for which Parliament as well as the State Government can enact laws. Laws pertaining to Stamp Duty are found in all three Lists in the Seventh Schedule:

(a) The Union List – rates of stamp duty in respect of *nine* specific instruments can only be fixed by Parliament. These are, bills of exchange, cheques, promissory notes, bills of lading, letters of credit, policies of insurance, transfer of shares, debentures, proxies and receipts. Thus, across India, the rates on these nine instruments are governed by the Schedule I to the Indian Stamp Act, 1899.

(b) The State List – rates of stamp duty in respect of documents other than those specified in the Union List. Thus, each State Government has power to frame rates for all instruments other than the nine instruments specified above.

(c) The Concurrent List – The Constitution gives powers to both the Centre and the State to frame laws relating to Stamp Duty. Accordingly, the Centre has framed the Indian Stamp Act, 1899 while some States have framed their own Stamp Acts. These States are Maharashtra, Gujarat, Rajasthan, Karnataka, Kerala, Jammu and Kashmir and Uttar Pradesh. Thus, in Maharashtra, we have the Bombay Stamp Act 1958, which in recent past rechristen as the *Maharashtra Stamp Act, 1958.*

How is Duty Chargeable?

One of the biggest myths surrounding stamp duty is that it is levied on a transaction. It is only levied on an instrument and that too provided the Schedule mentions rates for it. If there is no instrument then there is no duty is the golden rule one must always keep in mind. An English decision in the case of *The Commissioner of Inland Revenue vs. G. Anous & Co. (1891) Vol. XXIII Queen's Bench Division 579* has held that the thing, which is made liable to stamp duty is the "instrument". It is the "instrument" whereby any property upon the sale thereof is legally or equitably transferred and the taxation is confined only to the instrument whereby the property is transferred. If a contract of purchase or sale or a conveyance by way of purchase and sale, can be, or is, carried out without an instrument, the case would not fall within the Section and no tax can be imposed. Taxation is confined to the instrument by which the property is transferred legally and equitably transferred. Stamp Duty is leviable on every *instrument* (not a transaction) mentioned in Schedule I to the Maharashtra Stamp Act, 1958 at rates mentioned in that Schedule – *LIC vs. Dinannath Mahade Tembhekar AIR 1976 Bom 395*. However, for the nine instruments provided in the Union List, the rates are mentioned in the Schedule to the Indian Stamp Act, 1899.

An instrument is defined under the Maharashtra Stamp Act to include every document by which any right or liability is created, transferred, limited, extended, extinguished or recorded. However, it does not include a bill of exchange, cheque, promissory note, bill of lading, letter of credit, policy of insurance, transfer of share, debenture, proxy and receipt. This is because these nine instruments are within the purview of the Indian Stamp Act, 1899. All instruments chargeable with duty and executed in Maharashtra should be stamped before or at the time of execution or immediately thereafter or on the next working day following the date of execution.

A copy of an instrument whether by way of a fax or otherwise of the original instrument shall also be charged with full duty in cases where the original has not been stamped. However, if the original has been duly stamped, then the Maharashtra Stamp Act provides that a duplicate or a counterpart will be stamped with a maximum duty of ₹ 100.

Under section 18 of the Act, every instrument mentioned in Schedule I is liable to duty in Maharashtra if it's executed at any other place but it relates to property situated in Maharashtra and such instrument is received in the State. The Act further provides that if any instrument is chargeable with duty but it is executed outside Maharashtra then it may be stamped within 3 months of the instrument entering the State of Maharashtra. Further, in *L&T Finance Ltd. vs. M/s. Saumya Mining Ltd, ARBP/290/2014,* the Bombay High Court has held that the stage of paying differential stamp duty gets triggered only when the instrument or a copy is brought into the State and not until then. Once the Act gets triggered the parties have a maximum of 3 months to set right the defect.

The definition of the term instrument has been amended to incorporate an electronic record as defined under the Information Technology Act, 2000. This definition defines an electronic record to mean data, record or data generated, image or sound stored, received or sent in an electronic form or micro film or computer generated micro fiche. Thus, even a document in the form of an

electronic record is liable to be stamped. Hence, even a scanned copy of the original would be liable. What happens if a scanned copy is saved on a cloud storage is an interesting question – can it be said that the image has entered the State if the cloud server is not physically present in the State? Would mere viewing of the image be treated as an entry? These are issues which present posers similar to taxation of e-commerce transactions.

Movable property can be transferred by mere delivery and possession. Hence, if no instrument is executed for the transfer of movables, there would not be any liability to stamp duty. However, if for any reason, an agreement is executed which effects the transfer of the movable property, then it would be treated as a conveyance and would attract stamp duty @ 3% under the Maharashtra Stamp Act, 1958. In the case of immovable property there is no choice but to execute a written instrument which is attested and registered if the value of the property exceeds Rs. 100. Hence, instruments for immovable property transactions would attract duty at rates specified in the Schedule. For instance, a conveyance of immovable property would attract stamp duty @ 3-6% under the Maharashtra Stamp Act, 1958, depending upon the location of the property.

Stamp duty under the Act may be levied on any one the following three basis :

- the Fair Market Value of the property;
- the consideration mentioned in the instrument; or
- the area of the property involved

The instruments where stamp duty is levied on the basis of the Fair Market Value are as follows:

- Conveyance
- Lease deed
- Gift deed
- Transfer of lease
- Development Rights Agreement
- Power of Attorney granted for consideration and authorising to sell an immovable property
- Power of Attorney which is for development rights
- Trust deed
- Partition deed
- Release deed
- Partnership deed - if the capital contribution is brought in by way of property
- Dissolution/retirement deed - if a partner who did not bring in a property takes it on dissolution / retirement
- Settlement deed
- Instrument of Exchange of property

The above instruments are subjected to duty on the basis of **consideration recorded** in the instrument **or market value** of property **whichever is higher.** The term **"market value"** is defined to mean the higher of :

- the price which the property covered by the instrument would have fetched if sold in an open market on the date of execution of the instrument; or
- the consideration as stated in the instrument

For ascertaining the market value in Maharashtra, the Bombay Stamp (Determination of True Market Value of Property) Rules, 1995 empowers the Joint Director of Town Planning and Valuation to prepare an Annual Statement of Average Rates of market value for different types of immovable properties situated in every tahsil, municipal corporation or local body area. This dreaded Statement is popularly known as the *Ready Reckoner*.

Hence, the Ready Reckoner is applicable for the valuation of immovable properties in case of certain instruments. The term 'immovable property' is defined to include land, benefits to arise out of land and things attached to earth or permanently fastened to anything attached to the earth. It is extremely essential to ascertain whether or not the property in question is an immovable property. The Supreme Court's decisions in *Duncan's Industries Limited vs. State of U. P. (2000) 1 SCC 633; Triveni Engineering & Indus. Ltd., 2000 (120) ELT 273 (SC) and Sirpur Paper Mills (1998) 1 SCC 400* would be useful in this respect.

Stamp Duty on Mergers / Demergers

The provisions of the Maharashtra Stamp Act, 1958 (which is applicable in the entire State of Maharashtra) deal with stamp duty on mergers. A Court order approving a scheme of merger is treated as a conveyance The term Conveyance is defined to include,-

(i) a conveyance on sale,

(ii) every instrument,

(iii) every decree or final order of any Civil Court,

(iv) every Order made by the High Court u/s. 394 of the Companies Act in respect of amalgamation or reconstruction of companies and every order made by the RBI in respect of amalgamation or reconstruction of banking companies by which property or any estate/interest in property is transferred to or vested in any other person inter vivos.

The definition further provides that in order to be termed a conveyance the instrument must not be covered by any other Article under Schedule - I to the Act. Stamp duty is levied on a High Court Order sanctioning a Merger Scheme at the following rates:

(i) 10% of the Market Value of shares issued in exchange and the consideration paid for the merger

(ii) But not exceeding higher of the following limits:

(A) 5% of the Market Value of immovable property of the Transferor located in Maharashtra; or

(B) 0.7% of the Market Value of shares issued in exchange and the consideration paid for the merger

The Market Value of Shares must be determined as follows:

- If the transferee is listed and quoted for trading on a stock exchange then it is the market value as on the appointed date in the scheme or on the date of the Court Order

- If the transferee is listed and quoted for trading on a stock exchange then it is the Market Value Transferor's Shares or the Market Value as determined by the Collector.

The Market Value of Immovable Property must be determined in accordance with the Stamp Duty Ready Reckoner Valuation. The maximum stamp duty in Maharashtra in the case of mergers is ₹ 25 crore.

The Maharashtra Stamp Act, 1958 contains an express provision to levy stamp duty on instruments dealing with mergers and reconstructions. This amendment was made in 1993. Like the Maharashtra Stamp Act, express provisions to levy stamp duty on mergers exist in States such as Gujarat, Karnataka, Rajasthan, etc. However, several Indian States yet follow the Indian Stamp Act, 1899 which does not contain such express provisions for levying stamp duty on mergers. Prior to the insertion in 1993 there was a controversy in Maharashtra whether the State had power to levy stamp duty on mergers in the absence of any express provisions. This controversy continues even today in States which have adopted the Indian

Stamp Act since there is no provision in that Act. In *Li Taka Pharmaceuticals Ltd. vs. State of Maharashtra, 1996 (2) Mah. LJ 156,* the Bombay High Court expressly considered whether the order of High Court u/s. 394 of the Companies Act was a conveyance within the meaning of the term conveyance and was liable to stamp duty. The applicability of stamp duty on mergers in the context of the Indian Stamp Act was upheld by the Calcutta High Court in the case of *Gemini Silk Ltd. vs. Gemini Overseas Ltd. 2003 53 CLA 328 Cal.* This decision was succeeded by the Supreme Court's decision under the Maharashtra Stamp Act, 1958 in the case of *Hindustan Lever Ltd. 2004(3) Bom CR 767 (SC)*. The decision did not deal with the Indian Stamp Act expressly but it held that the foundation for a Merger Order was an agreement between two companies. A Court did not adjudicate the Scheme. The transfer pursuant to a merger was a voluntary act of parties and it had all the trappings of a Sale. Accordingly, the Scheme sanctioned by Court was an instrument u/s. 2(i) of the (then) Bombay Stamp Act. The Delhi High Court in the case of *Delhi Towers Ltd (2009) 97 CLA 106 (Delhi)* once again upheld this position under the Indian Stamp Act as applicable in New Delhi. A similar view has been taken by the Allahabad High Court in the case of *Hero Motors Ltd. vs. State of UP AIR 2009 All 93.* A Single Judge of the Calcutta High Court in the case of *Emami Biotech Ltd 112 SCL 33 (Cal)* held that stamp duty on merger is leviable even in the State of West Bengal and the Division Bench of the Calcutta High Court in the case of *ITP Ltd. 115 SCL 830 (Cal)* after considering all the decisions, has also taken a similar view. A collective reading of the above decisions would suggest that stamp duty as on a merger is payable even in those States in which there is no express provision like the Maharashtra Stamp Act.

Just when one thought that the burning issue of stamp duty on merger schemes has been settled once and for all, a Bombay High Court decision has stoked the fire some more! The Full Bench of the Bombay High Court in the case of *The Chief Controlling Revenue Authority vs. M/s. Reliance Industries Ltd., Civil Reference No. 1/2007* was faced with an interesting issue of stamp duty payable on an inter-state merger. In a case where, Reliance Petroleum Ltd., a company registered in Gujarat merged with Reliance Industries Ltd., a company registered in Maharashtra would stamp duty be payable once or twice was the moot question? In Maharashtra, the maximum duty on a Scheme of merger is ₹ 25 crores. Pursuant to the merger, Reliance Industries Ltd. had paid a stamp duty of ₹ 10 crores in Gujarat and hence, paid only the balance of ₹ 15 crores in Maharashtra. Thus, it claimed that it was eligible for a set off of the duty paid in one State against the duty payable in another State. For this, it relied upon s.19 of the Maharashtra Stamp Act, 1958 which provides that where any instrument described in Schedule-I to the Act and relating to any property situate or to any matter or thing done or to be done in Maharashtra is executed out of Maharashtra subsequently such an instrument / its copy is received in Maharashtra the amount of duty chargeable on such instrument / its copy shall be the amount of duty chargeable under Schedule-I less the duty, if any, already paid in any other State. Thus, similar to a double tax avoidance agreement, a credit is available for the duty already paid.

The Bombay High Court upheld the stand of the Revenue Department. It held that the duty is payable on a Court Order and not a Scheme. The Bombay High Court Order which sanctioned the merger would be the instrument and that was executed in Mumbai, i.e., in Maharashtra. Therefore, essentially the duty was leviable on the instrument and not the transaction. Although the Scheme may be same, the Bombay High Court Order being a conveyance and it being an instrument signed in State of Maharashtra, the same was chargeable to duty so far as State of Maharashtra was concerned. It further held that although there were two orders of two different High Courts pertaining to the same Scheme they were independently different instruments

and could not be said to be same document especially when the two orders of different High Courts were upon two different Petitions by two different companies. When the scheme of the Act was based on chargeability on an instrument and not on transaction, it was immaterial whether it was pertaining to one and the same transaction. The instrument, which effected the transfer, was the Order of the Court that sanctioned the Scheme and not the Scheme of amalgamation itself.

It thus concluded that s.19 of the Act providing double-duty relief was not applicable. The Order of the Bombay High Court related to property situated within Maharashtra and was also passed in Maharashtra and hence, a fundamental requirement of s.19, i.e., the instrument must be executed outside the State, was not fulfilled. While paying duty on the Bombay High Court Order rebate could not be claimed for the duty paid on Gujarat High Court's Order by invoking s. 19 of the Act.

This judgment of the Bombay High Court has several far reaching consequences on the spate of cross-country business restructuring. Emboldened by this decision, other States would also start demanding stamp duty on mergers involving companies from more than one state. Companies would now have to factor an additional cost while considering mergers. The same would be the position in the case of a demerger.

An interesting scenario arises if instead of a merger, one considers a slump sale of a business involving companies located in two States. In such an event, if a conveyance is executed for any property, then there would only be one instrument. Here it is very clear that s.19 would apply and the duty paid in one State would be allowed as a set off in the other. Thus, depending upon the mode of restructuring the duty would vary. Is that a fair proposition?

Stamp Duty on takeovers

In case of a takeover, i.e., a share purchase, the stamp duty is much lesser as compared to a merger. If the shares are in physical form then stamp duty is payable on the share transfer instrument under the Indian Stamp Act, 1899 @ 0.25% of the value of shares transferred. This is so irrespective of where the company is registered or where the parties to the transfer are located since under the Constitution of India, stamp duty on transfer of shares can be levied only by the Central Government under the Indian Stamp Act, 1899. No stamp duty is payable in case of transfer of shares in dematerialised form. A Share Purchase Agreement would attract duty in the State of Maharashtra @ 0.01% or 0.1% / 0.2% of the value of the transaction.

Stamp Duty on Sale of Business Undertakings

In the case of itemised sale of assets or slump sale of a business undertaking where any immovable property is involved or where there are actionable claims, then the instrument of transfer of such properties will entail payment of stamp duty. Hence, one will have to pay the stamp duty prescribed by the State in which the transfer takes place or in the case of immovable property, the stamp duty prescribed by the State in which such immovable property is situate. It is possible to transfer movable assets other than an actionable claim by delivery of possession without making a conveyance. In that case, stamp duty is not payable. Since an undertaking may have both movable and immovable property, the parties may bifurcate the assets of the undertaking into movable and immovable property. The Income-tax Act has clarified that such a bifurcation for the purposes of payment of stamp duty would not vitiate the concept of a slump sale under the Income-tax Act. Further, in the case of an itemised sale, it must be ascertained whether the asset in question is a movable property. However, if a conveyance of movables is made for any reason,

then in Maharashtra it would attract duty @ 3% of the value of the consideration mentioned in the agreement or the market value of the asset. If a conveyance is made for the sale of a business undertaking as a whole with both movables and immovables, then the Bombay High Court in the case of *Anil Purshottam Kakad, 1993 (2) Mh.LJ. 1049* has held that it is to be treated as a sale of a movable property and stamped accordingly. The stamp duty on a conveyance of an immovable property is based on the true market value and varies depending upon the location of the property. It is very relevant to determine whether or not a particular asset can be classified as an immovable property under the applicable law. For example, there is a difference in the rates of stamp duty on conveyance of a movable property and an immovable property. Similarly, GST is payable only in respect of sale of a movable property and not an immovable property.

Stamp Duty on Conversion into LLP / Company

Stamp Duty on the conversion of a company into a Limited Liability Partnership (LLP) would be a major concern. The Limited Liability Partnership Act, 2008 states that that effect of registration of a company as an LLP would be that all tangible (movable and immovable) property as well as intangible property vested in the company and the whole of the undertaking of the company shall be transferred to and shall vest in the LLP without further assurance act or deed. Stamp duty is payable only on an instrument and not on a transaction. If there is no "instrument" of transfer, then no stamp duty can be levied. If there is a statutory vesting of the assets of the erstwhile company in the newly incorporated LLP there is no transfer under the Transfer of Property Act. Therefore, no conveyance is required and hence, correctly speaking there should not be any incidence of Stamp Duty.

This view is also supported by the decision in the cases of *Vali Pattabhirama Rao 60 Comp Cases 568 (AP)* and *Rama Sundari Ray vs. Syamendra Lal Ray ILR (1947) 2 Cal 1* rendered in the context of a conversion of a partnership firm into a company under Part IX of the Companies Act 1956. Applying the same principle, it may be contended that a conversion of a company into an LLP would not attract any Stamp Duty as it amounts to a statutory vesting of the assets of the company in the LLP. However, it should be noted that the issue is not clear cut and there is a possibility of litigation on this issue.

Multiple Instruments

If an instrument covers several matters then the duty would be the aggregate of the duties chargeable on each separate instrument. For instance, if one instrument makes a conveyance of both movables and immovable property, then the duty levied would be the total of the duty on movable property and duty on immovable property. This may happen in the case of a slump sale of an undertaking for which a conveyance is made even for the movable property. The Supreme Court in *Member, Board of Revenue vs. A. P Benthall, 1956 AIR 35* has held that this provision applies only when the instrument comprises more than one transaction, and if is immaterial for this Purpose whether those transactions are of the same category or of different categories

However, if one instrument falls within several descriptions in Schedule I to the Stamp Act, then the duty charged would be the highest of the duties. For instance, in *Board of Revenue, Madras CCRA vs. Narasimhan, AIR 1961 Mad 504,* it was held that portions of a composite document may be construed as a deed of dissolution of a partnership while portions may be construed as a deed of release. Accordingly, it was to be charged with the highest stamp duty which applied to a deed of dissolution of partnership.

On the other hand, if for executing one transaction, several instruments are executed, then only the principal instrument would be liable to duty and the other instruments would be chargeable with a duty of ₹ 100 only. This

is a very important distinction which needs to be kept in mind – if one transaction is covered in several instruments, the duty is only once at the highest duty which would be chargeable in respect of any of the instruments employed, but if one instrument comprises more than one transaction within itself then the duty on that one instrument would be then aggregate of all instruments.

The decision of the Supreme Court in *Chief Controlling Revenue Authority vs. Costal Gujarat Power Ltd., Civil Appeal No. 6054 of 2015* has held when a company had entered into an arrangement with a consortium of 13 lenders and executed one single mortgage deed with all of them then it was done with the sole purpose of evading stamp duty. Since the company had availed financial assistance from 13 lenders for its project and consequently, the company was required to execute mortgage deed in favour of the 13 lenders, in substance, the mortgage deed between the trustee on behalf of the lenders and the company was actually a combination of 13 mortgages dealing with the company and such lenders. Accordingly, the Court regarded it as 13 distinct transactions each liable to stamp duty even though the instrument was only one and thus, the Apex Court upheld the stand of the revenue that the correct amount of duty was the duty payable on one mortgage deed multiplied by 13!

Understamped Document

Under the Maharashtra Stamp Act, any instrument which is inadequately /not stamped, then it shall be inadmissible in evidence for any purpose, e.g., in a Civil Court. Such instruments can be admissible in evidence on payment of the requisite amount of duty and a penalty @ 4% per month on the deficient amount of duty calculated from the date of execution. However, the maximum penalty cannot exceed four times the amount of duty involved.

The Maharashtra Stamp Act, 1958 now gives more powers of inspection to the Collector. If he has reason to believe that there is an evasion of duty by fraud or omission, then he may call for any registers, books, records, electronic device, electronic record, CD, disk, papers, etc. He can also enter any premises and impound any documents. Thus, an inspection for suspected evasion could lead to severe consequences.

Conclusion

Stamp Law is all-pervasive, dynamic and fast changing. If one does not keep abreast with the latest developments under this very important legislation then one would run the risk of having an inadequately stamped document which would not be admissible as evidence and a high penalty for setting right the deficiency.

The constant see-saw between companies on one hand and the revenue department on the other hand to save valuable stamp duty reminds one of the famous nursery rhyme (albeit with a little tweak):

"To Market, to Market, to save Stamp Duty,

Home Again, Home Again, sans any Booty!!"

To think there is any imperfection creates it. Thoughts of strength and perfection alone can cure it.

— *Swami Vivekananda*

Sharad D. Abhyankar[1], *Advocate*

Slump Sale under Shareholders' Approval vs. Scheme of Arrangement

Business restructuring has become a way of life for India Inc. Boards are busy dealing with the corporate risk profiles, concentrating on core competencies, expanding the entrepreneurial horizons, shedding business models which may not be aligned with long term objectives and aspirations. The companies are also looking at opportunities for inorganic growth to augment the toplines, profitability, building the improved bouquet of diverse goods, brands and services. All these M&A activities are undertaken using various forms such as asset sale, business sale, joint ventures, share purchase, merger, demerger, amalgamation, acquisition, takeover, strategic alliance etc. In this article, we will primarily focus on the concept of spin-off or divestment of an undertaking/division by a company. This may be accomplished by either executing a slump sale/business transfer agreement or by seeking sanction for a scheme of arrangement. While both the transaction routes achieve similar objectives, there are specific reasons and rationale as to why the sellers or purchasers would prefer one form over the other. We will discuss the distinctions in procedures and formalities and also consider some of the challenges that either form poses for sellers and buyers of an undertaking.

What is a Slump Sale?

The term 'slump sale' was statutorily defined under Indian law for the first time under the Income-tax Act. Section 2(42C) of the Income-tax Act, 1961 ("IT Act") defines a "slump sale" as follows:

"Slump sale" means the transfer of one or more undertakings as a result of the sale for a lump sum consideration without values being assigned to the individual assets and liabilities in such sales.

In order to fully appreciate the concept of slump sale, we need to understand the provisions of Section 2(19AA) ("demerger") of the IT Act which deals with the meaning of an 'undertaking'.

Section 2(19AA) defines a demerger as follows:

"Demerger", in relation to companies, means the transfer, pursuant to a scheme of arrangement under sections 391 to 394 of the Companies Act, 1956 (1 of 1956), by a demerged company of its one or more undertakings to any resulting company in such a manner that—

(i) all the property of the undertaking, being transferred by the demerged company, immediately before the demerger, becomes the property of the resulting company by virtue of the demerger;

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(ii) all the liabilities relatable to the undertaking, being transferred by the demerged company, immediately before the demerger, become the liabilities of the resulting company by virtue of the demerger;

(iii) the property and the liabilities of the undertaking or undertakings being transferred by the demerged company are transferred at values appearing in its books of account immediately before the demerger;

(iv) the resulting company issues, in consideration of the demerger, its shares to the shareholders of the demerged company on a proportionate basis except where the resulting company itself is a shareholder of the demerged company;

(v) the shareholders holding not less than three-fourths in value of the shares in the demerged company (other than shares already held therein immediately before the demerger, or by a nominee for, the resulting company or, its subsidiary) become shareholders of the resulting company or companies by virtue of the demerger, otherwise than as a result of the acquisition of the property or assets of the demerged company or any undertaking thereof by the resulting company;

(vi) the transfer of the undertaking is on a going concern basis;

(vii) the demerger is in accordance with the conditions, if any, notified under sub-section (5) of section 72A by the Central Government in this behalf.

Explanations Sections 1 to 3 to Section 2(19AA) of the IT Act are also material in understanding the concepts involved in a slump sale.

Explanation — For the purposes of this clause, "undertaking" shall include any part of an undertaking, or a unit or division of an undertaking or a business activity taken as a whole, but does not include individual assets or liabilities or any combination thereof not constituting a business activity.

Explanation 2 — For the purposes of this clause, the liabilities referred to in sub-clause (ii), shall include –

(a) the liabilities which arise out of the activities or operations of the undertaking;

(b) the specific loans or borrowings (including debentures) raised, incurred and utilised solely for the activities or operations of the undertaking; and

(c) in cases, other than those referred to in clause (a) or clause (b), so much of the amounts of general or multi-purpose borrowings, if any, of the demerged company as stand in the same proportion which the value of the assets transferred in a demerger bears to the total value of the assets of such demerged company immediately before the demerger.

Explanation 3 — For determining the value of the property referred to in sub-clause (iii), any change in the value of assets consequent to their revaluation shall be ignored.

Concept/Meaning of "undertaking" under Companies Act

The word "undertaking" is defined under the *Explanation* to sub-clause (a) of Section 180(1) of Companies Act, 2013 **("CA 2013")** as follows:

"Undertaking" shall mean an undertaking in which the investment of the company exceeds 20% of its net worth as per the audited balance sheet of the preceding financial year or an undertaking which generates 20% of the total income of the company during the previous financial year".

It is pertinent to bear in mind the context of Section 180 of the CA 2013. Under Section 179 of the CA 2013, the Board of Directors of a company are fully empowered to do everything

that the company itself can do or perform. The overwhelming power is however subject to the limitations, restrictions and conditions imposed under the CA 2013 and the provisions of the memorandum and Articles of Association of the company. Section 179 sets out a list of major decisions which may be undertaken by the Board of Directors only at a Board meeting. Further, Section 180(1) provides that the Board may exercise certain powers only with the consent of the company by a special resolution. The first of such restriction on the exercise of Board's power is to sell, lease or otherwise dispose of the whole or substantially the whole of the undertaking of the company or where the company owns more than one undertaking, of the whole or substantially the whole of any of such undertakings.

The above definition of 'undertaking' is thus to be read in the context of Section 180 of CA 2013.

As can be noted from the above, the CA 2013 merely specifies the thresholds beyond which an undertaking of a company will be considered as an 'undertaking' for the purposes of Section 180. However, it does not specify what is an 'undertaking' of the company. In view of the circular drafting defect in the above definition, we need to rely upon the judicial precedents discussing the ambit of Section 180 of the CA 2013, or the corresponding provisions contained in the Companies Act, 1956, i.e. Section 293, to understand what qualifies as an 'undertaking'.

(i) In the case of *Sree Yellamma Cotton, Woollen and Silk Mills Company Limited vs. Official Liquidator, High Court Buildings*[2], the Hon'ble High Court of Mysore has opined that,

"It is not in its real meaning anything which may be described as a tangible piece of property like land. machinery or the equipment; it is in actual effect an activity of man which in commercial or business parlance means an activity engaged in with a view to earn profit. Property movable or immovable, used in the course of or for the purpose of such business can more accurately be described as the tools of business or undertaking, i.e., things or articles which are necessarily to be used to keep the undertaking going or to assist the carrying on of the activities leading to the earning of profits."

From the above, it is clear that an 'undertaking' is the activity engaged in with a view to earn profit and not simply the property whether movable or immovable used in the course of or for the purpose of the business. The property can be considered the tools of the business or the undertaking.

(ii) In the case of P. S. Offshore Inter Land Services Private Limited and Anr. vs. Bombay Offshore Suppliers and Services Limited and Ors.[3], the Hon'ble High Court of Bombay has opined that,

"In my judgment, the expression "undertaking" used in this section is liable to be interpreted to mean **"the unit", the business as a going concern, the activity of the company duly integrated with all its components in the form of assets and not merely some asset of the undertaking.** Having regard to the object of the provision, it can, at the most, embrace within it all the assets of the business as a unit or practically all such constituents. If the question arises as to whether the major capital assets of the company constitute the undertaking of the company while examining the authority of the Board to dispose of the same without the authority of the general body, **the test to be applied would be to see whether the business of the company could be carried on effectively even after disposal**

2 [1970] 40 Comp Cas 466b (Kar.)

3 [1992] 75 Comp Cas 583 (Bom.)

of the assets in question or whether the mere husk of the undertaking would remain after disposal of the assets? The test to be applied would be to see whether the capital assets to be disposed of constitute substantially the bulk of the assets so as to constitute the integral part of the undertaking itself in the practical sense of the term.

…

It appears to me that, for the purpose of section 293(1)(a) of the Act, all the capital assets of the undertaking taken together would be embraced by the expression "undertaking" as, otherwise, it would be very easy to defeat the legislative intention and avoid procurement of the consent of the general body when the legislative intention is clear that the directors cannot dispose of the entire or substantially the whole business of the company without the consent of the general body. If, after disposal of practically all the capital assets of a company, what remains is only the husk of the assets, it would be perhaps difficult to take the view that, merely, assets of the undertaking were disposed of and not the undertaking itself. It is, therefore, possible to take a view that the Board of Directors cannot dispose of "all the capital assets of the company" taken together which will denude the company of its business or will leave merely the husk left behind."

From the above extract, it is pertinent to note that an 'undertaking' can be understood to mean the "the unit", the business as a going concern, the activity of the company duly integrated with all its components in the form of assets and not merely some asset of the undertaking. However, where the Board of Directors of a company seeks to dispose major capital assets of the company, one will be required to consider whether the business of the company could be carried on effectively even after disposal of the assets in question or whether the mere husk of the undertaking would remain after disposal of the assets.

(iii) While interpreting the test laid down in the P. S. Offshore ruling in the case of *Tracstar Investments Limited and Anr. vs. Gordon Woodroffe Limited and Ors.*[4], the Company Law Board observed that,

"Mr. Justice D. R. Dhanuka in P. S. Off-shore Inter Land Services (P.) Ltd. vs. Bombay Off-shore Suppliers and Services Ltd. [1992] 75 Comp Cas 583 (Bom.); [1994] 2 Comp LJ 407, has prescribed a test and has stated as follows (at page 596):

"If the question arises as to whether a major capital asset of the company constitutes the undertaking of the company while examining the authority of the Board to dispose of the same without the authority of the general body, the test to be applied would be to see whether the business of the company could be carried on effectively even after disposal of the assets in question or whether the mere husk of the undertaking would remain after the disposal of the assets."

72. If we apply this test in the present case it would transpire that the main business of the company is not to invest in the shares of GWL. The main object of the company is not even to engage in the business of investing in shares. Consequently, the disposal of these shares would not bring the business of the company to a standstill. Thus, the sale of the shares does not certainly pass through the test prescribed. On going through the Memorandum of Association, we are convinced that the business of the company does not relate to investing money in shares of GWL. We are also convinced that though the main business activity is suspended the pursuit of such business is not ruled out. The sale of the shares also would not mean that the company cannot carry on its business. We note that

4 [1996] 87 Comp Cas 941 (CLB)

the Board of Directors is functioning and the company is alive. We are, therefore, unable to accept the contention of the petitioners that by sale of the shares, the company has parted with any "undertaking" or even a substantial part of the "undertaking" of the company and as such we reject the contention of the petitioners in this regard."

In this case, the test laid down in the P. S. Offshore ruling was implemented to state that the disposal of substantial assets of a company (in this case, shares held by the company) would not amount to disposal of an undertaking if such disposal of assets would not stop the company from carrying on its business.

(iv) In the case of *Rushvi Estate and Investments (P) Limited vs. Official Liquidator of Shri Ambica Mills Limited*, the Hon'ble High Court of Gujarat observed that,

"As far as Rushvi Ltd. is concerned, the property which was sought to be sold is described on page 3 of that document in Gujarati and it includes 'bungalow, godown, chawls, out-house and other constructions etc. situated on the concerned land'. As far as Rutuja Ltd. is concerned, the property which is said to be sold is a land admeasuring 9,215 square metres including 'factory and shed and other constructions'. Nobody can possibly say that factory or godowns of the mill company are not a part of the undertaking of the mill company. Shri Ambica Mills Ltd., was an integrated textile mill and its principal activity was production of cloth through its factory. The raw material as well as the finished products would be stored in its godowns. The factory and the godowns are essential parts of the undertaking of the mill company. By no stretch of imagination can it be said that it does not form a part of the undertaking of the mill company as was sought to be canvassed by Mr. Soparkar. This being the property which was sought to be sold and since no resolution passed in the general meeting is produced authorising directors or said Rajesh Jaykrishna giving any such powers of attorney, anything done by any purchaser in furtherance of that power of attorney, cannot bind the mill company."[5]

From the above, it may be understood that the disposal of property which forms the essential parts of the company's undertaking thereby affecting its principal activity would require the approval of the shareholders.

(v) Further, in *Pramod Kumar Mittal vs. Andhra Steel Corporation Limited and Others*[6], the Hon'ble High Court of Calcutta observed that,

"In the case before us, it is an admitted fact that the Dankuni unit of the company has remained closed since December, 1976. In view of the fact that the Dankuni unit has not been in production for more than five years past, it cannot be said that it is an "undertaking" of the company which is being sold in this case. In that view of the matter, the restrictions imposed by Section 293 are not attracted in the instant case and the provisions of Section 293(1)(a) in terms do not apply to the proposed sale of the Dankuni unit of the company."

From the above, it may be noted that where one unit of many of a company which has been closed down for a prolonged period is being disposed, this cannot be understood to mean disposal of an "undertaking" requiring the approval of the shareholders.

To summarise, a mere aggregation of assets or investments; or aggregated assets and liabilities would not constitute an "undertaking" or fulfill the essential ingredients of an "undertaking". An "undertaking" is necessarily composed of an integrated stand-alone economic or commercial activity.

5 MANU/GJ/0003/1989.

6 [1985] 58 Comp Cas 772 (Cal).

Scheme of Arrangement under Sections 230-232 of CA 2013

Sections 230-232 (corresponding to the provisions of sections 391-394 of the Companies Act, 1956 prescribe a procedure for sanction of the scheme of arrangement between two companies. The slump sale i.e., sale of an undertaking as a going concern can also be accomplished by means of a scheme u/ss. 230-232. This would primarily involve the following principal steps:

(i) Identification (definition) of undertaking;

(ii) Valuation of the undertaking[7];

(iii) Formulation of a scheme of arrangement whereby one of the undertakings of the Transferor Company will be transferred to and vested in the Transferee Company;

(iv) Evaluation of exchange ratio, if the consideration of demerger is to be discharged by allotment of shares;

(v) Approval of the scheme by the shareholders and creditors of the Transferor Company and the Transferee Company pursuant to the directions issued by the National Company Law Tribunal **("NCLT")**;

(vi) Sanction of the scheme of arrangement by the NCLT;

(vii) Registration of the Order sanctioning the Scheme with the Registrar of Companies; and

(viii) Implementation of the Scheme by mutation of title in case of immovable property and discharge of consideration in cash or allotment of shares.

Key distinctions between Slump Sale / Scheme of Demerger

Sr. No.	Issue	Slump Sale under Shareholders' Approval	Slump Sale through NCLT Approved Scheme
(i)	Scope of the Transaction and Consideration	(a) The transaction constitutes sale of business for monetary value, the consideration must be a lump sum amount.	(a) The consideration for vesting of the undertaking may be discharged in cash or shares.
		(b) The monetary consideration will have to be paid to the Transferor Company only	(b) The consideration, if discharged by issue of shares, the new shares may be allotted either to the Transferor Company or to the shareholders of the Transferor Company.
			(c) There are some schemes in which the transferor's undertaking is vested in a wholly owned subsidiary of a listed parent company and the consideration is discharged by issue and allotment of shares by the listed parent company instead of the Transferee Company. This affords ready liquidity and marketability of shares for the shares allotted to the Transferor Company's shareholders.

7 Pursuant to the provisions of Chapter XVII (s. 247) of CA 2013 the valuation may be undertaken only by registered valuers.

Sr. No.	Issue	Slump Sale under Shareholders' Approval	Slump Sale through NCLT Approved Scheme
(ii)	Effective date of Transaction	The slump sale agreement or Business Transfer Agreement operates only prospectively on completion of conditions precedent.	Under a scheme of arrangement the parties may choose a prospective or retrospective date for effecting the vesting of the undertaking by operation of law.
(iii)	Taxability	Capital gains, if any will be taxable in the hands of the Transferor Company	(a) Capital gains, if any, will be taxable in the hands of the Transferor Company, if the consideration is discharged in cash.
			(b) The demerger can be a non-taxable event, if the conditions laid down under Section 2(19AA) of Income-tax Act are fulfilled.
(iv)	Approvals required	1. Board of Directors of the Companies;	1. Jurisdictional NCLT/(s); a. Audit Committee, for listed entity; b. Board of Directors of the Companies; c. Shareholders' and Creditors' approval – 3/4th in value and majority in number d. Regional Director; e. Registrar of Companies; and f. Income-tax Authority g. Industry specific sectoral regulatory authority, if applicable.
		2. Shareholders' approval (no approval from shareholders shall be required, if exempt or does not meet threshold as mentioned under Section 180(1)(a) of the CA 2013);	2. Existing contracting parties for release from any restrictive or negative covenants;
		3. Creditors approval is not required;	3. Stock exchanges/SEBI (for listed entities); and
		4. Existing contracting parties for any restricting covenants; and	4. Any other statutory or regulatory authority/(ies), as applicable.
		5. Any other statutory or regulatory authority/(ies), as applicable.	

Sr. No.	Issue	Slump Sale under Shareholders' Approval	Slump Sale through NCLT Approved Scheme
(v)	Stamp duty	(a) A Slump Sale Agreement will be subject to stamp duty as an agreement under Article 5(h) of Maharashtra Stamp Act or equivalent provision under State Stamp Act in which the agreement is executed.	(a The Order of NCLT sanctioning the Scheme is the instrument chargeable to stamp duty, under Article 25 (conveyance).
		(b) Transfer of immovable property, and transfer of intangible property/assets can be achieved only through written deeds of conveyance or deeds of assignment.	(b) If the registered offices of the Transferor and Transferee Companies are situated in different States, the Companies will have to file Company Petitions before NCLT Benches having territorial jurisdiction. In this case, two instruments come into existence and are thus separately chargeable under State Stamp Laws. This may lead to additional costs.
		(c) If the Slump Sale Agreement operates like an agreement for sale, the deeds of conveyance executed on completion of transaction will also be subject to stamp duty. However, the parties will be able to claim rebate for the stamp duty paid on the Slump Sale Agreement.	(c) As of date there are only two States – Maharashtra and Gujarat which provide for a monetary ceiling on stamp duty.
(vi)	Time involved	Since this is achieved through a negotiated documentation, the transaction may be expeditiously concluded and can be successfully accomplished within 9-10 weeks.	The procedures before NCLT may be time consuming. Apart from the requirement for filing several affidavits and reports, there may be process delays caused by frequent adjournments. These can delay the implementation of the scheme and may consume up to 9-10 months.

Some aspects requiring special attention in Slump Sale as well as Scheme of Arrangement

Approvals for Related Party Transaction

(a) A slump sale transaction with a related party will be subject to shareholders' approval pursuant to the provisions of Section 188 of CA 2013 if the financial thresholds as prescribed under the rules framed under CA 2013 are attracted. This would be in addition to the approval by the Audit Committees and the Boards of Directors of the Transferor and Transferee Companies.

(b) If the related party is a shareholder of the transacting company, then such related party is not permitted to vote on the resolution for approval of related party transaction, under the provisions of CA 2013.

(c) If the seller company is a listed company, and the slump sale constitutes a material related party transaction pursuant to the provisions of Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements) Regulations, 2015, then in such a situation none of the related parties are entitled to vote. Thus, the voting rights of all related parties regardless of whether or not they are contracting parties are not are legally suspended by Securities and Exchange Board of India.

(d) In case of a negotiated Slump Sale Agreement, it is usual to require the seller/transferor to make substantial representations and warranties and subject the transferor to strict indemnities for any breach of warranties. In a classical scheme of arrangement the aspects of representations, warranties and indemnities akin to a slump sale agreement or business transfer agreement are conspicuously absent. However, if the acquirer insists on these matters, the parties will end up executing an Agreement of Sale and a Scheme of Arrangement. Consequently, the timelines for accomplishing the transaction through the scheme may be further extended apart from enhancement of the transaction costs.

Issues pertaining to classification of immovable and movable property comprised in the Undertaking

(a) The terms 'immovable property' is defined under the Transfer of Property Act, 1882 as follows:

Section 3 of the Transfer of Property Act, 1882 defines "immovable property" as which does not include standing timber, growing crops or grass".

Under the General Clauses Act, 1897, the term "immovable property" is defined to include land, benefits to arise out of land, and things attached to the earth, or permanently fastened to anything attached to the earth.

(b) The term "goods" is defined under the Sale of Goods Act, 1930 to mean every kind of movable property other than actionable claims and money and includes stock and shares, growing crops, grass, and things attached to or forming part of the land which are agreed to be severed before sale or under the contract of sale"

(c) Further, as per Section 3(36) of the General Clauses Act, 1897, "movable property" shall mean property of every description, except immovable property."

(d) In a slump sale whether by approval of shareholders or through a scheme, the undertaking may comprise of immovable and movable properties. The question whether a machinery which is embedded in the earth is movable property or an immovable property, depends upon the facts and circumstances of each case. Primarily, the Court will have to take into consideration the intention of the parties when it decided to embed the machinery whether such conveyance was intended to be temporary or permanent.[8] For example, a machinery such as a lathe machine may be affixed to a platform attached to earth for its better functional efficacy and not with the intention to be permanently fastened to earth. Such intent would permit a lathe machine to be treated as a movable property. Whereas the optical fibre network laid in the ducts

8 Duncans Industries Ltd. vs. State of UP, 2000 1 SCC 633

under the entire township may be treated as immovable property.

(e) The purpose for which the machines were obtained and fixed seems to me unmistakable; it was to complete and use the buildings as a factory. It is true that the machines could be removed if necessary, but the concrete beds and bolts prepared for them negative any idea of treating the machines when fixed as movable chattels.[9]

(f) The machines are permanently fastened to things attached to the earth. They were set up there with the definite intention of running the oil mills and not with the idea of being removed after temporary use. Therefore, no hesitation in holding that the plant and machinery of the Company is not movable property.[10]

Registration of Documents

It is critical to bear in mind that in case of both forms of slump sale through execution of document and through a scheme of arrangement, the title to the immovable property is required to be mutated in property records maintained by the State. If the parties fail to register the deeds of conveyance of immovable property or register the Order of NCLT sanctioning the scheme of arrangement within the time stipulated under the Registration Act, 1908, the purchaser's or the transferee's title to the property is at serious risk. Section 49 of the Registration Act, 1908 provides for effect of non-registration of documents and states that no document required by Section 17 or by any provision of the Transfer of Property Act, 1882 (4 of 1882), to be registered shall —

(a) affect any immovable property comprised therein, or

(b) confer any power to adopt, or

(c) be received as evidence of any transaction affecting such property or conferring such power, unless it has been registered:

Provided that an unregistered document affecting immovable property and required by this Act or the Transfer of Property Act, 1882 (4 of 1882), to be registered may be received as evidence of a contract in a suit for specific performance under Chapter II of the Specific Relief Act, 1877 (3 of 1877) or as evidence of any collateral transaction not required to be effected by registered instrument.

Whether benefit of past track record or credentials of past projects be transferred?

Unfortunately not. Neither a Slump Sale Agreement nor the demerger of an undertaking as a going concern will have the effect of migrating the benefit of past track record or credentials to the transferee of the business. This may be a major factor for consideration whether the acquirer desires to purchase the undertaking or the ownership of the entity which has the undertaking with established past track record. If this is the most crucial determinant to acquire an undertaking, the parties may consider a share purchase transaction rather than business/ undertaking acquisition. This may be coupled with the demerger of the residual business to the shareholders of the Transferor Company or demerging such residual business to the company owned by the selling shareholders.

Conclusion

This article attempts to summarise certain critical attributes for choosing a particular structure for an M&A transaction, the parties should recognise that each transaction is unique in its own way and will need professional advice and guidance for evaluation of various pros and cons of each transaction structure and for crafting appropriate documentation.

9 House of Lords in Reynolds vs. Ashb & Son, 1904 AC 466

10 Official Liquidator vs. Sri Krishna Deo and Ors. AIR 1959 All 247

CA Zubin Billimoria

Accounting Treatment of Schemes and Arrangements under Ind AS-103 on Business Combinations

Introduction

Business combinations are one of the most common and key sources of inorganic growth for corporates, both locally as well as internationally. Whilst the definition of business combination has changed over time, it basically covers circumstances in which an entity obtains *control of a **business*** or transactions as a result of which an *entity becomes a **subsidiary** of a parent.*

Prior to the advent of Ind AS, there was no comprehensive accounting standard which dealt with all business combinations, with different accounting standards, as under, dealing with specific aspects.

Accounting Standard	Matters Dealt With
AS-14 – Accounting for Amalgamations	Applies to amalgamations under the Purchase Method and Pooling of Interests Method
AS-21 – Consolidated Financial Statements	Accounting for Investments in Subsidiaries in the Consolidated Financial Statements
AS-21 – Accounting for Investments	Accounting for Investments in Subsidiaries in the Standalone Financial Statements
AS-10 – Accounting for Fixed Assets	Accounting when a demerged division is acquired on a slump sale basis by another entity.

In contrast, **Ind AS-103 on Business Combinations** broadly deals with the following aspects:

1. Accounting in case of *acquisition of a subsidiary*, which is a *business*, as defined in Ind AS-103 (discussed later) in the *Consolidated Financial Statements* by prescribing the accounting for business combinations and their effect on consolidation, including treatment of Goodwill / Capital Reserve arising thereon. *However, the accounting requirements for consolidated financial statements are dealt with under **Ind AS-110 on Consolidated Financial Statements.***

2. Accounting for *acquisition of a business* through *amalgamation, demerger, slump sale* etc., both in the *Standalone and Consolidated Financial Statements.*

It may be noted that in the separate financial statements, investments in subsidiary will be accounted for in accordance with **Ind AS-27 on Separate Financial Statements.**

Another important distinguishing feature is that in the case of acquisition of subsidiaries as discussed in point 1 above, there is no specific approval of the Court or the NCLT which is required, whereas in the case of point no. 2 above approval of Courts and / or the NCLT would be required in terms of the Companies Act, 1956 and 2013 *vide* a ***scheme of arrangement / reorganisation***. This in turn initially led to an overwhelming reliance on what was stated in the scheme, including accounting treatment, many times **against Generally Accepted Accounting Principles (GAAP)** which could be passed off under the guise that *law prevails over the Accounting Standards* as prescribed in the **Framework for Preparation and Presentation of Financial Statements** issued by **The Institute of Chartered Accountants of India (ICAI).** However, over time SEBI prescribed that listed companies would need to obtain a certificate from the Statutory Auditors that the accounting treatment prescribed in the Scheme should be in accordance with the prevailing GAAP which subsequently got extended to all companies with the enactment of the Companies Act, 2013, thereby significantly plugging this loop hole.

Accordingly, the main focus of this article is to deal with the accounting treatment of such schemes under Ind AS-103, going forward, consequent to adoption of Ind AS and related applicability challenges and transition issues on first time adoption.

Overview of Ind AS-103

As discussed above, Ind AS-103 is now a one stop solution to accounting for all types of business combinations. However, like in case of several other Ind ASs, before proceeding with the accounting treatment, it is necessary to identify the applicability criteria of the type and nature of transactions which are covered by the respective Ind ASs. These are what could be referred to as *quasi legal issues* which primarily involve determining transactions or events keeping in mind the fundamental principle of *substance over form* which is enshrined under many Ind ASs.

Accordingly, our analysis of Ind AS-103 is broadly structured on the following lines for the purposes of further study and discussion.

- **Quasi Legal Issues (also referred to as Substance over Form issues)**
- **Accounting Requirements (see below)**

Further, the accounting requirements under Ind AS-103 can be further sub-classified as under, as per the method of accounting applied.

- **Acquisition Method of Accounting**
- **Accounting for Common Control Transactions**

Let us now proceed to dig a little deeper into each of the above aspects.

Quasi Legal Issues

These primarily involve determination of and identification of certain parties and nature of transactions, also referred to as the *scoped in transactions* to which the accounting requirements laid down under Ind AS-103 apply. Most of these are sometimes complex and involve judgment and in certain cases legal interpretation whereby the substance rather than the legal form needs to be interpreted and hence these are sometimes referred to as ***quasi legal issues.***

These issues which dealt with and on which guidance is provided under Ind AS-103 can be broadly categorised as under:

a) Determining whether the acquired set of assets and liabilities is a ***business***.

b) Determining whether the transaction or event is a ***business combination.***

c) Identifying the ***acquirer***.

d) Determining the ***acquisition date.***

Each of these aspects are briefly discussed in the following paragraphs.

Determining whether the acquired set of Assets and Liabilities is a business

The determination of whether an acquired set of assets and liabilities constitutes a business will have a significant impact on the accounting treatment and hence determination of what constitutes a business is of paramount importance. If the transaction(s) involving an acquired set of assets and liabilities do not meet the definition of a business the same would be accounted for as an *asset acquisition,* which impacts the accounting not only on the acquisition date but also subsequently. Hence it essential for us to understand as to what constitutes as business.

Meaning and scope of the term Business

Ind AS-103 defines the term business as *an integrated set of activities and assets that is capable of being conducted and managed for the purpose of:*

a) providing a return in the form of dividends,

b) lower costs, or

c) other economic benefits directly to investors or other owners, members or participants.

Accordingly, any business consists of the following **three elements:**

- ***Inputs*** – These are referred to as an *an economic resource that creates or has the ability to create an output through one or more processes that are applied to it.* **Examples of inputs include non-current assets, intellectual property and the ability to obtain access to necessary materials or rights or employees.**
- ***Processes*** – These are referred to as any *system, standards, convention, protocols or rules applied to an input to create outputs.* Processes include **strategic management processes, operational processes and resource management processes.** These processes though are normally documented it may not always be the cases especially if there is an organised workforce having the necessary skills and experience and following the necessary rules and conventions over a sustained period of time. **Processes do not normally include accounting, billing, payroll and similar administrative processes.**
- ***Outputs*** – These are referred to as *end results that achieve one or more of the objects identified in (a) to (c) above whilst defining a business.*

Development stage entities may qualify as a business even though output may not necessarily be there and hence some of the following factors need to be considered:

a) It has begun its planned principal activities.

b) It has employees, intellectual property, and other inputs and processes that can be applied to these inputs.

c) It is pursuing a plan to produce outputs.

d) It has identified customers who would purchase the outputs.

Determining whether a particular set of assets and liabilities constitute a business should be based on whether the integrated set is capable of being conducted and managed as a business by **market participants and not whether the seller operated it as a business or the acquirer intends to operate it as a business.**

*The nature and elements of a business varies by industry and the entity's structure and may in certain cases present challenges and use of significant judgment. These typically arise for example in **real estate and exploration business** whereby the acquired entities having only land under development or exploration assets which are not still developed may not always constitute a business in the absence of further processing or outputs being generated.*

Determining whether the Transaction or Event is a *business combination*

Ind AS-103 defines the term Business Combination as *a transaction or other event*

*in which an **acquirer (discussed later)** obtains **control (discussed later)** of one or more **businesses (defined above).***

An acquirer might obtain control of an acquiree in a variety of ways as under:

a) By transferring cash, cash equivalents and other assets.

b) By incurring liabilities.

c) By issuing equity shares / equity interests.

d) By a contractual arrangement without transferring consideration.

Further, a business combination may be structured in a variety of ways for legal, taxation or other reasons, which include but are not limited to:

a) one or more businesses become subsidiaries of an acquirer or the net assets of one or more businesses are legally merged into the acquirer;

b) one combining entity transfers its net assets, or its owners transfer their equity interests, to another combining entity or its owners;

c) all of the combining entities transfer their net assets, or the owners of those entities transfer their equity interests, to a newly formed entity (sometimes referred to as a roll-up or put-together transaction); or

d) a group of former owners of one of the combining entities obtains control of the combined entity.

Finally, the following business combinations are ***scoped out*** of Ind AS-103:

a) Acquisitions made by an investment entity as defined and referred to in Ind AS-110 on Consolidated Financial Statements since these are excluded from consolidation in terms of the said Ind AS. Investments in such subsidiaries are required to be accounted as FVTPL. *The determination of what constitutes an **investment entity** is in itself a challenge and may involve several judgment calls which is dealt with in Ind AS-110 is not discussed within the scope of this article.*

b) Accounting for formation of joint arrangement in the financial statements of the joint arrangement.

c) Acquisition of assets or group of assets that do not constitute a business as defined earlier.

As we have seen in the aforesaid definition of Business Combination, it is dependent on who the acquirer is and whether he obtains control which are dealt with in the following section.

Identifying the *Acquirer*

Ind AS-103 requires that one of the combining entities has to be identified as the acquirer which is referred to as the *entity which obtains control of another entity i.e. acquiree.* Since obtaining control is the pre-requisite for identifying the acquiree, *Ind AS-103 prescribes that **initially, control** needs to be **ascertained** based on the **guidance as provided in Ind AS-110 on Consolidated Financial Statements.*** Hence before proceeding further it is imperative for us to briefly understand the meaning and scope of what constitutes control.

Meaning and scope of the term "Control" under Ind AS-110

As per Ind-AS 110, an investor controls an investee when the investor *is exposed, or has rights, to **Variable returns** from the involvement with the investee and has the ability to affect those returns through its **power over the investee**.* Power is signified by existing rights that give the **current ability to direct the relevant activities.**

Based on the above definition, the following steps are involved in assessing control:

- **Identify Power**: In the normal course the exercise of majority voting rights would determine control in the absence of any other factors / arrangements. If the *voting rights are not the dominant consideration, an analysis of the other factors, including necessary written documentation, both external and internal, would be warranted to* determine which party has the ***current ability to direct relevant activities.*** Some of the common examples of such activities are selling and purchasing of goods and services, selecting, acquiring and disposing off assets, R&D activities, funding decisions, operating and capital decisions, approving budgets, appointment, remuneration and termination of KMPs and key service providers.

  Apart from the ability to direct the relevant activities, *rights* from which *power is derived* like voting rights, ***potential voting rights,*** right to appoint ***KMPs,*** decision making rights through ***contractual obligations, kick out / removal rights,*** rights of *de facto agents* and related parties are also to be considered. Further, the ***protective rights*** i.e. those which are designed to protect the rights of the investor without giving power over the investee are not to be considered. Examples of such rights include rights of lenders restricting borrowers from undertaking activities which would impact the credit risk of the borrower to the detriment of the lender, or rights of non-controlling shareholders to approve capital expenditure in excess of limits.

- **Assess Returns**:- It involves assessing whether the investor is exposed, or has rights, to variable returns from the involvement with the investee. The returns could be positive or negative or both. Some of the common examples of such returns are dividends, remuneration, economies of scale, cost savings, scarce products, proprietary knowledge, synergies etc.

- **Evaluate Linkages between Power and Returns**: it involves evaluating if the investor has the ability to use its power to affect the investors returns from its involvement with the investee. This primarily involves determining whether the investor is the principal or agent after considering various factors like, scope of its authority, rights of the other parties, remuneration, exposure to variability from other interests

As can be seen from the above discussion, the concept of control is totally different from the existing concept as per AS-21 which refers to the legal control through existing voting rights or control over the composition of the Board of Directors, and involves assessment of the substance of the arrangements which may be certain cases require legal intervention and use of significant management judgment.

Additional Guidance in Ind AS-103

It may so happen that in many cases the guidance given in Ind AS-110, as discussed above, may not clearly indicate which of the combining entities is the acquirer. In such cases, Ind AS-103 provides additional guidance as under:

- In a business combination effected by **transferring cash or other assets or acquiring liabilities,** the entity that does the same would be generally regarded as the acquirer.

- In a business combination effected by **exchanging equity interests**, the entity that issues the equity interests is regarded as the acquirer, unless it is a ***reverse acquisition, as discussed below.***

Reverse acquisition

In such cases, the entity issuing securities (legal acquirer) is identified as the acquiree for

accounting purposes e.g. private operating entity wants to become a public entity. The acquirer in such cases needs to be identified based on the factors indicated below:

- **The relative voting rights in the combined entity after the business combination**— The acquirer is usually the combining entity whose owners as a group retain or receive the largest portion of the voting rights in the combined entity. This also involves consideration of the existence of any unusual or special voting arrangements and options, warrants or convertible securities.
- **The existence of a large minority voting interest in the combined entity if no other owner or organised group of owners has a significant voting interest**— The acquirer is usually the combining entity whose single owner or organised group of owners holds the largest minority voting interest in the combined entity.
- **The composition of the governing body of the combined entity**— The acquirer is usually the combining entity whose owners have the ability to elect or appoint or to remove a majority of the members of the governing body of the combined entity.
- **The composition of the senior management of the combined entity**— The acquirer is usually the combining entity whose (former) management dominates the management of the combined entity.
- **The terms of the exchange of equity interests**— The acquirer is usually the combining entity that pays a premium over the pre-combination fair value of the equity interests of the other combining entity or entities.

New Entity as the Acquirer

One of the common areas which would present challenges is whether a newly formed entity to effect a business combination can be considered as an acquirer. Under normal circumstances a new entity formed to effect a business combination is not necessarily the acquirer. If a new entity is formed to issue equity interests to effect a business combination, one of the combining entities that existed before the business combination should be identified as the acquirer. However, if the new entity transfers cash or other assets or incurs liabilities as a consideration may be the acquirer.

Let us understand the same with the help of an example:

Facts of the Case

W Ltd. decides to spin off / demerge two of its separate business segments X and Y into a newly incorporated entity N Ltd. W Ltd. subscribes to a nominal equity in N Ltd. and also appoints independent directors. Further, N Ltd. signs an agreement to acquire X and Y businesses in cash conditional on obtaining sufficient funding and for this purpose it issues shares. At the conclusion of the transaction, a new set of shareholders owns 90% of the shares in N Ltd. and W Ltd. owns 10%. Identify the acquirer/

Analysis

The new set of investors have paid cash to acquire control of N Ltd. in an arm's length transaction against which N Ltd. acquired the businesses X and Y through the acquisition of their respective assets and liabilities and accordingly W Ltd. has relinquished control. ***Although N Ltd. is a newly formed entity, it is identified as the acquirer since it has paid the cash even though the new owners of W Ltd. have obtained control of the two businesses.***

Determining the *acquisition date*

Ind AS-103 defines acquisition date as that on which the *acquirer obtains control over the acquiree.*

This is generally the date on which the transfer of consideration takes place which is commonly referred to as the closing date. In certain cases, it could be different based on the agreement.

In many cases, it depends upon the shareholders and regulatory approvals. In India, merger and acquisition schemes that require a Court / Tribunal approval under the Companies Act, 1956 and 2013 have an *appointed date* mentioned in the scheme, which is the date on which the merger and acquisition are accounted for. However, the scheme becomes *effective when the Court or Tribunal order is passed and the same is filed with the ROC*. Existing Indian GAAP was also aligned to these concepts.

However, with the introduction of Ind AS-103, the acquirer would need to identify the acquisition date based on the criteria discussed above. Accordingly, the concept of appointed date is no longer relevant. This may present challenges when the transactions involve court schemes, both for outside acquisitions and common control transactions. Even though the agreements or court schemes may provide a retrospective date (commonly referred to as the appointed date), the acquisition date under Ind AS-103 is the date on which the control is actually obtained which may or may not correspond with the date specified in the agreement or the appointed date as specified in the scheme. An important criteria in the Indian context is the *nature of the regulatory approvals required to determine the date on which control is passed. This in turn is dependent on the nature of the industry, relevant regulatory requirements, the shareholding pattern etc., in addition to what is stated in the agreement.* Accordingly in the Indian context, even if all the regulatory and statutory approvals are obtained, *the Court / Tribunal order would generally be treated as substantive pre-condition and determine the acquisition date.* Without the Court / Tribunal order the companies would continue to have their separate legal existence.

In the context of the above, the **Madras High Court *vide* its order dated 6th June, 2016** in the case of *Equitas Ltd.* passed an order whereby it observed that the appointed / effective date could be conditional upon the happening / non-happening of certain events, which in this case would be the date on which RBI granted an in-principle approval subject to the transfer of the two transferor companies into the transferee company, prior to commencement of the Small Finance Bank business. *Accordingly the appointed / effective date could be set in the scheme, without specifying a particular date.*

Further, in the context of the requirements laid down in the Companies Act, 2013 that the auditors need to certify whether the accounting treatment as specified in the scheme is in accordance with the GAAP, many schemes shy away from determining the accounting treatment by specifying that the requirements as per the applicable accounting standards should be applied. In such cases, even if there is ***an appointed / effective date specified in the scheme, the same may be used for tax purposes and for financial accounting and MAT purposes the financial statements should be prepared based on the acquisition date determined under Ind AS-103, discussed above.***

In view of the peculiarities in the Indian context, it would be desirable for the ICAI to provide appropriate clarifications.

Finally, there could be certain other complications / issues involved in accounting for Court Schemes, especially on the transition date, which are discussed later.

Acquisition Method of Accounting

This method of accounting is applicable to acquisition transactions between external parties and primarily involve the following issues:

- **Classification and designation of identifiable assets acquired and liabilities assumed.**
- **Recognising and measuring the identifiable assets acquired, liabilities assumed and non-controlling interest in the acquiree.**

- **Recognising and measuring Goodwill or gain from Bargain Purchase.**
- **Accounting for Business Combination achieved in Stages.**
- **Accounting for Business Combination achieved without Transfer of Consideration.**
- **Measurement Period Adjustments.**
- **Acquisition related Costs.**

The broad requirements in respect of each of the above matters are discussed hereunder.

Classification and designation of identifiable assets acquired and liabilities assumed

At the acquisition date, the acquirer shall classify or designate the identifiable assets acquired and liabilities assumed as necessary to apply other Indian Accounting Standards subsequently. The various factors which need to be considered as on the acquisition date for determining such classification are as under:

a) Contractual terms

b) Economic conditions

c) Operating or accounting policies

Examples include classification of financial instruments, designation of hedges, embedded derivatives etc., which should be in accordance with Ind AS-109- Financial Instruments

There are *two exceptions,* as under, to the above principle:

a) classification of a *lease contract* as either an operating lease or a finance lease has to be in accordance with Ind AS 17- Leases ; and

b) classification of a contract as an *insurance contract* has to be in accordance with Ind AS 104 – Insurance Contracts.

The acquirer shall classify the above contracts on the basis of the contractual terms and other factors at the inception of the contract or, if the terms of the contract have been modified in a manner that would change its classification, at the date of that modification, which might be the acquisition date.

Recognising and measuring the identifiable assets acquired, liabilities assumed and non-controlling interest in the acquiree:

Recognition Principles

On the acquisition date the acquirer shall recognise separately from Goodwill, the following:

a) Identifiable assets acquired;

b) Liabilities assumed; and

c) Any non-controlling interest

The following are the general conditions which need to be satisfied for recognition of the above:

a) The identifiable assets and liabilities must meet the definitions within the Framework for Preparation and Presentation of Financial Statements.

b) Costs which the acquirer expects to incur after the business combination is effected are not recognised (e.g., reorganisation costs, payment to CEO of additional compensation to integrate and manage the business for a specified period after the business combination).

c) The identifiable assets acquired and liabilities assumed must be part of the business combination transaction rather than as a result of a separate transaction.

d) Assets and liabilities assumed because of pre-existing relationship between the acquirer and acquiree not to be recognised (e.g., pre-existing law suit, franchise arrangement, operating or finance lease arrangement, supply / service contract etc.).

Apart from the general conditions specified above, there are certain specified conditions which need to be satisfied for particular assets and liabilities, the main ones being as briefly discussed in the following sections.

Intangible Assets

These are by far the most important assets which need to be identified under most transactions involving business combinations, especially since these are normally not reflected in the books of the acquiree on the ground of being internally generated assets, but would now qualify for recognition since they would be construed as externally acquired. It is the acquisition of various intangibles which primarily drive the value and the premium for most acquisitions and mergers which should be appropriately reflected rather than being subsumed as part of Goodwill as is currently the case.

Ind AS-103 provides for recognition of identified intangible assets which were not recognised earlier since they were internally generated intangible assets, if they satisfy the following conditions:

a) They are separately identifiable which implies that capable of being sold, transferred, licensed, rented or exchanged either individually or together. However saleability is not a necessary criteria if the asset exhibits evidence of exchange transactions for that type or similar assets.

b) The acquirer is able to control the use of the asset.

c) The acquirer should be able to derive future economic benefits from the use of the asset.

An intangible asset that arises from a *contractual basis or other legal rights* (e.g., favourable lease terms, licences, patents etc.) is always separately identifiable regardless of whether the same is transferable or separable from other rights and obligations.

All such assets which qualify for recognition should be based on the fair value on the acquisition date. Determining and assigning an appropriate fair value to each of the identifiable is one of the biggest challenges in accurately determining the Goodwill as discussed later.

Most intangibles are generally classified as follows:

a) Market related intangibles (e.g., trade marks, non-compete arrangements, internet domain names etc.)

b) Customer related intangibles (customer lists, customer contracts)

c) Artistic related intangibles (literary works, pictures and photos)

d) Contract based intangibles

e) Technology based intangibles

Contingent Liabilities

Another peculiar requirement under Ind AS-103 deals with the recognition of contingent liabilities which is in a way an ***exception to the general recognition principles*** dealt with earlier since these do not meet the definition of a liability as defined in the framework.

Accordingly, in terms of Ind AS-103, an acquirer shall recognise as of the acquisition date a contingent liability assumed in a business combination if it is a present obligation that arises from past events and its *fair value can be measured reliably*. This is *contrary* to **Ind AS 37 on Provisions, Contingent Liabilities and Contingent Assets,** and the acquirer recognises a contingent liability assumed in a business combination at the acquisition date even if it is *not probable* that an outflow of resources embodying economic benefits will be required to settle the obligation. However, *no contingent liability in respect of an obligation which represents a possible obligation arising from a past event whose existence will be confirmed only by the occurrence of one or more uncertain future events not wholly*

within the control would be recognised under Ind AS-103 and it will continue to be governed by Ind AS-37 principles. The subsequent recognition of such contingent liabilities recognised is dealt with subsequently.

Hence a mechanical approach is not permissible to recognise all contingent liabilities, but a close and careful assessment of the *probable vs. possible obligation* would be required coupled with reliability in the measurement of the fair value thereof. *In the Indian context on boarding of the contingent liabilities is likely to have significant repercussions on the valuation of many deals considering the litigious, long winding and tortuous nature of our legal system, especially in respect of tax related disputes.*

There are certain other items of assets and liabilities which are an exception to both the recognition principles as specified above as well as the measurement principles discussed below, which are covered later.

Measurement Principles for Assets, Liabilities and Non-Controlling Interests

Assets and Liabilities

The overriding principles laid down in Ind AS-103 is that all assets acquired and liabilities (including contingent liabilities as discussed above) should be measured on the basis of the *acquisition date fair values*, subject to certain exceptions as discussed below.

The acquisition date fair value is a sum of the fair values as under:

a) Assets transferred by the acquirer;

b) The liabilities incurred by the acquirer to the former owners of the acquiree; and

c) The equity interests issued by the acquirer.

This is one of the key Standards wherein extensive use of fair valuation is mandated. The broad principles governing fair valuation under Ind AS-113 would need to be kept in mind depending upon the nature of the assets and liabilities being acquired.

The acquirer may settle or transfer the consideration for a business combination in a variety of ways, as under:

a) Cash

b) Other Assets

c) A business or a subsidiary of the acquirer

d) ***Contingent Consideration (see below)***

e) Equity Instruments

f) Options and warrants

Contingent Consideration

As per Ind AS-103, contingent consideration generally arises when an acquirer agrees to transfer additional assets or equity interests to the former owners of the acquiree after the acquisition date, if specified future events occur or conditions are met. Also, in some cases, contingent consideration may also give the acquirer the right to return previously transferred consideration, if specified conditions are met. Such payments may be in the form of cash or shares or other assets which may generally be linked to one or more of the following future events:

- Earnings or EBITDA exceed a pre-specified target over an agreed future period.
- Approval of a patent or licence.
- Commencement of commercial production in a new plant within a certain time frame.
- Cash flows arising from specified assets over an agreed period.
- Continuing by certain employees or KMPs for a certain period of time.

Before deciding on the appropriate accounting treatment for contingent consideration as discussed below, the acquirer would need

to *evaluate the true economic substance of the contingent payments to determine whether they are as such or are in the nature of payment for future employee services which are outside the scope of Ind AS-103.* This may involve a close scrutiny of the terms of the transaction including the documentary evidence, both external and internal, which is available or the rationale of the management judgment which is exercised when adequate documentation is not available.

The accounting treatment for contingent future payments which are purely in the nature of contingent consideration is summarised hereunder:

- **Initial recognition and measurement**:- On the basis of the fair value of the consideration transferred in exchange for the acquired in accordance from the perspective of the market participants which holds the identical item as an asset on the measurement date.
- **Subsequent accounting**:- Generally does not affect the fair value subject to the following two exceptions:
  a) If there is an error in the application of the acquisition method, the same should be accounted in accordance with Ind AS-8 – Accounting Policies, Changes in Accounting Estimates and Errors.
  b) Changes occurring as a result of the acquirer obtaining *additional information* about the *facts and circumstances at the acquisition date* which occur *within the measurement period* as discussed later, which is adjusted against the original accounting value and hence may impact the goodwill.

Non-Controlling Interests

As per Ind AS-103, the acquirer shall measure at the acquisition date, components of non – controlling interest **(NCI)** in the acquiree which are present ownership interests which entitle the holders to a share of the net assets either at:

a) Fair value; or

b) Present ownership instruments proportionate share in the recognised amounts of the acquiree's identifiable net assets.

The above choice is separately available for each business combination. Further an entity is not required to follow this option consistently to all business combinations. Accordingly its application is likely to have various implications on amongst matters, the amount ***of Goodwill which can be recognised or the impact on equity applicable to the parent shareholders.***

It would be useful at this stage to understand the implications about the above choices with the help of certain simple examples:

Example of Measurement of NCI at the acquisition date

On 1st April, 2015, the fair value of Company A's shares was ₹ 100,000. Company B purchased 60% of Company A for ₹ 80,000. The fair value of 40% of the NCI is ₹ 40,000. The fair value of Company A's identifiable net assets as at the acquisition date is ₹ 70,000.

The accounting implication based on both the above methods is tabulated below:

Particulars	Option 1 – Fair Value	Option 2 – Proportionate Net Assets
NCI	₹ 40,000 - resulting in grossing up of the Balance Sheet	₹ 28,000 (40% of ₹ 70,000) – no grossing up of Balance Sheet
Goodwill	Higher	Lower

Whilst the above measurement choice applies at the acquisition date, it may affect the financial position in subsequent periods through impairment of Goodwill whose trigger would be reached much faster if the fair value

option is exercised with a corresponding higher impairment loss.

Further, under Ind AS-103, the *acquisition of NCI post the acquisition of control* is regarded as a *transaction with the shareholders* and consequently the difference between the consideration paid to acquire the NCI and its carrying value is recognised as an equity attributable to the parent. *This treatment is adopted irrespective of the option exercised above.*

Let us understand the impact on the equity attributable to the parent shareholders under both the options with an example.

Example of subsequent acquisition of NCI

Continuing with the above example, assume that Company A made a profit of ₹ 10,000 and ₹ Nil during the years ended 31st March, 2016 and 2017 respectively. Also, there was no impairment of Goodwill in both these years. On 31st March, 2017, Company B acquires an additional 30% interest in Company A for ₹ 36,000.

The accounting implication based on both the above methods is tabulated below:

Particulars	Option 1 – Fair Value	Option 2 – Proportionate Net Assets
NCI at Acquisition date (as above)	₹ 40,000	₹ 28,000
Share of profit	₹ 4,000	₹ 4,000
Total (40%)	₹ 44,000	₹ 32,000
Carrying Value of 30% interest	₹ 33,000	₹ 24,000
Consideration paid	₹ 36,000	₹ 36,000
Net decrease in equity of parent shareholders	₹ 3,000	₹ 12,000

As can be seen the impact on equity attributable to the parent shareholders is lower in the first option since the NCI has a higher carrying amount before acquisition and *vice versa*.

Finally, Ind AS-103 requires that certain components of NCI like share warrants need to be measured only on the basis of fair value unless another measurement basis is required by Ind AS.

The following table summarises the application of the above principles to various instruments.

Instruments issued by the acquiree	Measurement
Ordinary / Equity Shares	Proportionate share of net assets or Fair Value
Preference shares entitled to pro rata share of net assets on liquidation	Proportionate share of net assets or Fair Value
Preference shares not entitled to pro rata share of net assets on liquidation	Fair Value
Equity Component of convertible debt and other compound financial instruments	Fair Value
Share Warrants	Fair Value
Options on Own Shares	Fair Value
ESOPS	As per Ind AS-102

Exceptions to Recognition and Measurement principles

Ind AS-103 lays down exceptions to the above principles in respect of certain assets and liabilities, some of which are briefly discussed below.

Income Taxes

As per Ind AS-103, the acquirer shall recognise and measure a deferred tax asset or liability arising from the assets acquired and liabilities assumed in a business combination in accordance with Ind AS 12 – Income Taxes. The acquirer shall account for the potential tax effects of temporary differences and carry forward losses of an acquiree that exist at the acquisition date or arise as a result of the acquisition in accordance with Ind AS 12. Since Ind AS-12 prohibits discounting of deferred tax assets and liabilities they may not necessarily reflect at fair value.

Employee Benefits
As per Ind AS-103, the acquirer shall recognise and measure a liability (or asset, if any) related to the acquiree's employee benefit arrangements in accordance with Ind AS 19 – Employee Benefits. The assessment should be based on existing terms and conditions of the employee benefit and related plans.

Indemnification Assets
In many situations as part of the business combination arrangements, the seller / acquiree may contractually indemnify the acquirer for the outcome of a contingency or uncertainty related to all or part of a specific asset or liability like uncertain tax positions, environmental liabilities or legal matters.

As per Ind AS-103, the acquirer shall recognise an indemnification asset at the same time that it recognises the indemnified item measured on the same basis as the indemnified item, subject to the need for a valuation allowance for uncollectible amounts. Therefore, if the indemnification relates to an asset or a liability that is recognised at the acquisition date and measured at its acquisition date fair value, the acquirer shall recognise the indemnification asset at the acquisition date measured at its acquisition-date fair value. For an indemnification asset measured at fair value, the effects of uncertainty about future cash flows because of collectibility considerations are included in the fair value measure and a separate valuation allowance is not necessary.

Exceptions to Measurement principles
Ind AS-103 lays down exceptions to the above principles in respect of certain assets and liabilities which are briefly discussed below.

Reacquired Rights
As part of a business combination, the acquirer may reacquire a right that it had previously granted to the acquiree to use one or more of the acquirer's recognised or unrecognised assets like a trade name under a franchise arrangement or a technology.

As per Ind AS-103, the acquirer shall measure the value of a reacquired right recognised as an intangible asset on the basis of the remaining contractual term of the related contract regardless of whether market participants would consider potential contractual renewals in determining its fair value. If the terms of the contract giving rise to a reacquired right are favourable or unfavourable relative to the terms of current market transactions for the same or similar items, the acquirer shall recognise a settlement gain or loss. In such cases, the PV of the cash flows for the remaining term of the agreement is the fair value of the right which shall be amortised over the remaining term.

Share Based Payments
As per Ind AS-103, the acquirer shall measure a liability or an equity instrument related to share based payment transactions of the acquiree or the replacement of an acquiree's share-based payment transactions with share-based payment transactions of the acquirer in accordance with the method in Ind AS 102 – Share Based Payments.

Additional guidance as under, in Ind AS-103 in respect of outstanding share based payment transactions that are not replaced by the acquirer:

a) If vested, they are measured at their market based measure at the date of acquisition and the entire amount is treated as NCI.

b) If non-vested, they are measured as if the acquisition date was the grant date.

Assets held for Sale
As per Ind AS-103, the acquirer shall measure an acquired non-current asset (or disposal group) that is classified as held for sale at the acquisition date in accordance with Ind AS 105 – Non-Current Assets held for Sale and Discontinued Operations, at fair value less costs to sell. This would avoid the need to recognise a

loss for selling costs immediately after a business combination.

Recognising and Measuring Goodwill or Gain from Bargain Purchase

Goodwill or bargain represents the end result of the entire recognition and measurement process and reflects the rationale of the entire transaction from the point of view of the acquirer.

Goodwill represents future economic benefits arising from acquisition of assets and benefits not separately identified. The acquirer shall recognise goodwill as of the acquisition date measured as the **excess of (a) over (b) below:**

a) the aggregate of:

   (i) the consideration transferred measured in accordance with the Ind AS as discussed earlier, which generally requires acquisition-date fair value;

   (ii) the amount of any non-controlling interest in the acquiree measured in accordance with this Ind AS as discussed earlier; and

   (iii) in a *business combination achieved in stages (see later)*, the acquisition-date fair value of the acquirer's previously held equity interest in the acquiree.

b) the net of the acquisition-date amounts of the identifiable assets acquired and the liabilities assumed measured in accordance with this Standard.

A bargain purchase (capital reserve) arises when the identifiable assets acquired and liabilities assumed exceeds the consideration paid **[i.e. (b) > (a) as determined above]**. The same is ***normally recognised in OCI and accumulate in equity as capital reserve, except as discussed below.*** It normally happens in a forced sale.

Before recognising the gain, the acquirer should review the procedures used to measure the assets and liabilities to reflect the consideration paid. If required a reassessment is required to be done. The objective of the review is to ensure that the measurements of the assets and liabilities as discussed earlier reflect the consideration of all available information, including the rationale of the transaction, as of the acquisition date. In such a case the recognition under OCI as discussed above would be in order. However, if there is no clear evidence of the underlying reasons for classifying the business combination as a bargain purchase, the same should be recognised directly in equity as capital reserve.

It may be noted that the accounting treatment as discussed above is a ***carve out*** *from the corresponding IFRS which requires such gains to be regcognised in the Profit and Loss Statement in line with the treatment under existing GAAP. Though the jury is still not out on the appropriateness of this carve out by the ICAI, the above treatment is more prudent. However, it could result in mismatches in the future since depreciation, amortisation and impairment of the assets acquired would be routed through the Profit and Loss Statement. Also it may impact the dividend paying ability of the entity in the future.*

Whilst the above discussion covered the core principles as enshrined in the Ind AS, there are several other special situations which need specific accounting treatment, the key ones of which are discussed in the following paragraphs.

Accounting for Business Combination achieved in Stages

An acquirer sometimes obtains control of an acquiree in which it held a non-controlling equity interest immediately before the acquisition date. In a business combination achieved in stages, the acquirer shall remeasure its previously held equity interest in the acquiree at its acquisition-date fair value and recognise the resulting gain or loss, if any, in profit or loss. In prior reporting periods, the acquirer may have

recognised changes in the value of its equity interest in the acquiree in other comprehensive income (for example, because the investment was classified as FVTOCI). If so, the amount that was recognised in other comprehensive income shall be recognised on the same basis as would be required if the acquirer had disposed directly of the previously held equity interest.

Accounting for Business Combination achieved without Transfer of Consideration

Sometimes, a business combination could be achieved without transfer of consideration under certain circumstances as under:

a) The acquiree repurchases a sufficient number of its own shares for an existing investor (the acquirer) to obtain control.

b) Minority *veto* rights lapse that previously kept the acquirer from controlling an acquiree in which the acquirer held the majority voting rights.

c) The acquirer and acquiree agree to combine their businesses by contract alone. The acquirer transfers no consideration in exchange for control of an acquiree and holds no equity interests in the acquiree, either on the acquisition date or previously. Examples of business combinations achieved by contract alone include bringing two businesses together in a ***stapling arrangement*** (discussed below) or forming a dual listed corporation.

A stapling transaction occurs as a result of a contractual arrangement between two or more legal entities, typically without the transfer of consideration, whereby one legal entity issues equity securities that are combined with (or stapled to) the securities issued by one or more other legal entities. The entities each have the same owners, and the stapled securities are quoted as a single price and cannot be traded or transferred independently.

Ind AS is clear that the acquisition method of accounting needs to be followed. The acquirer shall remeasure any previously held equity interest in the acquiree at its acquisition date fair value and recognise any resulting gain or loss in the Profit and Loss Statement. The fair value of the previously held stake is treated as a part of the consideration for measuring goodwill which is somewhat similar to the acquisition achieved in stages, discussed above.

Measurement Period Adjustments

The application of the acquisition method of accounting amongst other matters, involves fair valuation of identifiable assets and liabilities as well as the consideration. This involves significant volume of data and the use of valuation specialists and other professionals and consequential complexities due to which it may not be possible for an acquirer to complete the acquisition method of accounting in a short period of time. To overcome these challenges, Ind AS-103 contains provisions in respect of a ***'measurement period' (which shall not exceed one year from the acquisition date),*** which gives the acquirer reasonable time to complete the accounting.

If due to the above reason, the initial accounting for a business combination is incomplete by the end of the reporting period in which the combination occurs, the acquirer shall report in its financial statements provisional amounts for the items for which the accounting is incomplete. During the measurement period, the acquirer shall retrospectively adjust the provisional amounts recognised at the acquisition date to reflect new information obtained about facts and circumstances that existed as of the acquisition date and, if known, would have affected the measurement of the amounts recognised as of that date. Further, during the measurement period, the acquirer shall also recognise additional assets or liabilities if new information is obtained about facts and circumstances that existed as of the acquisition date and, if known, would have resulted in the recognition of those assets and liabilities as of that date.

The measurement period ends as soon as the acquirer receives the information it was seeking about facts and circumstances that existed as of the acquisition date or learns that more information is not obtainable, subject to the maximum time limit of one year, as specified above. The acquirer recognises an increase (decrease) in the provisional amount recognised for an identifiable asset (liability) by means of a ***decrease (increase) in goodwill***.

During the measurement period, the acquirer shall recognise adjustments to the provisional amounts as if the accounting for the business combination had been completed at the acquisition date. Thus, the acquirer shall ***revise comparative information for prior periods presented in financial statements as needed, including making any change in depreciation, amortisation or other income effects recognised in completing the initial accounting. After the measurement period ends, the acquirer shall revise the accounting for a business combination only to correct an error in accordance with Ind AS-8.***

Acquisition Related Costs

These represent costs incurred by the acquirer to effect a business combination. Examples of such costs include finder's fees, legal, accounting, advisory and valuation fees, other professional fees, general administrative expenses and cost of issuing debt and equity securities.

As per Ind AS-103, these need to be expenses paid off in the period in which they are incurred, except for equity and debt issuance costs which shall be recognised in accordance with Ind AS-32 and 109, respectively.

ACCOUNTING FOR COMMON CONTROL TRANSACTIONS

Appendix C of Ind AS-103 deals with the accounting for business combinations of entities involving common control by using the "pooling of interests" method which is broadly similar to the existing GAAP under AS-14.

The pooling of interest method is to be applied as under:

a) Assets and liabilities of the combining entities have to be recorded at the carrying amounts.

b) No fair value adjustments are permitted.

c) No new assets or liabilities need to be reflected.

d) Adjustments to be made to harmonise accounting policies.

e) Identity of the reserves needs to be preserved. However, the balance of retained earnings appearing in the financial statements of the transferee have to be correspondingly aggregated or may be transferred to General Reserve.

f) Difference in consideration shall be shown as Capital Reserve with a separate disclosure of the nature and purpose thereof.

The consideration for the business combination may consist of securities, cash or other assets. Consideration in the form of securities needs to be recorded at nominal value, whereas consideration of assets other than cash need to be recorded at fair value.

Practical Challenges / Contentious Issues

The application of the pooling of interest method is not without its fair share of challenges or other contentious issues. Some of these are briefly touched upon hereunder:

a) The first question which arises is whether the carrying amount of assets and liabilities of the combining entities should be reflected in the *books of the entities merged or the ultimate parent.* This can be clear with the help of an example. Suppose A Ltd. is the parent having two subsidiaries B Ltd. and C Ltd. Further, consider the following two scenarios:

- **B Ltd. merges with C Ltd.**
- **B Ltd. merges with A Ltd.**

The **Ind AS Transition Facilitation Group (ITFG)** constituted by the ICAI, opined in the first case that in the standalone financial statements of C Ltd., the carrying values of the assets and liabilities as appearing in the financial statements of the entities being combined will be reflected. However, in the second case, it was opined that since B Ltd. is merging with A Ltd., the parent, nothing has changed and the transaction only means that the assets, liabilities and reserves of B Ltd. which are appearing in the consolidated financial statements immediately before the merger would now be part of the standalone financial statements of A Ltd. Accordingly, it would be appropriate to recognise the carrying values pertaining to B Ltd. as appearing in the Consolidated Financial Statements of A Ltd. The standalone financial statements to the extent of the common control transaction will be considered as continuation of the consolidated group.

Though the ITFG views appear to be logical, the Standard is not clear on which carrying values need to be used, a clear accounting policy choice needs to be exercised.

b) The requirement to mandate the use of the pooling of interest method to all common control transactions may not be appropriate when groups enter into the same as a part of their *IPO plans*, whereby post the IPO there could be significant NCI and hence the acquisition method would be more suitable in such situations.

c) It is not clear whether the principles also apply to acquisition of *an associate or joint venture from an entity under common control.*

Appropriate clarifications from the ICAI would be desirable to deal with these and any other similar matters.

TRANSITION ISSUES AND CHALLENGES

As with any Ind AS, Ind AS-103 also presents various alternatives and practical challenges which need to be judiciously exercised. This get further complicated by the requirements to obtain court / NCLT approvals in the Indian context. A brief discussion on the same follows:

Business Combinations prior to the Transition date

In respect of **Ind AS-103** the entity has **three options** as under, to account for business combinations prior to transition, as per the acquisition method on a fair value basis, as provided in Ind AS-101:

a) To restate past business combinations retrospectively; or

b) To restate past business combinations from any other earlier date, in which case, all business combinations after that date would have to be restated; or

c) To apply Ind AS-103 prospectively.

This choice would depend upon whether the necessary data and information is available as also the business rationale of the earlier acquisitions to enable fair values to be attributed to any intangibles especially against any goodwill which is accounted, whose amortisation would need to be reversed and it would need to be tested for impairment annually. Any such decisions could have a significant impact on the consolidated net worth. *Whilst there is no prohibition or restriction on retrospective application, a first time adopter needs to consider whether retrospective application to Ind AS-103 requires extensive use of hindsight, and, if so, it would be advisable to avoid the same beyond a date when the first time adopter can get information to*

apply the same without undue use of hindsight. This is due to the fact that use of hindsight is prohibited under Ind AS-101.

The following are certain other matters which are relevant in the context of the transition, some of which are briefly discussed hereunder:

a) The exemption also applies to past acquisitions of associates, interests in joint ventures and interests in joint operations.

b) When the exemption is availed the classification of the combination as an acquisition, reverse acquisition or pooling of interests does not change.

c) As per Ind AS-101,the first time adopted should recognise all assets and liabilities at the date of transition to Ind AS which were acquired or assumed in a past business combination, except certain financial assets and liabilities which were derecognised. Examples of such items could *be finance leases which are a part of past business combinations which need to be capitalised as per Ind AS-17, but not done as per previous GAAP or contingent liabilities which need to be based on a possible outflow criteria, which was not done as per previous GAAP.*

d) Ind AS-101 provides that as a result of recognition of assets and liabilities as per (c) above, the resultant changes should be adjusted against retained earnings or another category of equity, as appropriate.

e) Any intangible asset recognised under previous GAAP which does not qualify for recognition in accordance with Ind ASs should be reclassified as a part of Goodwill or Capital Reserve. An example could be sales promotion or advertising costs.

f) In case a company decides to adopt Ind AS-103 retrospectively, it needs to remeasure its Property, Plant and Equipment (PPE) which is part of the business combination at fair value even if it uses the deemed cost exemption for PPE provided for in IndAS-101.

Accordingly just because the acquirer company intends to avail of the first time exemption under Ind AS-101 it does not mean that it has to ignore the past business combinations completely since some adjustments may still be warranted.

Impact of Court Schemes on the Transition Date: Apart from the issue of appointed and effective date, there are other issues which may also arise in respect of transactions approved under court schemes on the transition date.

Whilst we have discussed the requirements to obtain auditors certificate confirming the accounting treatment of the court schemes as per the prevailing GAAP, this could have certain unintended consequences.

In this context it needs to be noted that the notification for adoption and implementation of Ind AS states that *Ind ASs, as specified, are intended to be in conformity with the provisions of the applicable law. However, if due to the subsequent amendments to the law, a particular Ind AS is found not to be in conformity with such law, the provisions of the said law would prevail and the financial statements shall be prepared in conformity with such law.* ***However the course of action to be adopted when an Ind AS is not in conformity with the law is not clear.***

One argument could be that court schemes are a part of law and hence the accounting treatment prescribed therein would continue even under Ind AS, subject to the company making appropriate disclosures. However, the other argument could be that with regard to schemes approved under Indian GAAP, the accounting under the same is not relevant for preparing Ind AS financial statements. Pending clarifications by the ICAI and / or the MCA both views seem possible.

As indicated earlier, this could lead to several unintended consequences and choices, as under, which are explained with the help of an example.

Facts of the Case

An acquirer company which is in phase I having a transition date of 1st April, 2015 had made three acquisitions, of which only acquisition 2 which happened in 2010, was under a court sanctioned scheme and hence provided certain accounting concessions as under:

a) Impairment losses for the next 10 years to be adjusted against reserves

b) Indefinite life intangible assets that were correctly recognised under Indian GAAP were the acquiree were written off against reserves.

It may be noted that SEBI at that point of time did not mandate that court schemes should be in accordance with accounting standards.

Let us now consider two separate scenarios:

- **Scenario 1 –** Acquirer does not wish to restate past business combinations.
- **Scenario 2 –** Acquirer wants to restate past business combinations from acquisition 1.

Comments on Scenario 1

There are no specific issues with regard to acquisitions 1 and 3 since they are not part of court approved schemes. However, with regard to acquisition 2 under a court approved scheme, the following two views are possible:

a) The court order would be supreme and hence would apply to both Ind AS and Indian GAAP financial statements.

b) The court scheme is applicable only to Indian GAAP financial statements and hence not relevant and the company may have to recognise the intangible assets under Ind AS as well as adjust future impairment losses against profit and loss.

Comments on Scenario 2

The following three views are possible:

a) The acquirer can restate all three acquisitions. Further, though acquisition 2 was under a court scheme, it can be restated under Ind AS by disregarding accounting concessions given by the court.

b) The acquirer can restate acquisitions 1 and 3. However, acquisition 2 cannot be restated since it is under a court mandated accounting scheme and is in the nature of a law.

c) The acquirer cannot restate acquisition 2 due to (b) above. Due to this, *acquisition 1 is also affected since under Ind AS-101, if a first time adopter restates any business combination prior to the date of transition to comply with Ind AS-103, it must restate all business combinations after that date. Hence the acquirer can only restate acquisition 3.*

Pending clarifications, flexibility is available to the companies to adopt differing practices, subject to adequate disclosures by the Management. This may lead to comparability challenges amongst various stakeholders.

CONCLUSION

The above discussion is just the tip of the ice berg on a topic which is quite complex involving interactions with various internal and external stakeholders and specialists whose conflicting views need to be harnessed with commercial, business, regulatory and legal considerations before the appropriate accounting can be accomplished.

CA Jagruti Sheth

Due diligence in M&A

Eris Lifesciences avails term loan facility of ₹ 400 cr. to finance Strides Shasun deal

Tata Steel to acquire 74% stake in Bhubaneshwar Power

HDFC Life's Merger with Max Life Called off

IDFC-Shriram $12-b merger called off on differences over swap ratio

RIL may acquire Den Networks

Lupin acquires Symbiomix Therapeutics for $150 mn cash

Idea-Voda merger on track for completion: Vodafone India, CEO

Rcom calls off merger deal with Aircel[1]

Was the deal making or deal breaking mentioned herein – purely a result of negotiations between business houses or there is some basis on which these decisions were taken?

Basically, when two companies decide to come together by combining their operations into one, it is called merger and when one company acquires another company, it is an acquisition.

Key Elements to decide before acquisition

Coming together of any two entities is like matching of minds in terms every part related to business and therefore it requires critical evaluation of various elements. Every sector of economy has different underlying deal drivers for consideration. Following are few critical factors which has bearing across the sectors for M & A:

- **Strategic alliance**

Major alliances' motive is to expand the main activities in which an entity is engaged into. Any combination would look for an organisation which not only gives itself the benefit of elimination of overlapping activities and cost effectiveness but also brings in the benefit of effective competitiveness, strategy, opportunity to expand product offering, geographical expansion, penetration into new market, organisational culture and leadership style which can be achieved by forward or backward integration. For example, Google acquired EBook Technologies in early 2011 to expand into the electronic reader market, a natural extension of its project to scan books electronically.

- **Synergistic benefits**

Synergies comes not only from cost savings and revenue upstreaming but also from other economic benefits such as integration of operations, human resources, common functional

1. ***Extracts from news articles from various newspapers and web links***

units like accounting, finances, investor relationship, integration of compliances and more streamlined executive structures.

- **Talent pool**

When Google and EBook or software maker Oracle and hardware vendor Sun Microsystems merged, the merged entities gained access to experienced engineers, research expertise, copyrights and patents. Merger of valuable human resource talent is one of the major reasons for alliance in service sector.

- **Increased market share and benefits of Intellectual Property**

Open economy with itself has also brought in fierce competition amongst the players in industry and to protect market share of the similar products, to take benefit of intellectual properties like brands, trademarks, etc. Acquirers look for alliance which can avail the benefits of branding and customer's acceptance towards new, larger canvas.

- **Strengths and Weaknesses**

To determine the viability of M & A, one always needs to understand the strengths and weaknesses of potential target which would bring on table say, larger fund-raising potential or attractiveness to bring in capital, strong financials, technological advancement, niche products and market are some of the factors which brings in motivated parties to join together.

- **Cultural ties**

In any acquisitions culture under which the organisations operate is very important to evaluate as unless the cultures are adoptive enough, the results would not be as desired for which the acquisitions were contemplated.

Though success of any merger or acquisitions depends upon numeral factors, the very critical factor for any deal to sail through is creation of trust which is outcome of the process undertaken between an initial agreement (memorandum of understanding) and execution of definitive documents (merger agreement) called "due diligence". Due Diligence in a nutshell is the internal review of the Target vis-à-vis external factors affecting transaction with the target.

What is Due Diligence (DD)?

The concept of due diligence has its origin set under the American Securities laws which imposed stringent criminal liabilities on the issuer, brokers and dealers of securities for securities being issued to public excepting liabilities which are reasonably and materially disclosed and the issuer has taken the responsibility towards such liabilities. Such standard care being taken by brokers, dealers and underwriters was termed as due diligence and soon it became the art, the concept attached from very beginning for the transaction between strangers and even familiar parties.

DD is basically common sense coupled with a reasonable degree of skepticism. DD aims at creating a stronger relationship based on the analysis and investigation of information, processes, documentation, finances, market, etc. of the target so as to form a reasonable opinion on target which allows the alliance to sail through in spite of some rocky patches about which the investor/acquirer is well aware of and can pre-plan on the way ahead and also take indemnities from the target in case of eventualities.

Black's law dictionary defines due diligence as *"A measure of prudence or assiduity, as is properly to be expected from, and ordinarily exercised by, a reasonable and prudent man under the particular circumstances".*

Legal dictionary defines the word due diligence as

1. *reasonable care and caution exercised by a person who is buying, selling, giving professional advice, etc., especially as required by law to protect against incurring liability*

2. the process of gathering or disclosing relevant and reliable information about a prospective sale, purchase, contract, etc.

DD is the process of determining whether representations (legal, financial and otherwise) made by target are true; and whether the assumptions used by the acquirer for its proposed bid are reasonable. The purpose of DD is to uncover weaknesses or uncertainties that might prevent the transaction from meeting a acquirer's desired goals. In today's environment, companies that are considering a merger or acquisition must devote considerable time and energy to performing due diligence.

Accordingly, due diligence i.e. verification of information and forming an opinion on the target, <u>whether buy-side or sell-side</u>, can be bifurcated into following major baskets by its functions:

Financial due diligence (FDD)

Whether it is mergers, acquisitions, investments, strategic buy-outs or private placement, potential investors/acquirers would always feel comfortable when their target is audited. Reliance, purely on the audited financial statement of the target (which may not identify significant issues likely to be of interest to an acquirer or target) may prove fatal unless the financials of the target has been re-verified for clarity and conscience of commercial understanding between the parties which would provide assurance that the target meets the truth reflected by such re-verification. The first step towards such assurance building runs through financial position of the target i.e. financial due diligence.

FDD includes assessing the key issues facing the business, understanding of key drivers behind revenue and margins, assessing free cash flows in the business, identifying the key financial risks and potential deal breakers in the transaction. This is a business-oriented fact gathering exercise with a focused analysis based on level of comfort of the parties, of available information and not only accounting analysis. It involves in depth analysis into the following:

Analysis parameters	**Results of analysis**
Financial statements	Understanding the financial performance for the historical period and reasons driving the company's performance. This is achieved by trending of key revenue and expenses for the historical period.
Accounting Standards	During DD process, it often becomes apparent that the target has failed to comply with at least some Accounting Standards (for various reasons). Typical examples include the Target recognising revenue incorrectly (this is more likely if the target has multiple revenue streams and/or long-term contracts with stage payments spanning accounting years). From an M&A perspective, it is very likely that there will be differences between the Accounting Standards adopted by the acquirer and those of the target (such differences may be more pronounced if the transaction is cross-border and where there are two (or more) accounting conventions being considered (for instance, Indian versus US GAAP).
Actual earnings and quality of earnings (extra-ordinary incomes and expenses, major factors for sustainable earnings)	Investors would be more focused on fair valuation of the business based on multiple of earnings before interest, taxes, depreciation and amortisation (EBITDA) subject to the adjustments arising out of unusual or non-recurring income and expense items, over/understated assets and liabilities, cost structure changes -post-closing and the inconsistent application of accounting principles. Such adjusted EBITDA would reflect some indicative sustainable earnings. The sustainability of a entity's EBITDA is not reflected in a standard audit report.
Financial projections	Key assumptions used in management's forecast which may generate sustainable growth. Once the DD team has grasped any historical trends/norms, they should consider the connection between actual historical results and budget/forecast to gauge the accuracy and reasonableness of the target's budgets/forecasts. For instance, if the target has forecast for revenue growth and/or margin increases, how successful has it been at achieving this performance in the past? A review of the constituents of any projected revenue growth should be carried out to ascertain if growth is dependent on key customers, as an example.
Cash flow generators	To analyse the cash flow generated from financial activities, commercial activities or investments activities.
Capital expenditure	Trend of capital expenditure by the target in past and to quantify/substantiate the future infusion in capital expenditure based on the financial projections
Working capital	The amount of working capital needed for business is generally determined based on historical working capital needs and projected requirements based on financial projections. However, one may also consider (i) recent growth trends, (ii) industry conditions, (iii) the seasonality of the business, and (iv) the specific composition of working capital balances.

Analysis parameters	Results of analysis
Related party transaction	Problematic related party transactions are often uncovered during the DD process – the crux of the matter here is non-commercial transactions which could not be arm's length (or fair value). For instance, it should be determined whether the target makes sales to other entities within a group. If intra-group sales are made, are these at higher margins than usual? Conversely, if intra-group purchases are made, are these at lower rates (therefore improving margins)? The balance sheet of the Target may show loans due to/from related parties. A review of payables and receivables will reveal the parties these amounts are due to/from and whether the balance sheet is "inflated" due to related party transactions.
Management Information System (MIS) and control environment	MIS and control environment plays an important role in due diligence. MIS assists in understanding how Management views business. These are numbers beyond financial statements and provides actual drivers of the business.
Employment issues	In case of manufacturing units there could be labour unions who could negotiate a better deal should there be change in ownership. Ensuring that the company has adequate provisions for employee benefits as required by local laws. Understanding the terms of agreement if there are any Golden Parachutes in the agreement.
Legal and professional expenditure of substantial nature	Analyses of legal expenses helps understanding whom these expenses are being paid to and for what reasons. Are there payments to lawyers for some legal cases which are not captured in contingent liabilities? Are settlement done and reasons for the same, etc.
Commitments and contingent liabilities	Commitments and contingent liabilities that might endanger financial performance or otherwise adversely affect the target's financial position after the transaction.

Result of FDD

FDD brings out the following results which needs consideration from parties

- Misrepresentation in financial statements and non-compliance with acceptable Accounting Standards/practice, mis-stated accounts
- Misrepresentation on business performance by Management
- Valuations and price
- Funding (bank financing) and conditions relating thereto
- Lack of preparation by the vendor
- False projections about the business

Tax due diligence (TDD)

Tax whether past or present or future is the base for any corporate restructuring, mergers and acquisitions or deals' decision-making exercise, though sometimes taxation is sub-sided in light of financials and commercial due diligence. Growing complexities in direct and indirect tax structure and changes over the years from State and Central Taxes to Value Added Tax to Goods and Services Tax,

applicability to global taxation in case of multinational operations, etc. needs detailing to unearth significant tax exposure post-merger or acquisition which will help the acquirer to take informed decision.

Completing any mergers or acquisition means managing tax – whether direct or indirect. Identified tax risks can have a significant impact on the market value of the target and might constitute a crucial argument in price negotiation process.

TDD aims at analysing

- the target's tax treatment in respect of its compliance with tax regulations;
- level of corporate and other taxes paid, refund due;
- compliance with tax under different regulatory wherever applicable;
- global and Indian tax and history of appeals and proceedings – history of tax settlements completed along with judicial pronouncements vis-à-vis ongoing matters;
- validating representations made by target
- validating the assumption made by acquirer in valuing the target;
- any potential tax risks;
- identifying any material upside;
- any aggressive tax positions considered.

Depending upon the type of entity the target is i.e. whether partnership firm, limited liability partnership or company, type of industry – service or manufacturing or trading entity, the following applicable taxes needs to be evaluated

- income tax. Where target companies have either foreign subsidiaries or foreign parents, TDD may include a review of transfer pricing and foreign tax credit issues;
- indirect taxes including but not limited to customs duty, state sales tax and central sale tax, service tax, value added tax, goods and services tax, import duty;
- payroll and employment taxes;
- levies, duties and cess;
- property taxes;
- unclaimed and abandoned property (escheatment);
- estate duty;
- domestic transfer pricing if related party transactions;
- such other specific taxes as may be applicable

The general process for TDD generally requires running through various tax returns filed including status of assessments, notices and replies for all types of taxes for as many past years as may be found appropriate by the acquirer. One also needs to undertake study of non-tax documents, making inquiries with management and its tax consultants and advisors to understand the status of potential tax liabilities which the target may attract in future. Reading non-tax documents like minutes of corporate and board meetings, members' meetings, financial statements and related notes thereto, contracts and agreements, prior structuring exercises already undertaken and any tax dues arising therefrom, ownership changes and effects thereto.

Results of TDD

This tax and non-tax study helps to understand

- the tax position of the target;

- target's ability to absorb the carried forward losses if any to be adjusted against future profits;
- differed compensation and credits in form of Minimum Alternate Tax or Alternative Minimum Tax;
- interest and penalties levied or potential applicability;
- identifying any material upside;
- potential tax benefits not claimed by target;
- structuring deal in a tax efficient manner;
- suggesting tax efficient structures.

TDD is also required to understand the structuring of transaction and potential tax upon transaction between the same group entities or related parties, whether through asset sale or slump sale or acquisition or scheme-based acquisition. As long as the acquirer and target are unrelated parties dealing at arm's length and the fair market value is the base of valuation, there should not be any significant risk of historical tax liability accruing to the acquirer.

Legal due diligence (LDD)

Though very widely used in the deal world, the term "legal due diligence" is not defined under the Indian laws. There is famous latin maxim used in legal language "caveat emptor" meaning "buyer be aware" and "Ignorantia juris non excusat, Ignorantia Facti Excusat" meaning "Ignorance of law can't be pardoned but ignorance of fact can be pardoned". Hence it is important to understand legal position of the target.

Another crucial verification is to understand the legal position for various matters which may affect the transaction, for example to ensure that an intellectual property claimed to be held by the target and are crucial to the future success of the company are legally tenable and usable.

Coupled with LDD is must to see, immovable properties transaction and ownership or leasehold rights of the same in the name of target. LDD provides for the risks associated with legality of entity and its contracts, properties, approvals, licences, find lacunae or liabilities which the entity or assets carry and analyse them so as to enable the acquirer to take informed decision and to arrive at proper valuation and minimise the risks associated with the transaction. This is because ultimately post the transaction, if the liabilities or lacunae is noticed giving rise to negative scenarios, it is the acquirer who is at loss and in some situation of 100% buyouts, may not even have any recourse to recover losses of such surprises. It is therefore in the best interest of an individual or a business establishment interested in either merging, partnering with or acquiring another business entity, or in acquiring an immovable property, that it exercises due care by carrying out a detailed LDD of such target or its immovable property.

LDD depends upon what the acquirer intends to achieve under M&A i.e., the acquirer needs to be focused on the scope of transaction. For e.g., whether the intention is to acquire all business operations, whether target has movable and/or immovable assets and such assets are to be acquired or not and whether they are legally movable or not, whether business synergies require human resources or such other immovable properties as are used by the target and whether the same can be part of transaction or not.

Once the objectives and commercials are decided, LDD is customised to evaluate asset and documents. Listed below are some of the important issues that an individual or an organisation would need to consider when merging, acquiring, or subscribing to the shares of a target or whilst acquiring an immovable property.

- legal structure and validity of the structure;
- investigation into the history of ownership of the target entity;
- compliance with various provisions of law as may be amended from time-to-time;
- applicability and compliance with various other statutory requirements such as labour laws, environmental laws, industrial laws, employees related laws, etc. *vis-à-vis* registrations under them;
- for an entity whose securities are listed, compliance with rules and regulations of such exchanges and its governing bodies e.g., in India compliance with rules and regulations of Securities and Exchange Board of India including listing agreements of the stock exchanges;
- secretarial compliances under corporate laws;
- investigation into immovable property which forms part of the transaction. These involve title search, verification of charge and encumbrances on the property, charges filed with registrar of companies, property records of municipal corporations of the State (e.g 7/12 extract in Maharashtra), construction whether approved or unauthorised, etc.;
- investigation into human resource and intellectual properties and its commercial worth for the transaction;
- terms and conditions of various contracts, loans, liabilities, which may have impeding effect;
- pending litigation with respect to suits filed by and/or against the target and potential consequences thereto. One can also scrutinise the target with respect to potential contingent situations giving rise to asset or liabilities

Results of LDD

The results of LDD provides for the following:

– Confirmation of the ownership of property – physical verification *vis-à-vis* documentary evidence

– Flaws in ownership structure if any

– Compoundable and non-compoundable non-compliances

– Potential liabilities arising from non-compliances on the entity and its promoters

– Legality of proposed structure post-transaction

– Coverage of litigation/ potential liabilities – through Indemnities or through hold back from transaction amounts

– Earlier investments. M & A deals and conditions attached thereto

– Non-acceptable conditions of assets and facilities

– Positions of approvals and licences, etc.

Commercial due diligence (CDD)

Business Dictionary defines the term "Commerce" as exchange of goods or services for a price, usually on a scale large enough to require transportation from place to place or across city, State or national boundaries. Commerce means trade – any activity undertaken with an intention to earn profits. The basics of any commercial activity is generation of profits. Hence CDD is the process to decide on the basic fundamental of the business whether to invest in to the target in light of future performance analysis. Generally, CDD goes hand-in-hand with FDD. CDD is the process a corporation or private equity firm undertakes to gauge a company's commercial attractiveness. Unlike FDD, which focuses primarily on the financial health of the

company, CDD provides a full overview of the target's internal and external environment.

CDD considers the market in which a business sits, for example involving conversations with customers, an assessment of competitors and a fuller analysis of the assumptions that lie behind the business plan. All of this is intended to determine whether the business plan stands up to the realities of the market. Its aims at analysing key market drivers, sales strategies, customer relationships and customer churn and attempt to understand whether the trends reflected in the financials are sustainable.

Ultimately, CDD helps the acquirer to increase the success rate of the future merger or integration process. CDD generally takes place during valuation phase prior to actual deal.

CDD at minimum would require to analyse the following:

- **Company:** Look at the strategy for development of product and portfolio, target's driving products and/or services, its capabilities for expansion (growth strategy and capabilities), the attractiveness and sustainability of the target's business model, revenue streams (e.g. Kingfisher Airlines), cost and revenue model supported by historical data, future cash flows and financial forecasts, profit drivers. The gatherings from above would determine the target's revenue drives, past revenue and future maintainability of revenue.

- **Market:** Under CDD market plays a very important role for any deal. By analysing the market, it means to verify market size and growth for the products or services of target, position of the product in market, future sustainability of the product, competition, customers etc. (e.g. Nokia, Kodak, Whatsapp, Amazon), segmentation of market along with its size and growth, key product indicators, suppliers and distribution network, technological advancement, potential threats and opportunities.

- **Competition:** Though competition is one of the parameters of market analysis, it has its own niche requirements. One needs to analyse competitive intensity and target's position in the market, level of customers, new avenues and prospective.

- **Customers:** Verification of customers is very important to understand the product demand. Customers segmentation in the market and price which the customer is willing to pay for the product and services, adaptation of product and services amongst customers, purchasing power, purchasing behaviour and trends.

Results of CDD

CDD report analyses target's performance, the likelihood that the business will meet its targets, and highlights potential problems that may occur as a result of an acquisition, base case, upside case, downside case, potential challenges and risks to achieve projections, sustainability of projections, points to consider for exit options, etc.

This report provides the potential acquirer with in-depth knowledge of the target and the market in which it is positioned. It is designed to enable the prospective acquirer to make an informed decision and highlight any potential risks associated with the target's business.

Typically, CDD can address the following issues:

- Market mapping, segmentation and sizing

- Demand drivers and key purchase criteria

- Customer portfolio development and customer referencing
- Market positioning, business performance and sustainability of strategy
- Industry dynamics and competitor behaviour
- Pricing and margins including projection sensitivities
- Revenue and gross margin modelling.

Indemnity to be taken for major diligence red flags

The issues arising of due diligence could results in case of extreme case result in to deal-breaker but case otherwise would result into appropriate adjustments to the pricing/ valuation or into an indemnity/ warranty or into escrow mechanism or fulfilment of conditions. Indemnity i.e., to cover up for potential challenges which may arise from transaction, one needs to understand, what are red flags arising from DD report. It is a general practice in any deal to make the target and its management responsible to make good the losses which may arise in future and which relates back to the past for such nature of transactions as mentioned below

- Potential tax liability
- Potential employee/creditor's claims arising from litigation
- Undisclosed liabilities which are not forming part of DD process or which could not be identified
- Indemnity arising from contractual obligations
- Freezing valuation based on future profits and cost estimates

Decide materiality and proceed with / drop the deal

Based on the results of various DD being undertaken by the acquirer, the materiality of such result would decide whether the results are negotiable to proceed with or are non-negotiable which results in deal breaker. If the transaction can be moved ahead with indemnities, conditions precedent or subsequent to deal and adjustments to valuations, the deal may sail through.

Few sample which a deal driver or deal breaker can be, are

Result of DD	Type of DD	Decisive factor
Industry leader opening a plant nearby	CDD	Go/No-go
Majority of the sales being institutional or Government driven	CDD	Valuation
Significant indirect/Direct tax benefits due to expire in near future	TDD	Valuation
Various Tax Litigations	TDD	Valuation / Indemnities /Escrow
Acquisition of target leading to significant market share in the region	CDD/LDD	Go/No-go/Future course of action
Dispute title to land /Factory Building	LDD	Go/No-go

Some other factors which may be considered are

- Fraudulent transactions
- Theoretical Valuations and practical price based on future benefits
- Change in Law
- Cultural issues or personal deal breakers
- Lack of preparation by the vendor
- Personal relationship with the business
- Reputation in market of target and its management and future potential in the business *vis-à-vis* current capacity utilisation
- Balance reserves or capacity utilisation
- Negotiation behaviour
- Lack of clarity on future integration

Conclusion/Practical insight

If one looks back due diligence has been always helpful not only pre-transaction but also to find out underlying truth of executed deal whether with large group of people or individually

– Look at sub-prime crises of 2008, which unearthed Bank of America's acquisition of Countrywide Financial for about $4 billion

– Dai-Ichi Sankyo and Ranbaxy deal-wherein initially Dai-Ichi Sankyo paid for Ranbaxy $4.6 billion for 63% of its shares. However later wrote down the acquisition's value by $3.6 billion as it failed to evaluate investigations made by the US Foods and Drugs Administration (FDA) more than a small risk factor.

DD is of utmost importance and it cannot be emphasised enough that most deals fail due to nothing more than inadequacy of DD or over-confidence of acquirer due to which the acquirer ends up overpaying or experiencing major integration problems or assuming unknown liabilities.

Disclaimer

Though the language of this article may seem as buy-side due diligence, the same also stands true of sell-side due diligence.

The views expressed in this article is just to bring to the notice of the readers the importance of conducting due diligences in certain transactions and to give a brief overview of the issues to be looked into before undertaking such transaction. The above information / suggestions / guidelines / tips are generic in nature and should not be acted upon unless a professionally qualified consultant has examined the requirements of the transaction and has advised upon his findings.

Further the author shall not be held responsible or liable for any losses or damages (direct, indirect, punitive, incidental, special, consequential damages or any damages whatsoever including, without limitation, damages for loss of use, data or profits and irrespective of whether it is based on contract, tort, negligence, strict liability or otherwise, even if we have been advised of the possibility of damages) caused to any person or entity on account of such person or entity acting upon the information provided in this article without seeking the advice of a professionally qualified consultant.

> Test everything, try everything, and then believe it, and if you find it for the good of many, give it to all.
>
> — *Swami Vivekananda*

CS Vijay Shah & CS Mayur Shah

Takeover Regulations in M&A

Introduction

Across the globe, the jurisprudence of Takeover Regulations revolves around offering an exit opportunity to some extent to public/ minority shareholders of a company in the event of any substantial change in shareholding or change in control of the company.

Securities and Exchange Board of India (SEBI) had initially enacted Takeover Regulations in 1994 which were superseded by new Takeover Regulations in 1997.

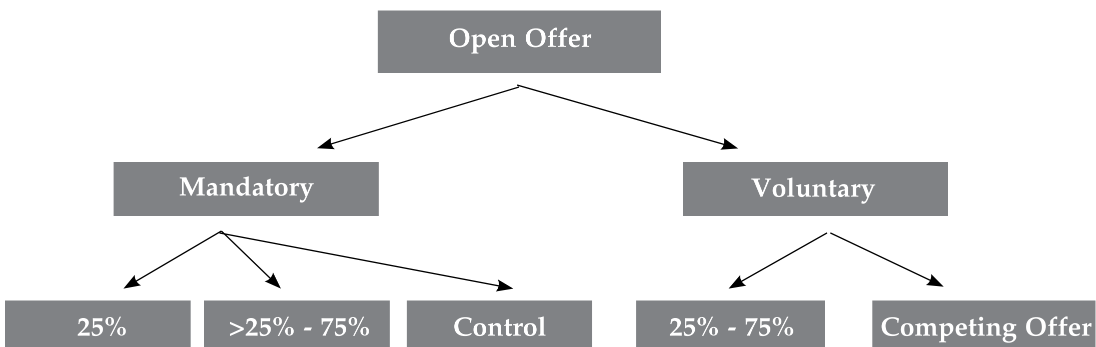
During September 2011, based on Takeover Regulations Advisory Committee, chaired by late C. Achuthan (former Presiding Officer of Securities Appellate Tribunal), SEBI released revamped SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011 (Takeover Regulations) to facilitate inorganic business growth, especially through easier and faster processes and increased measures for transparency and governance.

The Takeover Regulations govern any direct or indirect acquisition of equity shares with voting rights (shares) or securities with voting rights or control in a Target Company (TC), being a company whose shares are listed on a recognised Stock Exchange (SE). Any acquisition of securities by acquirers which enables to exercise voting rights in the TC, including shares underlying depository receipts are covered by the provisions of the Takeover Regulations.

This article seeks to provide insights on key aspects of the Takeover Regulations:

Triggers for making an open offer to public shareholders of TC

Open offer can be either mandatory or voluntary. Let us examine the various cases which can trigger making an open offer:



A. Mandatory open offer

Takeover Regulations provide the triggering events on the happening of which the acquirer is required to make an open offer to the shareholders of the TC. The triggering event may be signing of Share Purchase Agreement with the promoters or actual acquisition of shares from the market or passing of special resolution by the TC for preferential allotment of securities etc. Thus, as soon as the intention of the acquirer to acquire the shares/voting rights/control of TC beyond the prescribed threshold limits mentioned in the regulations is established, the acquirer is required to make an open offer to the shareholders of the TC. There are, however, certain exemptions contained in Regulation 10 of Takeover Regulations.

Open offer made under Takeover Regulations shall be made to all shareholders of the TC, other than the acquirer, persons acting in concert (PACs) with him and the parties to any underlying agreement including persons deemed to be acting in concert with such parties, for the sale of shares of the TC. PAC is defined under the Takeover Regulations as the persons with common objective or purpose of acquisition of shares or voting rights in, or exercising control over a TC. Takeover Regulations mentions certain categories of persons which shall be deemed to be PAC.

Regulation 3 provides specific limits beyond which the acquirer(s) is required to come out with an open offer in accordance with these Regulations.

1. Initial Threshold Limit (25%)

When an acquirer together with one or more persons acting in concert intends to acquire shares or voting rights which along with the existing shareholding would entitle him to exercise 25% or more of the voting rights in the TC, the acquirer is required to make a public announcement to acquire at least additional 26% of the voting rights of TC from the shareholders through an open offer.

2. Creeping Acquisition (25%-75%)

Regulation 3(2) allows the persons either by themselves or through PAC with them who are already holding more than 25% but less than 75% shares or voting rights in the TC, to acquire further up to 5% shares or voting rights in the financial year (April-March).

When such further acquisition is more than 5% shares or voting rights in the financial year, the acquirer is required to make an open offer for additional acquisition of at least 26% of the voting rights of TC from the shareholders. This trigger to make open offer is also referred as Consolidation Trigger.

However, it is to be noted that the creeping acquisition limit is subject to the condition that the post-acquisition shareholding of the acquirer does not exceed the maximum permissible non-public shareholding in TC which is 75%.

For purposes of determining the quantum of acquisition of additional shares or voting rights, it is important to note that:

- the limit of 5% shall be calculated by aggregating all the purchases without netting the sales;
- in the case of acquisition of shares by way of issue of new shares, the difference between the pre-allotment and the post-allotment percentage voting rights shall be regarded as the quantum of additional acquisition.

3. Control

When an acquirer acquires 'control' directly or indirectly over the TC, irrespective of acquisition or holding of shares or voting rights in such a TC, the acquirer is required to make an open offer for additional acquisition of at least 26% of the voting rights of TC from the shareholders.

Regulation 2(1)(e) of Takeover Regulations defines Control which includes the right to appoint majority of the directors or to control the management or policy decisions exercisable by a person or persons acting individually or along with PAC, directly or indirectly, including

by virtue of their shareholding or management rights or shareholders agreements or voting agreements or in any other manner:

Provided that a director or officer of a TC shall not be considered to be in control over such TC, merely by virtue of holding such position.

Since the test for control is not defined by an objective shareholding threshold, acquisition of control is to be determined on a case-to-case basis.

In 2016, SEBI had issued a Discussion Paper on "Bright-line Tests for Acquisition of Control under SEBI Takeover Regulations" and had proposed two options-framework for determining control based on protective rights and adoption of numerical threshold. The test is to check whether the acquirer is in the driving seat. For numerical threshold, it had proposed to fix 25% voting rights as threshold lever for trigger of control for Indian listed companies.

SEBI after considering comments received from stakeholders and regulatory authorities, issued a press release in recent past to continue with the practice of ascertaining acquisition of 'control' as per the extant definition in the Takeover Regulations and no further amendment is proposed.

Indirect acquisition

An indirect acquisition is a situation where the acquirer acquires the ability to exercise or direct the exercise of such percentage of voting rights in, or control over any company that would enable such acquirer to exercise or direct the exercise of such percentage of voting rights in, or control over the TC that would trigger the initial, consolidation or control triggers described above to make an open offer subject to prescribed exemptions.

B. Voluntary open offer

It refers to the open offer made by the acquirer voluntarily without triggering the mandatory open offer obligations.

1. Acquirer already holding 25%-75% in TC

Regulation 6 of Takeover Regulations deals with voluntary open offer and provides the eligibility, conditions and restrictions. Let us go through each one of them in brief:

Eligibility:

- Acquirer along with PACs should be holding not less than 25% shares or voting rights in the TC prior to making voluntary open offer.
- The Acquirer or PACs should not have acquired any shares of the TC in the preceding 52 weeks without attracting the open offer obligation.

Conditions for making voluntary open offer:

- Minimum offer size is 10% of the total shares of the TC subject to an aggregate shareholding after completion of the open offer should not exceed beyond the maximum permissible non-public shareholding i.e. not more than 75%.
- No acquisition during the offer period except under the voluntary open offer.

Restrictions:

The acquirer becomes ineligible to acquire further shares for a period of six months after the completion of open offer except by way of:

- Another voluntary open offer;
- Acquisitions by making a competing offer.

The shares acquired through bonus issue or stock splits shall not be considered for purposes of the dis-entitlement.

2. Competing Offer

The term Competing Offer refers to an offer given by any other person (Competing Acquirer) after an offer that has already been given by an acquirer to the shareholders of the TC.

As per Regulation 20(1) of the Takeover Regulations, upon public announcement of an open offer for acquiring shares of a TC being made, any person, other than the acquirer who has made such public announcement, shall be entitled to make a public announcement of an competing open offer within 15 working days of the date of the Detailed Public Statement (DPS)

issued by the acquirer who has made the first public announcement

Such Competing Offer shall be for such number of shares which, when taken together with shares held by such acquirer along with PACs with him, shall be at least equal to the holding of the acquirer who has made the first public announcement, including the number of shares proposed to be acquired by him under the offer and any underlying agreement for the sale of shares of the TC pursuant to which the open offer is made.

Withdrawal of Tender Offers

The Takeover Regulations permit an acquirer to withdraw a tender offer in certain circumstances such as:

- Denial of statutory approvals
- The acquirer, being a natural person, has died
- Any condition of an agreement triggering open offer cannot be met beyond reasonable control of the acquirer
- SEBI at its discretion permitting the withdrawal at request of acquirer.

Prescribed disclosures are required to be made by an acquirer in order to withdraw open offer on the aforementioned grounds.

Exemptions

Regulation 10 of the Takeover Regulations specifies the acquisitions which are exempt from the obligation to make an open offer, subject to conditions. Some transactions are exempt from the initial, consolidation and control triggers, whereas others are only exempt from the consolidation trigger. However, in order to avail certain exemptions, an acquirer shall give an intimation to the TC in prescribed manner and prescribed time, and the exchange shall disseminate the information to public.

Further, for any exemption provided under the Takeover Regulations, the acquirer shall file a report with the SEs where the shares of the TC are listed, within 4 working days from the acquisition, and the SEs shall disseminate such information to the public immediately.

In respect of any acquisition of shares or increase in voting rights pursuant to certain exemptions provided under the Takeover Regulations such as *inter se* transfer, buy-back, rights issue, acquisition from Venture Capital Fund (VCF) / category-I Alternative Investment Fund (Cat-I AIF)/ Foreign Venture Capital Investor (FVCI) etc., the acquirer shall submit a report along with the supporting documents to SEBI giving all details in respect of acquisitions along with a non-refundable fee of ₹ 1,50,000 within 21 working days from the date of acquisition.

Some of the critical exemptions from M&A perspective are as under:

- Acquisition pursuant to *inter se* transfer of shares among qualifying persons. List of qualifying persons include:
  a. Immediate relatives;
  b. Persons named as promoters in the shareholding pattern filed by the TC for not less than 3 years
  c. PAC for not less than 3 years and disclosed to stock exchange
  d. Specified ensemble of persons or entities etc.
- Acquisition pursuant to a scheme –
  a. of arrangement involving TC or reconstruction of the TC including amalgamation, merger, de-merger pursuant to an order of court or an authority whether Indian or foreign
  b. of arrangement not directly involving TC or reconstruction not involving TC's undertaking including amalgamation, merger, de-merger pursuant to an order of court or an authority whether Indian or foreign.

  This exemption is subject to the following specific conditions viz:

i. Cash and cash equivalent paid is less than 25% of the consideration paid; and

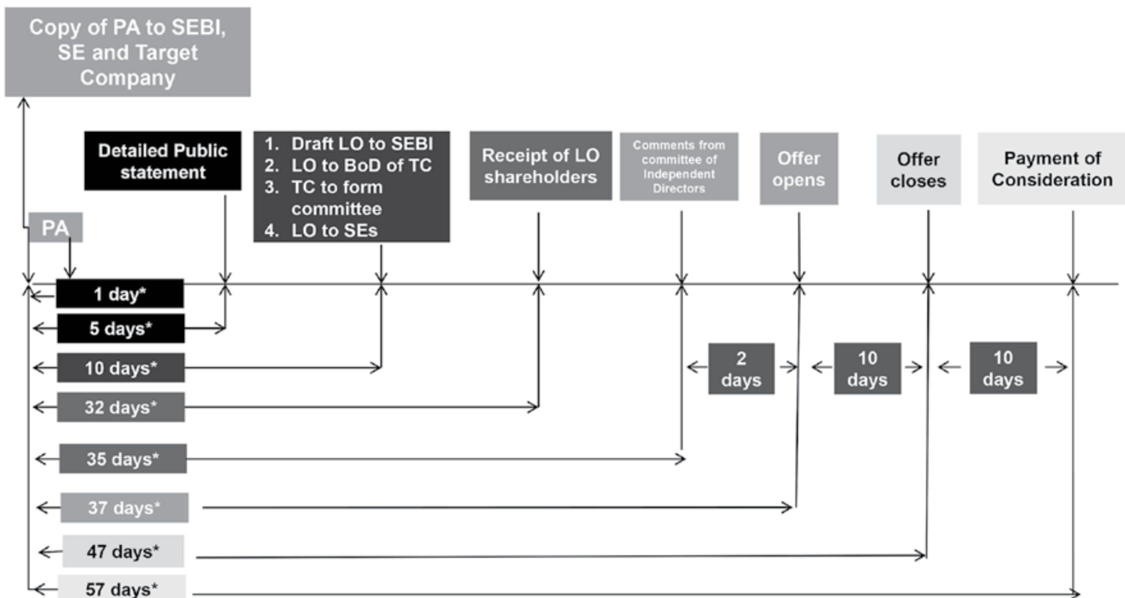
ii. After the implementation of the scheme, the persons holding minimum 33% of the voting rights in the combined entity are the same persons who held the entire voting rights before the implementation of the scheme.

- An increase in voting rights in a TC pursuant to buy-back of shares by the TC which necessitate making an open offer shall be exempt provided such shareholder reduces his shareholding so that the voting rights fall below the threshold within 90 days from the date of closure of the said buy back offer.
- Acquisition of shares by any person in the TC in exchange for shares of another TC pursuant to an open offer.
- Acquisition of shares from state level financial institution or their subsidiaries or companies promoted by them, by promoters of the target company pursuant to an agreement between such transferors and such promoter.
- Resolution plan wherein the Adjudicating Authority i.e. National Company Law Tribunal is satisfied that the resolution plan has been approved by the committee of creditors as per section 31 of the Insolvency and Bankruptcy Code, 2016.
- Acquisition of shares in a TC from a VCF or Cat. I AIF or a FVCI investor registered with SEBI, by promoters of the TC pursuant to an agreement between such investor and promoters.

Steps for Open Offer

A diagrammatic presentation of the brief steps to be followed in case of an open offer is illustrated hereunder:

Open Offer Process



Start date: Public announcement
Timeline is considering working days
*Maximum time allowed under the Regulations, assuming SEBI has not sought any clarification from acquirer.

It would be pertinent to note that the recommendations have to be given by the committee of Independent Directors of TC on the open offer to the shareholders of the TC which is also published in newspapers and provide to the SEBI not less than 2 days before Open Offer plays critical role to protect interest of shareholders of the TC.

Informal Guidance, Scheme of SEBI

Under the SEBI (Informal Guidance) Scheme, 2003 (Scheme), selected class of persons such as SEBI-registered intermediary, listed company, Mutual Fund Trustee and acquirer / proposed acquirer under Takeover Regulations can seek SEBI informal guidance in form of No-action letters or Interpretive letters.

Let us examine a couple of interesting informal guidance obtained from SEBI under the Takeover Regulations based on publicly available information at SEBI's portal.

Case 1

Facts of the case

The equity shares of KJMC Financial Services Limited (TC) are listed on BSE Limited (BSE) and the TC proposed to issue total of 5,00,000 equity shares of face value ₹ 10/- each, on private placement basis to the promoter and promoter group entities i.e. KJMC Corporate Advisors (India) Limited (KJMC CAIL), KJMC Shares and Securities Limited (KJMC SSL) and KJMC Capital Market Services Limited (KJMC CMSL) are wholly-owned subsidiaries of KJMC CAIL.

Key facts based on pre-issue and post-issue shareholding pattern as on 31st December 2016 are as under:

- o Post subscription/acquisition of total of 5,00,000 equity shares of the TC by KJMC CAIL, KJMC SSL and KJMC CMSL through the proposed private placement offer, the total promoter and promoter group shareholding in the equity share capital of the TC would increase from 69.10% to 72.02% (increased by 2.92%)
- o The total increase in the promoter and promoter group shareholding in the financial year 2016-17 would be from 67.03% (as on 31st March 2016) to 72.02% (increased by 4.99%) of the TC. The aggregate shareholding of the promoter and promoter group would not exceed 5% in a financial year, and
- o The post issue aggregate shareholding of KJMC CAIL, KJMC SSL and KJMC CMSL has increased from 24.97% to 32.06% which is in excess of 5%.

Based on the above, the TC sought an informal guidance that, KJMC CAIL, KJMC SSL and KJMC CMSL, currently holds in aggregate 24.97% of equity share capital of the TC but after the proposed acquisition of 5,00,000 equity shares in the TC their equity shareholding in aggregate will increase to 32.06% of resultant equity share capital of the TC. Whether the proposed acquisition of 5,00,000 equity shares in the TC will trigger the open offer under Regulation 3(3) or 4 of the Takeover Regulations i.e., will it attract the obligation to make an open offer for acquiring shares of the TC as there is a change in the aggregate shareholding of KJMC CAIL, KJMC SSL and KJMC CMSL in excess of 5% of creeping acquisition limits.

SEBI's view

SEBI expressed view through interpretative letter that the proposed transaction i.e., KJMC CAIL, KJMC SSL and KJMC CMSL subscribing to further 5,00,000 equity shares under private placement basis in TC would not trigger open offer under Regulations 3 and 4 of the Takeover Regulations as the total promoter & promoter group holding does not exceed 5% in FY 2016-17 and is only 4.99% thus as such acquisition do not breach creeping acquisition limits it will not trigger open offer.

Case 2

Below is the instance wherein the Securities Appellate Tribunal (SAT) overruled the informal guidance given by SEBI.

Facts of the case

India Bulls Real Estate Limited (IBREL) is a company that is listed on BSE Limited (BSE) and National Stock Exchange of India Limited (NSE). India Bulls Infrastructure and Power Limited (Target Co.) was listed on the BSE and NSE in year 2012 and accordingly the documents relating to promoter's shareholding pattern were filed with the SEs.

In order to consolidate the power business of IBREL and thereafter to demerge into Target Co. as a separate undertaking, a scheme of demerger was filed with Delhi High Court by IBREL and Target Co and the same was being sanctioned.

During the period from July 2014 to October 2014, Laurel Energetics Private Limited (LEPL) one of co-promoter of IBREL and Target Co. acquired various quantities of equity shares of Target Co. from other co-promoters of IBREL and Target Co.

All the said acquisitions were duly disclosed to the SEs under Takeover Regulations.

LEPL along with PAC made a public announcement for acquisition of 35.95 crore equity shares of Target Co. The draft letter of offer was filed with SEBI. However, SEBI issued an order to revise the price of the open offer as *inter se* promoter transfers are not exempt from open offer obligations under Takeover Regulations.

The question of law being raised is whether the *inter se* promoter transfers made prior to completion of 3 years of listing the TC are eligible for general exemption from open offer under Takeover Regulation 10(1)(a)(ii). These also raise the question of the legal status of informal guidance given by a department of SEBI, under the Scheme.

Provisions under the law

If an acquirer (along with PAC) holds shares or voting rights in TC entitling him to exercise 25% to 75% of voting rights, and proposes to acquire more than 5% of voting rights, then such acquirer is required to make open offer under Regulation 3 and Regulation 4 of Takeover Regulations. With reference to the present case, an acquisition relating to the *inter se* transfer of shares amongst promoters as per shareholding pattern filed by the TC in terms of the Listing Agreement / Takeover Regulations was held during period less than 3 years from date of listing of shares.

Summary and Analysis of SAT's observations

SAT observed that the Regulation 10(1)(a)(ii) clearly states that in order to be eligible for exemption from making an open offer *inter se* transfers of shares amongst persons named as promoters in the shareholding pattern by the TC in terms of its listing agreement has to be for not less than 3 years prior to the proposed acquisition.

SAT rejected the argument that promoters have to be named in shareholding pattern as 'Promoters' for minimum period of 3 years overall, not necessarily 3 years subsequent to the signing of the listing agreement.

SAT observed that, *"The law is not interpreted such that because nothing untoward has happened the benefit of law should be available to an entity. Compliance of law has to be the starting point, not the end result"*.

The Promoter cited SEBI's Informal Guidance dated October 25, 2012, which was issued to Weizmann Forex Limited (WFL) wherein SEBI opined that *inter se* transfer is exempt under Regulation 10(1)(a)(ii) of Takeover Regulations. The promoters argued that the situation is exactly similar to that in WFL. However, SAT stated that "When the statute is clear, informal guidance should not be relied on. Informal guidance scheme cannot be used to reduce the importance of the statute itself". SAT also mentioned that the SEBI official has erred by inadvertently providing an interpretation in the spirit of the Takeover Code, 1997 oblivious of the changes happened in terms of Takeover Regulations. SAT stated that "Such a mistake made by an officer of the respondent cannot be used to furtherance of the mistake."

Thus it should be noted that informal guidance though useful are administrative circulars in nature and are not views of SEBI. One needs to interpret Takeover Regulations keeping in mind objective for which it is formed.

Disclosures

Takeover Regulation states that the acquisition and holding of any convertible security shall also be regarded as shares, and disclosures of such acquisitions and holdings shall be made to recognised Stock Exchange where shares are listed and TC. The SE has obligation to disseminate the information so received to public at large. Below is illustrative list of annual and event based disclosures required under Takeover Regulations in relation to a TC:

Regulation	By Whom	Triggering event	Timeline
Event Based			
29(1)*	Any Acquirer with PAC	acquisition of 5% or more shares or voting rights	Within 2 working days of receipt of allotment or acquisition or disposal
29(2)*	Acquirer with PAC holding 5% and more shares	acquisition/disposal of 2% or more shares or voting rights	
Annual			
30(1)	Acquirer with PAC holding 25% or more shares or voting rights	Holding shares / voting rights as on 31st March.	Within 7 working days from the end of each financial year.
30(2)	Promoter with PAC		
Encumbered Shares			
31(1)	Promoter	Creation of encumbrance of shares held by promoter along with PAC	Within 7 working days of event date
31(2)	Promoter	Invocation of encumbrance of shares held by promoter along with PAC	

* Shares acquired by way of encumbrance shall be treated as an acquisition, shares given upon release of encumbrance shall be treated as a disposal. This shall not apply to a scheduled commercial bank or public financial institution as pledgee in connection with a pledge of shares for securing indebtedness in the ordinary course of business.

Penalty

Failure to carry out these obligations or non-compliance of other provisions of Takeover Regulations, penalties have been laid down such as monetary penalty shall not be less than INR 1 million but which may extend to INR 250 million or 3 times the amount of profits made out of such failure(whichever is higher), directing divestment of shares, transfer of proceeds to the investor protection fund, restriction on transfer of shares, restrictions on exercise rights including control by acquirer, pay interest etc.

Conclusion

Takeover Regulations have ushered in a fresh approach to acquisition of shares and/ or control in listed companies and have substantially streamlined the takeover process keeping the M&A regime in India on par with global practices and ease of doing business in India. Implications on a proposed transaction of acquisition of a listed company need to be carefully evaluated under the Takeover Regulations to avoid non-compliance as there are strict monetary penalties. In order to ensure a smooth process and taking into consideration the proximity of time, which is one of the most essential factors, it is always advisable to reach out to an expert professional before doing any restructuring within the group or any proposed acquisition. This is to ensure that the economic objectives are met with due compliance of the law of the land.

Janak Bathiya & Karan Thakker, *Advocates*

Combination under Competition Act 2002 – Role and Impact in M&A

The M&A game and the concept of Combination are, after the coming into force of the Competition Act, 2002, intertwined with each other. There is a growing need amongst M&A professionals to understand the basics of its impact on the M&A game. In the past the Competition Commission of India **("CCI" or "Commission")** has been active in levying penalties on combinations which were not notified to the Commission. There have been instances where mega transactions like Sun Pharma Ranbaxy merger or the PVR's acquisition of DT Cinemas which have been required by the Commission to undertake divestitures or undergo modifications. This may have a serious impact in some cases and therefore it becomes important to pre-empt an anti-trust issue in the M&A game and therefore this paper intends to familiarise with the need to know aspects and the interplay of the M&A game and competition law.

"Combination" a term used under the Competition Act, 2002 ("Act") is explained in section 5 of the Act.

Types of Combinations

The Act defines Combination as any of the following if the Combination at the combining entity level or at the combining group level exceed the thresholds (i.e., value of asset or value of turnover) as laid out in Section 5.

1. Any acquisition (Section 5(a)) or
2. Acquiring of control by a person over an enterprise when such person has already direct or indirect control over another enterprise engaged in production, distribution or trading of a similar or identical or substitutable goods or provision of a similar or identical or substitutable service (Section 5(b)) or
3. Any merger or amalgamation (Section 5(c))

Regulation of Combinations

Section 6 of the Act provides for the law relating to regulating Combinations. It prescribes that all transactions qualifying as a Combination should be notified to the Competition Commission of India in Form I (short form application) or Form II (long form application) as applicable. Section 6 further provides that a Combination shall not be given effect to until approved by the Commission or until 210 days have passed from the date of notifying to the Commission whichever is earlier. The CCI may either approve the Combination or may approve subject to modifications in the structure of the Combination or not approve the Combination.

Over the past few years CCI has suggested 'modifications' i.e., a change in structure of the Combination or a requirement of divestiture

of certain products prior to approving a Combination only in three out of the 500 odd notifications received by the Commission till date.

The Central Government has powers to exempt certain transactions from the applicability of Section 5 and Section 6 and pursuant to that the Central Government has notified certain exemptions from time-to-time by way of notifications. Certain exemptions are also provided by the Competition Commission in schedule I of the Competition Commission of India (Procedure in regard to The Transaction of Business Relating to Combinations) Regulations, 2011 (**"Combination Regulations"**). We shall discuss some of these in the later sections of this paper.

Section 5, Thresholds, Exemptions

Before we jump onto the threshold figures let us understand the basics of how the thresholds are to be calculated.

Enterprise level calculation. In enterprise level calculation, the calculation is based on summation of the assets / turnover of the buy side legal entity and the sell side legal entity. Until as recently as March 2017 even in case of a slump sale/business transfer of a miniscule undertaking of the seller the size of sell side legal entity was to be considered for the purposes of summation with the buy side legal entity assets and turnover leading to multitude of filings before the regulatory authority. Realising the futility of the exercise the Ministry of Corporate Affairs (**"MCA"**) in March 2017 permitted calculation of assets/ turnover of only portion of the assets/turnover attributable to the portion of the enterprise or division or business being transferred instead of the total turnover of the Sell Side legal entity (**"Calculation Concession"**). It is important to note that for transactions covered under Section 5(b) (i.e., Acquiring of control by a person over an enterprise when such person has already direct or indirect control over another enterprise engaged in production, distribution or trading of a similar or identical or substitutable goods or provision of a similar or identical or substitutable service) the relevant buy side entity for enterprise level calculation will not be the buying legal entity but will be entity over which the buying legal entity has direct or indirect control and which is engaged in similar or identical or substitutable goods or provision of a similar or identical or substitutable service.

Group level calculation. In group level calculation, the calculation is based on summation of the assets / turnover of the buy side group and the sell side legal entity. In case where only a portion of an enterprise or division or business is being acquired the Calculation, Concession will apply and instead of sell side legal entity only the proportionate assets and turnover of the sell side legal business shall be considered for summation with the buy side group size. It is important to understand the meaning of the term "group" as used in the Act. By definition "group" means two or more enterprises which, directly or indirectly, are in a position to— exercise **twenty-six per cent**[1] or more of the voting rights in the other enterprise; or appoint more than fifty per cent of the members of the board of directors in the other enterprise; or control the management or affairs of the other enterprise. Further, the Central Government *vide* a notification has exempted a 'group' exercising less than 50 % of voting rights in other enterprise from the provisions of section 5 of the said Act for a period of five years from the date of notification i.e., 4-3-2016. This effectively means that the twenty-six per cent in the definition of "group" is increased to more than 50 % (fifty percent) as per the exemption notification by Central Government.

1 Further, the Central Government *vide* a notification has exempted a 'group' exercising less than 50 % of voting rights in other enterprise from the provisions of section 5 of the said Act for a period of five years from the date of notification i.e., 4-3-2016.

With the aforesaid background in mind let us now understand the current thresholds for treating an M&A transaction as a Combination.

THRESHOLDS FOR FILING NOTICE				
		Assets		**Turnover**
Enterprise Level	India	>2000 INR crore	OR	>6000 INR crore
	Worldwide with India leg	>USD 1 billion with at least >1000 INR crore in India		>USD 3 billion with at least >3000 INR crore in India
			OR	
Group Level	India	>8000 INR crore	OR	>24000 INR crore
	Worldwide with India leg	>USD 4 billion with at least >1000 INR crore in India		>USD 12 billion with at least >3000 INR crore in India

A transaction will be a combination by definition (unless falling in the exemptions) if it fulfils any of the following

i) Enterprise Level Calculation India Assets test (i.e., India Asset summation exceeds INR 2000 crore)

ii) Enterprise Level Calculation India Turnover Test

iii) Enterprise Level Calculation Worldwide (with India Leg) Assets test

iv) Enterprise Level Calculation Worldwide (with India Leg) Turnover test

v) Group Level Calculation India Assets Test

vi) Group Level Calculation India Turnover Test

vii) Group Level Calculation Worldwide (with India Leg) Assets test

viii) Group Level Calculation Worldwide (with India Leg) Turnover test

Small Target Exemption. The Ministry of Corporate Affairs has *vide* notification dated 4th March, 2016 provided an exemption for certain combinations where the target being acquired is small and is below the thresholds given below

THRESHOLDS FOR AVAILING OF DE MINIMUS EXEMPTION FOR ACQUISITIONS				
		Assets (INR)	OR	**Turnover (INR)**
Target Enterprise	In India	≤350 crore		≤1000 crore

Apart from the above there are additional instances where exemption has been given as follows (see schedule I of Combination Regulations for details)

- An acquisition of shares or voting rights solely as an investment or in the ordinary course of business does not entitle the acquirer to hold twenty-five per cent (25%) or more. Presumption of less than 10% being solely for investment subject to non-existence of special clauses in agreement and non-existence of board seat.

- An acquisition of shares or voting rights where the acquirer, prior to acquisition, has fifty per cent (50%) or more shares or voting rights in the enterprise.
- An acquisition of assets not directly related to the business activity of the party acquiring the asset or made solely as an investment or in the ordinary course of business, not leading to control of the enterprise whose assets are being acquired.
- An acquisition of stock-in-trade, raw materials, stores and spares, trade receivables and other similar current assets in the ordinary course of business.
- Bonus issue or stock splits or consolidation of face value of shares or buy-back of shares or subscription to rights issue of shares, not leading to acquisition of control.
- Any acquisition of shares or voting rights by a person acting as a securities underwriter or a registered stock broker of a stock exchange on behalf of its clients.
- An acquisition of shares or voting rights or assets within the same group
- A merger of two enterprises where one of the enterprises has more than fifty per cent (50%) shares or voting rights of the other enterprise or if such entities are part of the same group.

Having regard to the above it will be worthwhile to throw light on the industry sector wise number of combinations handled by the CCI till date. Refer Figure 1.

Sl. No.	Sector	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17	Total
1	Finance	8	16	4	16	25	12	81
2	Pharmaceutica!s & Health Care	3	4	7	15	11	14	54
3	Information Technology and Services	3	6	3	5	12	6	35
4	Chemicals and Petro-Chemicals	2	1	2	9	11	3	28
5	Auto & Auto Components	5	5	3	6	4	8	31
6	Mining and Metals	4	3	2	6	2	3	20
7	Power & Power Generation	4	1	4	3	1	9	22
8	Media & Entertainment	3	6	0	3	2	4	18
9	Food & Refined Oil	0	3	2	2	5	6	18
10	Miscellaneous	15	18	19	26	38	40	156
	Total	**47**	**63**	**46**	**91**	**111**	**105**	**463**

Figure 1 Sector wise distribution of combination notices received

LONG FORM APPLICATION VS. SHORT FORM APPLICATION

The notice of a Combination, shall ordinarily be filed in Form I (**"Short Form Application"**) as specified in Schedule II to the Combination Regulations. In cases where the parties to the

combination have filed notice in Form I and the Commission requires information in Form II to form its *prima facie* opinion, it shall direct the parties to the combination to file notice in Form II (**"Long Form Application"**). Alternatively, the parties to the Combination may, at their option, give notice in Form II, as specified in Schedule II to the Combination Regulations, preferably in the instances where —

(a) the parties to the combination are engaged in production, supply, distribution, storage, sale or trade of similar or identical or substitutable goods or provision of similar or identical or substitutable services and the combined market share of the parties to the combination after such combination is more than fifteen per cent (15%) in the relevant market;

(b) the parties to the combination are engaged at different stages or levels of the production chain in different markets, in respect of production, supply, distribution, storage, sale or trade in goods or provision of services, and their individual or combined market share is more than twenty-five per cent (25%) in the relevant market.

The Short Form Application (Form I) is the most commonly used format for filing notifications of Combinations to the Commission. In rarely any case has the Competition Commission required filing in Long Form Application Form II by the parties.

Form I is a relatively simple, relatively short & relatively user friendly form requiring basic information on the Combination whereas the Form II is a comprehensive and extremely detailed form requiring significant level information from the parties making the application.

The total number of notices filed with the CCI and the speed with which they are disposed of are summarised below to give the readers an overview of the filing statistics.

	Notices				Disposed of by					
Year	Opening Balance	Received	Suo Moto	Total	Without Modification	With Modification	Rejection	Invalid/ Withdrawn	Closing Balance	Average No. of working days for Disposal
2011-12		48	00	48	40	00	00	01	07	16
2012-13	07	67	00	74	65	00	00	03	06	17
2013-14	06	47	00	53	44	00	00	02	07	18
2014-15	07	98	00	105	83	02	00	06	14	24
2015-16	14	118	07	139	107	00	00	12	20	26
2016-17	20	111	02	133	105	01	00	11	16	29
Total		**489**	**09**		**444**	**03**	**00**	**35**		

Figure 2 Receipt and disposal of Combination notices 2011-17

HOW HAND-IN-HAND CCI WORKS WITH OTHER REGULATORS

There are many areas where the role as CCI and the role of other areas may overlap or may require regulators working in tandem to achieve the object of the various statutes under which

such regulators have come to life. Competition Commission like the SEBI is an economic regulator and does not deal specifically with any particular industry unlike the TRAI or the IRDA or the RBI.

Other regulators ability to make a reference to CCI. Section 21 of the Act provides for a situation where if in the course of a proceeding before any statutory authority an issue is raised by any party that any decision which such statutory authority has taken or proposes to take, is or would be, contrary to any of the provisions of the Competition Act, then (or even suo motu) such statutory authority may make a reference in respect of such issue to the Commission. The Commission is duty bound to address such references and provide an opinion thereto. However, in practice we have observed that there are negligible references made officially to the Commission by other statutory authorities under the official. Below is an extract from the annual report of the CCI on the year wise number of references received by CCI from other statutory authorities.

Sl. No.	Description	Number						
		2010-11	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17
(i)	Number of references pending at the beginning of the year	–	–	–	–	–	–	–
(ii)	Number of references received during the year	1	–	–	–	–	–	–
(iii)	Total	1	–	–	–	–	–	–
(iv)	Number of references disposed off out of (i)	–	–	–	–	–	–	–
(v)	Number of references disposed off out of (ii)	1	–	–	–	–	–	–
(vi)	Total number of references disposed off during the year	1	–	–	–	–	–	–
(vii)	Number of references pending at the end of the year	–	–	–	–	–	–	–

Figure 3 References received from statutory authorities

CCI's ability to make reference to other statutory regulators. Similarly section 21A of the Act provides for a situation where if in the course of a proceeding before the Commission an issue is raised by any party that any decision which, the Commission has taken during such proceeding or proposes to take, is or would be contrary to any provision of this Act and whose implementation is entrusted to a statutory authority, then (or even suo motu) the Commission may make a reference in respect of such issue to the statutory authority. The statutory authority or regulator is duty bound to respond to such references to CCI by giving its opinion.

Case in point is the case of *Shri Neeraj Malhotra, Advocate vs. North Delhi Power Ltd. & Ors.* [Case No. 6/2009 where the Delhi Electricity Regulatory Commission categorically stated in its communication to the CCI that although all matters pertaining to electricity tariff have to be decided

as per the provisions of the Electricity Act and DERC Regulations, allegations of anti-competitive behviour, including abuse of dominant position by the discoms fall within the jurisdiction of the CCI.

Below are the statistics of the number of formal references made by CCI to other statutory authorities.

Sl. No.	Description	Number						
		2010-11	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17
(i)	Number of references pending at the beginning of the year	–	–	–	–	–	4	–
(ii)	Number of references received during the year	–	–	–	–	4	1	–
(iii)	Total	–	–	–	–	4	5	–
(iv)	Number of references disposed off out of (i)	–	–	–	–	–	4	–
(v)	Number of references disposed off out of (ii)	–	–	–	–	–	1	–
(vi)	Total number of references disposed off during the year	–	–	–	–	–	5	–
(vii)	Number of references pending at the end of the year	–	–	–	–	4	–	–

Figure 4 References made to statutory authorities

As can be seen from the above there are limited formal interactions between CCI and the other regulators. However increased co-ordination is needed between CCI and various regulators as there could be various complicated situations while assessing combination cases that need to be dealt in a cohesive manner by the regulators. The definition of "control" is one such example. How CCI deals with definition of "control" and how SEBI looks at it could be different in a same combination and will have different implication for the companies who are parties to the combination. Needless to say another example, of the recent CCI action on National Stock Exchange holding NSE guilty of abuse of dominant position on a compliant filed by a certain commodities exchange, is a case of CCI intervening in the jurisdiction of the entity governed by SEBI.

Piyush Goyal the Central Government minister was recently quoted as follows

"The one very, very serious crisis that the nation is facing today is the accountability of regulators. There is almost no accountability of regulators. And in the garb of independence of regulation, it occasionally goes to another extreme," the Union Minister of State for Power, Coal, New and Renewable Energy and Mines said in a recent gathering of regulators. He was speaking at a seminar on 'Ease of Doing Business - Regulators

as Facilitators' at Vibrant Gujarat Global Summit 2017 in Gandhinagar.

I will leave it at that quote and let the readers form their own opinion on the need to co-ordinate between regulators.

Some of the suggestions that experts give to improve the situation are as follows

1. Formal schemes for co-ordination can be considered, as is done in various countries, for example:

    a) The right to participate/observe proceedings before the other;

    b) Formal referrals;

    c) Appeal to a common authority;

    d) Non-interference in other's jurisdiction;

    e) Delineation of jurisdiction; and

    f) Presence of competition authority on sectoral regulator agency.

2. As a matter of policy, formal and informal exchanges between various sectoral regulators and CCI should be encouraged. The consultation process could be at two levels, one, at the policy level and two, in respect of individual cases. A forum should be created where the CCI and the sector regulators could meet on regular basis with a view to promote policy level co-ordination and make sector regulation as much competition driven as possible. This mechanism could also help in evolving principles for sharing information and determining the jurisdiction in different categories or types of cases.

3. Other mechanisms for co-ordination should also be explored such as:

    a) Use of experts from each other for facilitating enquiry/investigations.

    b) Exchange of personnel on deputation or internship basis.

    c) Participation in each other's training programs, workshops, seminars, etc.

    d) Conducting regular training programs by CCI for representatives of the sector regulators so that they are in a better position to appreciate various competition issues.

COVERAGE OF DEMERGER, RECONSTRUCTION, ENTITY SET-UP UNDER COMBINATION

Whether a demerger/reconstruction is required to be notified to the CCI?

The term demerger (forget defining) is not used in the Competition Act, 2002 and therefore it leaves us to interpret whether a demerger will fall under the term "acquisition" as used in Section 5(a) of the Act or will it fall under the term "merger" under Section 5(c) of the Act. The prevailing view derived implicitly from some of the judgments by CCI seems to suggest that the demerger transactions are covered under Section 5(c) (i.e. merger of two enterprises). Therefore, a demerger (which is not covered in the exemptions) will be required to be notified to the Commission. While reading the exemptions in Schedule I (discussed above) it will be worthwhile to note that certain exemptions are applicable only for acquisitions and not for mergers and it will be prudent to not include the term 'demerger' under the term 'acquisition' for the purposes of interpreting the exemptions.

However, the short answer to the question above is "yes" a demerger if not exempted is required to be notified to the CCI.

As regards general restructuring is concerned, it will need to be evaluated on a case by case basis whether a particular restructuring exercise will require notification to the Competition Commission. But a broad brush idea to have would be that generally intra group restructurings are exempted unless there is a transfer from joint control to sole control.

Having said that the policy to be adopted in dealing with interpreting Combination Regulations and the Act is that when it doubt whether a Combination will be covered under the requirement to notify to the Commission, you may request for a pre-filing consultation with the CCI and as per the Act the CCI is duty bound to provide the pre-filing consultation if sufficient notice is given to CCI.

Do I need to notify the creation of a joint venture?

This question is directly answered by one of the FAQs published by the Commission and the answer reads as follows

"Yes, if one or more enterprises transfer its assets to a joint venture company, then the formation of joint venture is treated as a notifiable Combination, provided that jurisdictional thresholds are met."

However, a new incorporation of entity without transfer of any assets or turnover by the joint venture partner would not generally be covered in the requirement to notify the Commission under section 6 of the Act.

CONCLUDING REMARKS

I hope the above will give you a fair overview of the need to know things relating to "combinations" under Combination law. This article just gives a tip of the ice berg idea on Combinations under Competition Law and there are various nuances and issues which I would have liked to discuss but neither do the publishers of this article have more space for me, nor you have any more time but all of us definitely have a next time!

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> Hold on to the ideal. March on! Do not look back upon little mistakes and things. In this battlefield of ours, the dust of mistakes must be raised. Those who are so thin-skinned that they cannot bear the dust let them get out of the ranks.
>
> — *Swami Vivekananda*

CA Yashasvi Sharma

Key challenges in mega deals

Rakesh* looked out of his corner office to the Arabian Sea. A streak of sweat rolled down his forehead. He was a veteran deal maker and had been a part of many deals in his career. But this one was special. It was a mega deal.

- Would his experience with previous, smaller deals be sufficient for him to pull through this?
- Will he be able to catapult the combined setup to new heights?
- Would this merger result in the erosion of the values of the individual organisations?

It was an opportunity (as well as challenge) of a lifetime. While driving the merger process, he would need to have adequate focus on both business growth and stability.

He knew that a substantial investment had been made and the directors and shareholders were watching closely. Will tapping the unexplored African market help them deliver on their business model? Will the new sales team be able to master products quickly enough to convincingly sell to their customers? Now was the time for the rubber to hit the road. This meant managing the complications, intricacies and idiosyncrasies of the two companies as well as investing enough time to form a working relationship.

He knew that sameness was divine but it was easier said than done. Tailoring the entire consolidation process to keep the marriage right, involved addressing a lot of ambiguous factors in a timely manner. Getting rid of the hostile "we own you now, so you will do it our way" culture and instilling harmony was one of the pre-requisites. He knew that the key personnel who didn't decamp, may begin to undermine the acquisition. So many challenges, so many questions and one constantly ringing question – "now what?"

I am sure we all have faced such dilemmas during the course of our professional careers – be it as an advisor or as an employee working for an organisation involved in a mega deal.

Having closely watched and been a part of the M&A space for the last 20 years, one thing we can say with certainty is that every deal is unique – in terms of stakeholder dynamics, market / internal challenges and value drivers. Over the years, we have seen many M&A deals which were announced with great expectations and fanfare, but ultimately failed to realise their goals. Some, in fact, lost market share and eroded shareholder value. When we look back, the reasons for these debacles were sometimes complex – for example, failing to capture the right synergies during the evaluation phase. Sometimes the reasons were quite simple and basic – such as the cultural misalignment between the two companies or the inability to dissolve parallel power structures post the merger.

This article attempts to highlight some of these pitfalls and also provides insights into how deal makers need to manage a complex, yet delicate process of post-merger value creation. This, we

* *Fictional name*

believe is particularly relevant in the current scenario, when more and more Indian companies are executing big-ticket M&A transactions.

Finding the right balance between business growth and stability

The motivation behind every deal may be different, but the underlying intent is always the same – value protection and value creation. There are two sources of value in the context of a deal, whether it's a large-scale merger or an acquisition to add a niche capability.

There is the value to be gained from the opportunities that arise when bringing two organisations together – increased market share and revenues, reduced costs, greater talent pool and the invigorated culture. There is also the value of the underlying businesses which needs to be protected while the integration is underway. This involves managing the integration risk sensibly, structuring the integration to meet time and cost objectives and avoiding complexity.

Balancing the integration between securing the new value (to make 1+1 > 2) and protecting the old (to ensure 1+1 = 2) is imperative for continued success.

For many dealmakers, a successful deal is as good as a mirage. Having said that, there is no denying that inorganic growth is an important weapon in management's arsenal for achieving its vision. If so, what does it take to make a successful deal a reality? The success of a deal is defined by the achievement of strategic, financial and operational objectives. However, the integration process—an important lever to achieve these goals—often does not find adequate space in the priority calendars of dealmakers, resulting in less than optimum value realisation. Accordingly, this becomes all the more important in mega deals given these are transformational. Both capturing new value and protecting the current value is complex in such mega deals. In mega deals, where generally large entities are merging or combining – generally termed as "marriage of equals", there is a risk that the combined entity becomes too large and monolithic to manage and loses its nimbleness to take decisions, which can prove costly in a competitive market environment. Also, most mega deals are executed on the premise of substantial synergy gains – be from market share gain, reduction of costs, operational efficiencies etc. If dealmakers fail to consciously track and monitor these synergies, we have seen that there is a significant risk of the company losing track, resulting in value erosion.

Some of the key challenges and imperatives for mega deals are discussed below:

- **Deal success measures should be clearly defined and tracked**
  Often, dealmakers consider their deals to be successful once the strategic objectives are met, even though operational objectives lag behind. However, can a deal really be termed successful in such cases? Not realising operational objectives implies leaving behind value on the table and, thus, not achieving the full potential of a deal. Dealmakers need to adequately assess, analyse and determine synergy levers as well as factors that may erode value. Once the identification process is complete, concrete steps need to be taken to realise synergies and streamline operations to avoid pitfalls.

- **Early and thorough planning, supported by rigorous execution and continuous monitoring, leads to deal success**
  We have seen that this is an area which is often neglected and which, in the end, causes most damage to company's value creation plan. We have seen that typically, corporates start thinking about integration only when the deal has closed or in best case, when the deal is nearing signing / closing. Ideally, integration work begins long before negotiations close, and even before due diligence starts. Understanding the differences between the companies involved in a merger, anticipating the issues, uncovering further challenges through the diligence process, and drawing up

a detailed, prioritised and time-bound execution plan is the mantra for success. We have also seen that many companies still look at diligence with a traditional lens. For most acquirers, diligence is used for value negotiation or as an input in legal documentation. We have noticed that in more successful deals, diligence (financial, IT, HR etc.) provide valuable inputs in drawing up an integration plan, identification of one-time costs and firming up synergy assessment. For example in one of the deals, IT integration was a major challenge as the acquirer had to comply with data protection laws and guidelines, which entailed heavy capex (which – yes, you guessed it right – was not identified in the diligence phase and came as a major surprise post execution of the deal).

- **Cultural issues and lack of communication are major challenges in the deal process**
  Understanding the anxieties and concerns of different stakeholders and enabling them to see the benefits of the transaction differentiate the successful from the 'also-ran'. In the case of cross-border deals, further understanding the cultural nuances in India, both professional and personal, is critical. Building on the target organisation's culture and leveraging formal and informal channels to deploy the ideal communication plan helps in disseminating a strong message. This also aids in building a transparent, friendly and trust-driven work environment. Well, it is certainly easier said than done as we have seen so many acquirers doing a mediocre job of recognising the cultural differences and communicating effectively to the wider employee group. Rumour mongering is very common in the run up to deal closure and even post deal closure.

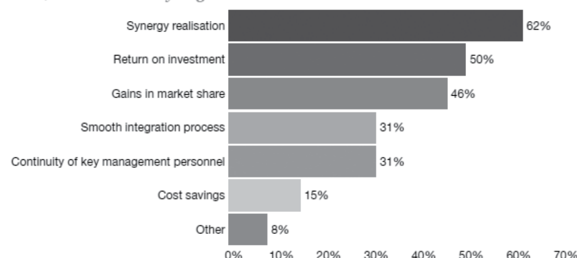
- **The integration team should involve the leadership and dedicated resources**
  Operational teams are often stretched by their day-to-day responsibilities. Having a core dedicated integration team to drive the cross-functional process is key to ensure integration initiatives get adequate focus. Further, senior leadership participation in the integration process is critical to bringing focus and drive to this cross-functional initiative. The integration team needs senior leadership sponsorship as well as a mandate to take timely decisions.

Capturing synergies

Any deal has certain objectives and successful realisation of the objectives determines the success or failure of a deal. While different organisation use different metrics to define deal success, successful realisation of the synergies estimated prior to deal becomes one of the key measures to measure deal success. This is more so true in mega deals where press releases and investor presentations highlight the multi-million dollar synergies that the deal can help realise.

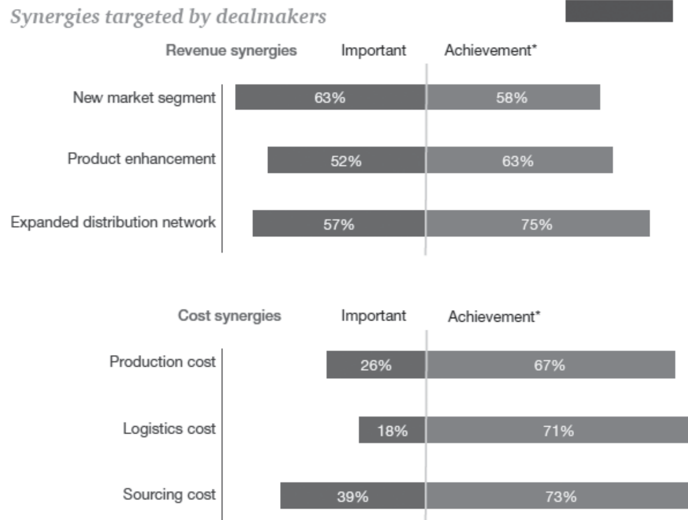
In a recent survey of deal makers, carried out by PwC, we gained key insights on how are deal makers driving deals' success, what are the top challenges and what are some of the best practices to effectively address those challenges.

KPIs/metrics used by organisations to measure deal success



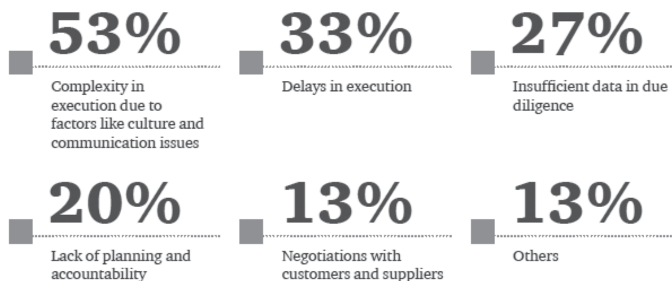
Synergy achievement

While the synergy numbers are highlighted and baked into the business plans, the actual realisation of these numbers leaves a lot to be desired. The revenue synergies around new markets, products and distribution are given significant importance but typically are more difficult to achieve and generally require longer time period to achieve. This is as compared to cost synergies like procurement and logistics which are lower hanging fruits and can kick start the benefits realisation at an early stage. One of the key reasons being cost synergies involve initiatives which are less dependent on the external environment while revenue synergies typically are dependent on the market and hence less predictable. On one of the deals where the dealer / distributor network was a key driver of the deal, the acquirer failed to rationalise dealer margins, which adversely impacted synergy realisations.



Key challenges

While overall strategic alignment often defines the benefits realization pace and success, organisations fall short on synergy realisation forecast at the beginning of the deal due to a variety of operations challenges including poor planning and communication, unstructured execution and inadequate monitoring.



Structured process

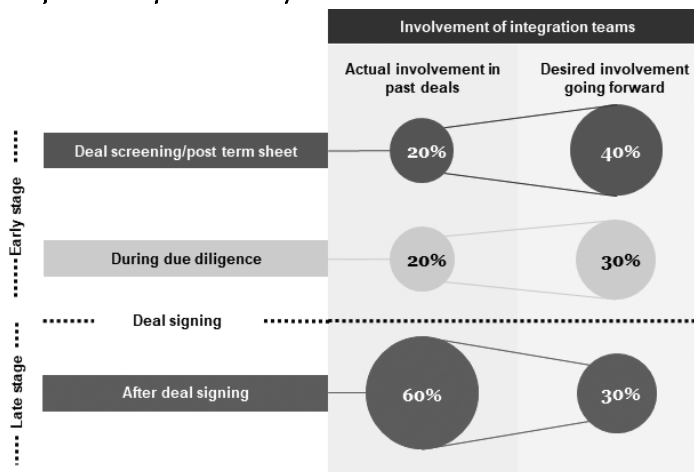
Establishing a structured and formal process for synergy realisations is often key to ensuring that operational issues are highlighted and addressed. Organisations often let the achievement of synergy realization be driven solely by the operational teams where the focus on ensuring the business as usual activities is often considered much more important than synergy initiatives. A structured programme should include leadership involvement and focus in driving these initiatives and giving them adequate priority among the plethora of business as usual activities being taken care by the operational teams.

With mega deals involving large organisations coming together with their own distinct cultures, a structured synergy realisation process becomes all the more important. A structured process not only helps in realisation of the benefits earlier but also helps in growing the quantum of benefits realized.

Ensuring business continuity

A key reason deals fail to achieve their potential is inadequate preparation and planning for the post-merger phase. While deal negotiators focus largely on closure in a complex transaction, anticipating bumps after the deal and planning appropriately for mitigation are what truly determines whether integration teams have prepared for the rocky road ahead. In hindsight, most deal makers state that probability of achieving deal objectives increases when integration planning starts earlier in the deal value chain.

Starting the integration process – pre deal or post deal?



Due diligence can often uncover issues that become the base for an integration plan. When not identified early enough, smaller concerns become critical issues and leave the team 'firefighting' to reach a resolution, often requiring more time, resources and efforts.

While deal and operational challenges will differ, certain critical areas are common across all deals and addressing these correctly can be the differentiator in determining deal outcome.

Organisational culture

Often at the negotiating table, dealmakers underestimate the importance of cultural integration. The overriding sentiment is that the companies involved are largely similar and hence there will be no issues in integrating. However, companies are seldom culturally similar. A company's work culture, which includes its leadership style, talent management, degree of autonomy, decision making, the extent to

which it holds employees accountable, its approach to innovation, employee engagement, building and maintaining internal or external relationships and other such parameters, defines and shapes its performance. Companies that have conflicting cultures and leadership styles are at risk of losing their top talent, having stretched integration periods and, ultimately, of failing to capture deal value. Some companies also struggle to re-align cultures and values in case of a large and complex merger. We have seen two diametrically opposite approaches – both not ideal. One approach is to ruthlessly thrust the acquirer's culture on the target company, which creates short term resistance, resentment and even anxiety. In the other approach, the acquired company simply does not do anything to integrate the cultures, due to the fear of a "revolt" like scenario, which means that the companies never share common values and cultures. They continue to work in a disjointed manner.

Employee expectations

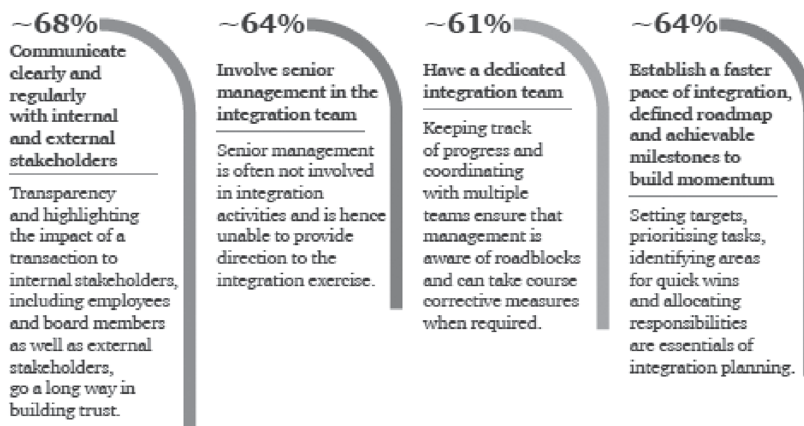
In today's knowledge-driven economy, people are often the biggest asset. Hence, managing the transition from a people expectation perspective assumes utmost importance. Further, expectations are often interpreted as being monetary only. However, often, ensuring that employees are aligned to a common purpose, having clarity on where the company and, thus, their employment and career are headed as a result of the transaction is very important. Lack of information often creates unnecessary speculation, resulting in anxiety.

IT integration

IT standards across companies can vary vastly, which only increases the complexity of bringing the different platforms together. In addition, the extraction and verification of data, buy-in required from multiple stakeholders, and technical complexity and cost of implementation make systems integration a herculean task.

So, what does it take to drive integration the right way?

Integrations can seem overwhelming with conflicts of opinions, cultures and personal incentives surrounded by uncertainty. However focusing efforts on the right fundamentals, can help streamline the process and drive the team to succeed.



Appropriate and timely communication can stabilise uncertainty. Companies need to communicate clearly and regularly with employees and external stakeholders. Indian organisations, especially mid-sized promoter-driven companies, are vastly different from larger corporates. In these mid-sized organisations, relationships, respect and loyalty can be far stronger incentives than monetary gains. Understanding these unique virtues, listening to stakeholder questions, concerns and issues, and proactively addressing those in thought and action go a long way and are instrumental in cementing a productive, trusting and encouraging workspace.

While communication through formal channels such as e-mails, town halls and notices/posters helps in publicising the leadership vision and strategy, informal communication/grapevine exchanges should be leveraged to further instil the message.

In this regard, aligning the acquired company's leadership with the deal rationale, vision and goals is paramount. This alignment is achieved through regular and clear communication. Through its role in achieving the vision, the acquired company's leadership lays the foundation of a successful integration.

Anticipating and understanding the anxieties, fears and beliefs of all stakeholders, and addressing them through clear, comprehensive and timely communication will have a lasting impact in aligning organisations. Apt communication not only inculcates the desired culture but also helps keep stakeholders engaged in and motivated towards achieving the overall deal vision.

Successful integration needs to happen quickly and systematically. A faster pace, combined with a defined plan and achievable milestones, builds momentum and confidence among stakeholders and helps dealmakers integrate smoothly.

A well-selected integration team orchestrates the pursuit of value creation opportunities, manages the deal complexity and builds robust yet simple processes that resolve sticky issues. In fact, it can serve as the litmus test to reveal the 'leadership of tomorrow'—one that is capable of dealing with tight timelines, tough decisions and conflict management. Thus the emphasis on having a dedicated integration team, running the integration as an independent business process.

Deals today are classified as "mega deals" by the size of the transaction. However with the continuously increasing focus on outcomes coupled with a tuned, intellectually aware and inquisitive shareholder base, the day is not far when deals will be classified as "mega" based on the value they've helped achieve. Adopting a goal centric, systematic and pragmatic approach charts the path from unlocked deal potential to tangible value on the table.

All power is within you ...
Believe in that, do not believe that you are weak ...
Stand up and express the divinity within you.

— *Swami Vivekananda*

CA Manoj Fadnis

HOT SPOT
NFRA & Other Challenges Before the Profession

Introduction

The expectations of the society from the Chartered Accountants keep increasing. In a way it reflects the confidence placed in the work done by the profession. While our auditing standards clearly say that audit provides a reasonable assurance that the financial statements are free from material mis-statement, the society probably expects absolute assurance. Hence, when the Punjab National Bank fraud is disclosed, the first sound that we hear is – catch the auditors.

This article deals with two major challenges before the profession:

1. NFRA and other provisions of the Companies Act
2. SEBI Order to take action against the firms

NFRA and Other Provisions of the Companies Act

1st March 2018 will be an important date in the history of the Chartered Accountancy profession. Nearly four years after the implementation of the Companies Act, 2013, section 132 of the Act was resolved to be notified by the Union Cabinet and thus leading to the establishment of the National Financial Reporting Authority (NFRA). In spite of the numerous and untiring efforts by the Council of the Institute of Chartered Accountants of India (ICAI) that NFRA will not be in the public interest, the 'public perception' has prevailed over the facts. However, once the law is promulgated it is our duty as citizens to ensure full compliance with the same and help in the smooth implementation thereof. At the same time, it is our right to continue to create awareness about those critical aspects which seem to have been overlooked. Also, we need to strategies our individual and collective actions to meet these challenges.

Satyam scam has shaped many provisions of the Companies Act, 2013 including the ones relating to NFRA. The magnitude of the said scam was enormous and had global implications. It was essential to deal with the fallout of the scam in a befitting manner to restore the global confidence in India as an investment destination. In the turmoil following the scam, NFRA took birth. This was even though the disciplinary actions in case of Satyam auditors, managers and the concerned employees of the company was taken in a record time.

Satyam case is a classic example where the public perception has overtaken the facts. The ICAI disciplinary action was quick and strong. The scam became public in January 2009. The disciplinary process was immediately initiated. But it was challenged before the Hon'ble Delhi High Court by way of writ. The crux of the issue before the Court was whether the criminal proceedings and the professional proceedings be initiated simultaneously. The Single Member ruled in

favour of the ICAI. An appeal was then filed before the Divisional Bench which also ruled in favour of the ICAI. The matter was taken up to the Hon'ble Supreme Court which finally paved the way for the initiation of the disciplinary action against the concerned members. The hearings in the case could be taken up only on the weekends and other public holidays as the criminal proceedings before the Civil Court had to be given preference. The DC hearings were also interrupted due to the same being stayed by the Hon'ble Courts when they were seized of the issues. Despite all these difficulties, all the six cases before the Disciplinary Committee were completed by 2012. The maximum punishment prescribed under the CA Act was imposed on the members found guilty of the professional misconduct.

Unfortunately, this could not prevent the public perception and the lawmakers' view that an autonomous body outside the ICAI is necessary to take up matters like Satyam, to boost the international confidence.

Internationally there is growing view that the self-regulations in the profession are not stringent enough to deter the erring members of the profession. This started in the developed economies and has fast spread the world over. The International Forum of Independent Audit Regulators (IFIAR) does not recognise a regulator as independent where the majority of the members of the governing council are from the profession and is funded by the profession. Consequently, the ICAI is not regarded as an independent regulator by IFIAR and is not admitted as a member. At the same time the membership of IFIAR is equally important so that the audit opinions issued by the members of ICAI are accepted in other economies. The IFIAR was informed that the ICAI is a statutory body enacted by the Parliament and is under the administrative control of the Ministry of Corporate Affairs (MCA). However, in the informal meetings, the view that was very often expressed was that if a professional body is a member of the International Federation of Accountants (IFAC) then it cannot be a member of the IFIAR. To overcome this challenge, it was also proposed that the Quality Review Board (QRB) be accepted as a member of the IFIAR as the majority of the members on the board of QRB are nominated by the MCA and they are not members of the profession. However, as QRB does not by itself have the right to take disciplinary actions, QRB fell short of the requirements. NFRA meets the requirements of the IFIAR and hopefully should be admitted as a member.

The Indian laws are based on the English law. The concept of the self-regulation in ICAI is similar to that of the Institute of Chartered Accountants of England and Wales (ICAEW). In UK, with the setting up of the Financial Reporting Council, most of the powers of the ICAEW have been taken away. In that sense, the NFRA is following the UK FRC. However, it needs to be kept in mind that the UK FRC has jurisdiction over the preparers, the auditors and the actuaries. Similarly, NFRA should exercise jurisdiction over at least the valuers and the actuaries. Under the Ind AS, the fair values determined by the valuers and the actuaries will have a major impact on the financial statements. The auditors will be relying on the work done by these professionals. Therefore, it will be in the public interest that these professionals are also brought within the ambit of NFRA.

The Rules relating to NFRA will now be notified shortly. It is expected that the misconduct prescribed under the Second Schedule to the CA Act relating to listed companies and unlisted companies over a threshold limit will be dealt with by NFRA. NFRA should focus only the information cases and not entertain complaint cases related to these companies. This will enable NFRA to deal with limited cases in a time bound manner.

Considering the above developments, an individual member would have two regulators to adjudicate the issues relating to professional misconduct, depending on the size and legal form of the auditees. In the initial period there will naturally be some issues which will need clarity.

For instance, if a listed entity, say a bank, is not incorporated under the Companies Act, will NFRA have jurisdiction over its auditors. This may be one of the first issues to be resolved as the fraud in Punjab National Bank has acted as a catalyst in the implementation of NFRA.

NFRA is thus, a product of expectation gaps, and the international developments.

The Companies Act, 2013 has widened the auditors' liabilities. There are penalties prescribed under the Companies Act as also under the Chartered Accountants Act. One needs to take note of how the law has evolved.

Prior to 2006, the CA Act provided only reprimand or removal of name from the register of members as a punishment for professional misconduct. The removal could extend to permanent removal. This was on the premise that for a professional, the professional stigma is the biggest punishment. Removal of name from the register of members was considered as a very serious punishment. The thinking changed over time. The Chartered Accountants (Amendment) Act, 2006 for the first time introduced monetary penalties under the Act. For a professional misconduct under First Schedule, the maximum penalty is rupees one lakh and for Second Schedule it is rupees five lakhs.

The Satyam scam possibly made the lawmakers again think on the quantum of punishment. The Companies Act, 2013 introduced even far more stringent penalties. Now it is possible that failure to comply with the Standards on Auditing could invite penalties under the CA Act as well as under the Companies Act.

The Companies (Amendment) Act, 2017 has reduced the harshness of the law to some extent. One of the important amendments in the Companies (Amendment) Act, 2017 is in clause (ii) of sub-section (3) of section 147 of the Act. Prior to the amendment the said clause provided that an auditor convicted under sub-section (2) of section 147 was liable to pay damages to the company, statutory bodies or authorities or ***to any other person*** (emphasis supplied). This is now restricted to shareholders and creditors of the company. The penalties have been linked to the audit fees. Be that as may, the consequences are humungous. The concept of the class action suit has been introduced in the law.

The next major amendment in the Companies Act, 2013 which has greatly influenced the profession is the Rotation of the Auditors. Since 2017, there has been a change in the auditors of the listed and other prescribed public and private companies. In many cases, this has reduced the audit fees.

Rotation has now become a global issue. The European Union has also introduced the rotation of the public interest entities. The USA is one country which has consistently opposed the rotation of auditors. Italy was possibly the first country where this had started more than three decades ago. The Italian experience has been that rotation has led to the audits getting concentrated more in the hands of the bigger audit firms as compared to the small and medium firms. While it may be early to say, but the trends indicate similar experience in India.

It is heartening that the Companies (Amendment) Act, 2017 has done away with the annual ratification of the auditors.

Section 139(1) provides that the shareholders at the Annual General Meeting (AGM) shall appoint an auditor of a company, for a consecutive period of five years, and that his appointment shall be ratified every year at the AGM. The first proviso to the said sub-section required the company to place the matter relating to such appointment, for ratification by the members in each AGM. It was pointed out by the Institute of Chartered Accountants of India (ICAI) that where the shareholders choose not to ratify the auditor's appointment as per Section 139(1), it would be akin to removal of the auditor and provisions of Section 140(1) should come into play. The sub-section (1) of section 140 provides for a special resolution and previous approval by the Central Government for removal of the auditor. There was an inconsistency due to the two provisions, wherein removal would require a special resolution and approval

of the Central Government while removal through non-ratification would need only an ordinary resolution.

This anomaly has now been removed by omission of the proviso to sub-section (1) of section 139. The auditor once appointed for a period of five years can be removed only by following the procedure prescribed under section 140 of the Act. This will strengthen the independence of the auditors.

The disqualifications provided in section 141 of the Companies Act, 2013 also pose a challenge to the firms growing bigger. Section 141(3)(d) of the Act, *inter alia*, provides that a person shall not be eligible for appointment as an auditor of a company, if he, or his relative, or partner, holds any security, or gives a guarantee, or is indebted to the company for specified amounts, etc. The Company Law Committee formed by the Hon'ble Minister for Corporate Affairs in 2015, went into this issue in detail. The Committee was apprised by the ICAI regarding the difficulties in the application of these provisions, as an auditor did not have any control over the financial decisions of his relatives who were not financially dependent on the auditor, like brother, married sister, or married daughter. It was suggested that, for the purposes of Section 141(3)(d), the term "relative" be restricted only to financially dependent relatives.

The Committee had accepted the suggestions of the ICAI and had accordingly recommended that the term relative should be restricted only to the financially dependent relatives. When the Companies Bill, 2016 was introduced in the Parliament, this amendment was proposed. However, when the Bill was re-introduced in 2017, this proposal was dropped. Thus, the same challenges continues. One practical way of overcoming the challenge is to give the information of all the relatives of all the partners to the Audit Committee and place the onus on them also to ensure that the provisions of the Act are being complied with.

The auditors also need to take note of section 271J of the Income-tax Act, 1961, which has been inserted by the Finance Act, 2017. It empowers the Assessing Officer or the Commissioner (Appeals) to impose a penalty up to a sum of rupees ten thousand for any incorrect information in any report or a certificate under any provisions of the Act. Every certificate or report issued by an auditor must be in accordance with the relevant Standards on Auditing. An incorrect information will not necessarily result in an auditor being guilty of a professional misconduct. The Courts have in number of cases held that every mistake does not mean that the professional has been grossly negligent. The various case laws have held that a professional was negligent which did not amount to gross negligence. Therefore, a peculiar situation can arise where the Assessing Officer may impose a penalty for a mistake for which an auditor may not be guilty of professional misconduct. The delegation of power to impose the penalty under section 271J should be only on the auditor being held guilty of professional misconduct in terms of the provisions of the Chartered Accountants Act, 1949.

SEBI Order – Action against firms

The ghost of Satyam again re-surfaced with SEBI order against the auditors of Satyam. The order imposes (a) Ban on the individual concerned partners from issuing any audit opinion in respect of any listed entity, (b) Monetary fines and (c) ban on the firm to carry out any audit engagement for two years starting from 1st April, 2018. It is reported that the Appellate Tribunal has extended the commencement of the ban from 1st April, 2019.

In so far as the ban on the engagement partners is concerned, it is more academic than real. The concerned partners have already been removed from the register of members for the whole life. Therefore, they cannot carry on the practice as a Chartered Accountants, leave aside issuing any audit opinions.

The decision to act against the firm is concerned needs to be understood in right perspective. Under

the Chartered Accountants Act, the ICAI cannot act against the firms but against the individual members. In 2010 the Council had resolved that the Act and the Rules need to be amended to enable the ICAI to act even against the firms. The necessary powers are yet to be conferred on the ICAI. Thus, the need to act against the professional firms besides acting against the concerned members is an accepted principle. It is also an international practice.

The SEBI has taken a view, as appears from the said Order that it has the necessary powers under the SEBI Act and Regulations. The Order is a legal order. It applies with full force till such time it is not reversed by the Appellate Tribunal or High Court or the Supreme Court.

Imposing the monetary penalties is also now recognised under the Companies Act. The firms need to have proper insurance to protect themselves from such penalties which can be very steep.

The decision to ban the firm for two years from carrying on any audit or attestation work for any listed entity or an intermediary is something which it is respectfully submitted, needs re-consideration. The essential difference between a profession and business seems to have lost out. When SEBI bans a company or an individual from entering into capital market, the punishment is on the company and the specific individuals. In the present case, the partners who committed the offence are no longer the partners of the firm. They cannot remain partners once their names are removed from the register of members by the ICAI. Thus, the ban is on the present partners, managers and the article assistants of the firm. When the offences were committed i.e. from 2001 to 2009, the present partners may not have been partners, the present managers may not even have been chartered accountants and certainly the present article assistants would only have been in primary schools. Considering this, the ban on the firm appears to be unreasonable and unfair to the present partners and staff of the firm which are carrying on the professional work.

From a practical point of view, the ban of two years is too long. Today the firms are appointed for a period of five years. The auditor once appointed can be re-appointed for another period of five years. If a firm is debarred for even a year, the ban is for a minimum of five years which can extend to ten years.

We are witnessing the evolution of law. The present case will set the trend for the future. In my opinion, the action against the firm should be only by way of monetary penalties and not extended to ban on carrying on the professional work.

A firm can be banned from practice only if the firm does not have qualitative norms and standards to carry on the professional work. If an aircraft crashes the airline is not banned. This is so because the airline has competent staff and policies and procedures to carry on the business. If one surgery fails and a patient dies, the hospital is not closed. Similarly, in case of an audit firm, the firm should be subjected to regular Quality Review/Peer Review. Every audit opinions can be subjected to review by the Financial Reporting Review Board. This will more effectively re-assure that the firm has policies and procedures to carry on the audit functions. What is the guarantee that after two years, the firm has competent staff to carry out the audit of listed entities? What is the assurance to the investors that after two years the firm is competent to issue audit opinions. Thus, the present decision of banning the firm for two years does not give any protection to the investors. On the contrary, such firms should be mandated to more rigorous and regular review processes.

We are living in challenging times. The speed of change will only increase. This necessitates us to be more rigorous in technical compliance and at the same time be more conservative when adhering to the ethical standards. I am optimist. I always believe that the profession can only grow stronger with every challenge.

CA C. N. Vaze

HOT SPOT
Supreme Court on MAFs

This is a summary-cum-analysis of the Hon'ble Supreme Court decision delivered on 23rd of February, 2018 in respect of the operations and regulation of multi-national Accounting Firms (MAFs) in India. It is a herculean task to condense this 72 page decision into a few pages. Nevertheless, I will try.

Two cases combined

Mr. S. Sukumar had filed a Writ Petition No. 17959 in the year 2012 against ICAI in the Hon'ble High Court of Karnataka. It sought directions on three points: viz.

- Initiate investigation against MAFs operating in India
- Initiate investigation against Indian CA firms having arrangement with such MAFs for breach of Code of Ethics under CA Act, and
- Take penal action by way of cancellation of permission granted to them by ICAI.

The Hon'ble Karnataka High Court passed an order on 3rd of August, 2015. The Hon'ble Apex Court granted leave in SLP (Civil) No. 1808 of 2016.

Simultaneously, there was a Writ Petition (Civil) No. 991 of 2013 filed in Supreme Court by *Centre for Public Interest Litigation vs. Union of India.* Since the issues in both the cases were identical, the Hon'ble Supreme Court disposed of both the cases by a common order.

Issue involved

Whether MAFs are operating in India in violation of law in force in a clandestine manner; and no effective steps are being taken to enforce the said law.

Averments in WP before HC

The petitioner pleaded that:

- MAFs are illegally operating in India providing Accounting, Auditing, Book keeping and Taxation services
- They are operating with the help of ICAI illegally
- Their operations are inter alia in violation of Sec. 224 of the Companies Act, 1956, Sec. 25 and 29 of CA Act, and Code of Conduct laid down by ICAI.

Actually, in the wake of liberalization policy and signing of GATT by India, the Council of ICAI had set up a Study Group in July 1994 to examine the attempts of MAFs operating in India without formal registration and without being subjected to any discipline and control. The Study Group gave its report on 15th of September, 2003. It was noted by the

Study Group that bodies corporate formed for management consultancy services were being used as a vehicle for procuring professional work for sister firms of CAs. Members of ICAI were associating themselves with such bodies as directors, managers, etc. Thus, MAFs were escaping from all regulatory controls.

The point of concern

The Study Group enumerated the concerns expressed in various quarters of CAs viz.:

(a) Sharing fees with non-members;

(b) Networking and consolidation of Indian firms;

(c) Need to review the advertisement aspect;

(d) Multi disciplinary firms with other professionals;

(e) Commercial presence of multi-national accounting firms;

(f) Impact of similarity of names between accountancy firms and MAFs/Corporates engaged in MSC-Scope for reform and regulation;

(g) Strengthening knowledge base and skills;

(h) Facilitating growth of Indian CA firms & Indian CAs internationaly;

(i) Perspective of the Government, corporate world and regulatory bodies and role of ICAI in shaping the view;

(j) Introduction of joint audit system;

(k) Recognition of qualifications under Clause (4) of Part I of the First Schedule to the Chartered Accountants Act, 1949 for the purpose of promoting partnership with any persons other than the CA in practice within India or abroad;

(l) Review the concept of exclusive areas for the keeping in view the larger public interest involved so as to include internal audit within it;

(m) Conditionalities prescribed by certain financial institutions/Governmental agencies insisting appointment of select few firms as auditors/concurrent auditors/consultants for their borrowers.

Study Group's observations

It was observed that due to the *modus operandi* of the MAFs, the Code of Ethics was sidelined. Many items listed in the First Schedule to the CA Act – such as advertising, soliciting the professional work, sharing fees with non-members were flouted. The Group felt that the real control and decision making should be with Indian Firms. Mentioning of affiliation with any person other than a member of ICAI may amount to advertising and should be prohibited. It was also felt that the concept of Multi-Disciplinary Firms was required to be explored for rendering integrated service with suitable safeguards. It was also observed that although upgrading of knowledge of our CAs was necessary, the commercial presence of MAFs should not be allowed – neither in law nor in fact.

In USA, there is Sarbanes Oxley Act, 2002. Under this Act, a foreign accounting firm preparing audit report is made accountable to the Public Company Accounting Oversight Board and the Securities and Exchange Commission. Hence, MAFs could not be allowed without registration with ICAI. MAFs should not authenticate any financial statement of any Indian entity.

MAFs claim is that they provide audit service through their Indian affiliates. This is an indirect entry of MAFs in India. There is no requisite reciprocity for Indian accountancy firms. It was suggested that even the affiliates should not use foreign brand. Use of brand gives an impression that Indian firm is not independent.

It was noted that even on visiting cards and stationery of Indian firms/partners, a separation

of entity should be clearly indicated; and under the omnibus head of management consultancy services, MAFs should not be allowed to violate our Code of Ethics. It was not possible to enforce Code of Ethics on such entities. Advertisement and publicity done by such firms also was considered harmful to the profession. It was further noted that though the CAs are not allowed to share fees or profits with anyone other than a member of the institute, some of the members were lending their names to the MAFs who are non-members and enabling them to illegally operate in the field of Chartered Accountancy and sharing fees and profits with them. Indian CAs have not been provided reciprocity in the countries to which the MAFs belong as per Sec. 29 of the CA Act.

Apart from the study group whose observations have been discussed in the foregoing paragraphs, the Hon'ble Court's attention was also drawn to a report on the operation of MAF in India dated 29-7-2011 by expert Group of ICAI. It was in the wake of 'Satyam Scam'. The observations of these expert groups were as follows:_

i. MAFs are rendering services rendered by CAs in terms of Sec. 2(2) of CA Act such as accountancy, auditing etc.

ii. MAFs are corporates/juridical persons. They solicit professional work in International brand name.

iii. They have registered Indian CA firms with ICAI with the same brand names which are their integral part.

iv. There is no regulatory regime for their accountability.

v. This implied that:-

   a. The principle of reciprocity contemplated in Sec. 29 of the CA Act was not followed; and

   b. Sec.25 of the CA Act that prohibits corporates from CA practice was also contravened.

vi. Code of ethics prohibiting advertisement and fee sharing was also flouted.

vii. MAFs also violated FDI policy in the field of accounting, auditing, book keeping, taxation and legal service.

ICAI submitted a status report to the HC. It stated that 161 out of 171 firms were examined by the High Powered Committee in pursuance of the report of the expert group dated 29-7-2011. It reported that some of the cases were referred to the Director (Discipline) for further action and that the remaining 10 firms were also being examined. The HC disposed off the writ petition on the ground that ICAI had already initiated the action.

In the writ petition directly filed by the Centre for Public Interest Litigation in the Supreme Court if pointed out further allegations as follows:-

i. A particular MAF (PwC Pvt. Ltd.) and their network audit firms operating in India have indulged in violation of Foreign Direct Investment (FDI policy). They also violated RBI Act & FEMA which calls for investigation.

ii. MAFs receive large amounts from abroad in contravention of law and Government policies. The concerned authorities have failed to take appropriate action.

iii. This particular MAF had been the auditor of Satyam Computer Services Ltd. for more than 8 years but failed to discover the biggest accounting scandal. The scandal was revealed only on the confession of the chairman in January 2009. Due to this scandal, the firm had to pay the penalty of USD 7.5 million approximately (₹ 38 crores) in USA. It was pleaded that many financial decisions such as subsidiaries, import incentives, grants, taxes, etc. depend on the certification by auditors. There was a need to oversee the work of certification carried out by such MAF. Despite their request letter dated

1-7-2013, no satisfactory investigation has been done.

Allegation against PwC

i. There are 10 audit firms under their network apart from a private limited company namely PwCPL. Their clients include Govt. depts., PSUs, various ministries. Huge amount of fee is paid to them.

ii. They have violated FDI policy, RBI Master Circulars, FEMA Act and Rules.

iii. They had received more than ₹ 400 crores from abroad under the guise of training and also to buy out the interest in an Indian firm namely Dalal & Shah. The *modus operandi* was to give interest free loans to the individual partners of the said firm. Just to circumvent the allegation of investment in India. This was also alleged to be in violation of Benami Transactions (Prohibition) Act.

iv. There was also a violation of Companies Act. Insurance premium has been paid by 3 firms of PwC for the benefit of other member firms which was illegal.

v. Their network firms also failed to point out high level of NPAs in Global Trust Bank (GTB). This forced the GTBs merger with Oriental Bank of Commerce in 2004.

vi. Lovelock & Lewes (LL), a network firm of PwC was found guilty for manipulating share prices and falsification of accounts by Service Fraud Investigation Officer (SFIO). PwC has been found guilty of accounting scandals outside India.

The petitioner before the Supreme Court prayed that:

a. Falsification of accounts should be made a non-bailable offence.

b. An independent regulator should be appointed for the auditors.

c. The use of brand name of PwC by the network firms should also be investigated into.

To sum up the case of the petitioners was:

i. Strengthen the regulatory framework by re-visiting the same to cover the gaps. Establishments of the separate oversight body to regulate the audit functions.

ii. Investigate into irregularities and violation of various laws committed by PwC.

iii. The mere fact that the network firms have paid income tax on the amounts received by them from abroad should not absolve them of violation of laws. The remittances from abroad were used for indirectly running the CA profession through the network firms.

iv. Falsification of accounts with regard to insurance premium and consequent violation of Companies Act.

v. PwC should be held responsible for the scams of Satyam, GTB and UB groups (Kingfisher Airlines).

vi. SFIO & CBI have found PwC guilty. Still large Government contracts like GST were awarded to them.

Thus, there was a prayer to investigate into all these alleged misdeeds of PwC.

High Powered Committee Expert Group Report dated 29-7-2011

The following issues were referred to this Expert Group.

a. Examine the link between MAFs and Indian Network firms. The firms and Indian partners carried visiting cards mentioning the name of the MAFs.

b. Whether the name of MAF was used in Satyam's report;

c. Terms and conditions and cost payable for use of international brand name. Since

it was obvious that there would be a consideration for the use of brand name, whether there was a sharing of fees/profit in violation of Code of Ethics.

d. Nature of extra benefits accrued to the Indian firms.

e. Examine how in the first place MAFs entered into Indian operations. RBI *vide* their letter dated 23-3-2004 made it clear that they had not permitted any foreign audit firm to set up office in India or to carry out any activity in India under the exchange regulations.

f. Permission, if any, originally granted by the Government and contravention, if any.of the relevant terms and conditions. Whether there was any reciprocity whereby Indian firms could open up offices in developed countries for rendering accounting and related services.

g. Consider additional powers to ICAI to effectively curb to malpractices by MAFs.

In general, there was a prayer for effective steps to control and regulate the MAFs' operations in India, by prohibiting them from providing auditing and assurance services. It also urged that Indian firms be prohibited from using the MAFs' brand and thereby indirectly flouting various items of misconduct under Code of Ethics (COE). There was also an emphasis on securing reciprocal permissions for Indian firms to operate abroad. Further, the petitioners also pointed out that entities having similar name as that of MAFs, which entered through automatic/ FIBP route are rendering CA services, contrary to the FDI policy.

The institute requested the Dept. of Company Affairs to take the following action:-

i. Review the existing situation to ensure reciprocal advantage to Indian firms to operate abroad.

ii. Appropriate action against MAFs, by cancelling/revoking/withdrawing the permission already granted.

iii. Effectively dealing with the non-compliances of terms and conditions of the permission.

iv. Prohibit MAFs/consultancy firms to set up commercial presence in any form and restrict them from violating the terms of any Government policy both in letter and spirit.

v. Prohibit the names of the companies which are same or similar to the name of the MAFs.

Working of the High Powered Committee of the ICAI

ICAI called for information from 171 Indian firms perceived to be having international affiliations. Such firms were classified into four categories a) b) c) and d) depending on the nature of affiliations. The response was received only from 135 firms. By and large the response was that:-

- There was reluctance to submit copies of agreement with foreign entities and their tax returns. Certain firms submitted the documents by masking certain portion of the agreements, partnership deeds, income tax returns, assessment orders, etc. claiming confidentiality and commercially sensitive nature of the documents. A few firms did not give any details.

The following points emerged from the responses of the firms:-

i. MAFs had permitted the network firms to use their brand name

ii. They did not disclose the relationship between members and firms and how the same are governed from same office under common management and control.

iii. The linkage was clear from the data disclosed on the website.

iv. These firms received financial grants from non-CA firms which was a violation of the misconduct clause of receiving share of profit from a non-member.

v. The network firms made remittance to MAFs purportedly towards subscription fees, technology cost, administration cost, etc. But the breakup of the cost was not furnished. It was obvious that it was a payment towards the use of brand name.

vi. The cost included marketing, publicity and advertising since it was not allowed as per the CA Act.

vii. No data was furnished to prove that the remittances were not related to the volume of business generated through efforts of MAFs.

viii. Total and full disclosure was not made in spite of repeated directions.

ix. The domain name used by all the firms in the networks was identical to the name of MAFs.

x. Some of the firms operate from the same premises from which the MAFs also operated. They shared the some telephone and fax machine. They also shared human resources including articled assistance with other firms without following the restriction imposed by ICAI. Similarly, in Group 'B', MAFs had entered into sub-licence agreements with the Indian firms. These firms also remitted large amount to MAFs as reimbursement of costs relating to certain central facilities and levies. They claimed that they did not share the fees or profits as such. They used the name of MAFs in their e-mail IDs. More or less similar situation was there in group 'C' or 'D'.

xi. These firms resorted to sub-contracting for carrying out the number of audits beyond the prescribed limits. This could result in deterioration of quality of performance.

xii. Member firms are required to refer the work among themselves for this a referral fee is payable and receivable. The agreements also provided for use of name and logo. Payment of such referral fee is prohibited as per code of ethics of ICAI. The expert group also noted that firms with names, identical to that of MAFs were operating in India. However, in absence of complete data a conclusive finding could not be recorded as to violation of CA Act. With regard to sharing of fees or profits with non-members, securing business through solicitation/publicity. Such affiliation to MAFs vitiated the level playing field with Indian CA firms who are subjected to Code of Ethics of ICAI.

The conclusion was that the control of Indian CA firms was effectively placed in the hands of non-members/companies and foreign entities.

Note:

The texts of certain paragraphs from the Expert Groups report have been reproduced in para 25, pages 23 to 42 of the decision. Interested readers may go through the same. The Expert Group's findings are recorded on pages 27 to 42. These findings have been summarised in the foregoing paragraphs of the present article.

Expert Group's Recommendations:

Accordingly, the recommendations were made to the effect that the Council should consider action against the firms which had not given the full information; consider action against the firms who are sharing revenue with multinational entity/consulting entity in India which may include cost of marketing, publicity and advertising as against the ethics of CAs; action should be considered against the firms who had received financial grant from the multinational entities in spite of prohibition against the CA firms. A member is not allowed to accept any share, commission or brokerage from a non-member unless such non-member is a member of a professional body with prescribed qualifications. Further recommendation is that action be taken against the audit firms distributing its work to other firms and allowing them access to all

confidential information without the consent of the client; require the CA firms to maintain necessary data about the remittances made and received on account of networking arrangement or sharing of fee; consider action against firms being paid or offered referral fee; it should be made mandatory for all firms who enter into any kind of affiliation/arrangement with any foreign entity to disclose their international affiliation/arrangement every year to the Institute; Council should consider action against the firms using name and logo of international networks; action should also be considered for securing professional business by means which are not open to CAs in India. The Council should also issue public statement that without specific approval of the Council, by a notification under Section 29(2) of the CA Act, no MAF can directly or indirectly operate in India through any agreement or arrangement with any Indian entity/firm of CAs. No international firm or entity should be permitted to hold out to public that they are operating in India as a MAF as part of their network. No Indian CA firm should be permitted to pay any part of their profit or fee or other receipts to any person other than a member of ICAI or a firm owned by them by way of cost or percentage except payment for specific professional fee. The Council may request the Ministry of Corporate Affairs, Reserve Bank of India and other relevant Ministries/Departments to take appropriate action so that the recommendations can be implemented to engage the services of accounting firms registered with ICAI. Only CAs and CA firms registered with ICAI should be permitted to provide audit and assurance services. Wherever MAFs are operating in India, directly or indirectly, they should not engage in any audit and assurance services without 'No Objection' and permission from ICAI and RBI. Instructions may be issued that any joint venture agreement, MOU, foreign collaboration agreement, stakeholders agreement, private equity fund condition, venture capital fund condition or side letters prescribing for appointment of a specific Chartered Accountant or a CA Firm or any other entity are illegal and against public interest.

i. Council should consider action against the firms who did not give the full information and also against those who are sharing revenue with MAFs. Such sharing may also include cost of marketing, publicity and advertising which is against the ethics of CAs.

ii. Council should also consider action against the firms who received financial grant from MAFs in spite of prohibition against the CA firm.

iii. Consider action against the audit firm distributing its work to other firms and allowing them access to all confidential information without the consent of the client.

iv. Council may also require CA firms to maintain necessary data about remittances made and received on account of network arrangement or sharing of fees.

v. Consider action against firms' being paid or offered referral fee.

vi. Council may also make it mandatory for all firms who enter into any kind of affiliation/arrangement with any foreign entity to disclose the details every year.

vii. Council should consider action against the firms using name and logo of international network.

viii. Action should also be taken for securing professional business by means which are not permitted for CAs in India.

ix. Most importantly council should also issue a public statement that without specific approval of the council by a notification u/s. 29(2) of the CA Act, no MAF can directly or indirectly operate in India through any agreement or arrangement with any Indian entity/firm of CAs. No MAF or international entity should be permitted to hold out to public that they

are operating in India as MAF as part of their network.

x. No Indian CA firm should be permitted to pay any part of their profit or fee or other receipts to any person other than a member of ICAI or a firm owned by them by way of cost or percentage except payment for specific professional fee.

xi. The council may request Ministry of Corporate Affairs, RBI and other relevant ministries/Departments to take appropriate action so that the recommendations can be implemented to engage the services of accounting firms registered with ICAI. Only CAs and CA firms registered with ICAI should be permitted to provide audit and assurance services. Wherever MAF are operating in India, directly or indirectly, they should not engage in any audit and assurance services without 'No Objection' and permission from ICAI & RBI.

xii. Instructions may be issued that any joint venture agreement MOU, foreign collaboration agreement, stakeholders agreement, private entity fund condition, venture capital fund condition or side letters prescribing for appointment of a specific Chartered Accountant or a CA firm or any other entity are illegal and against public interest.

Stand of ICAI

The economy of India had witnessed two major securities scams in 1992 and 2001. The CA Act was amended on the recommendation of the Joint Parliamentary Committee which enquire into the stock market scams. ICAI also took cognizance of the report of the high level committee on the 'Corporate Audit and Governance' under the chairmanship of Shri Nareshchandra.

As regards PWCs working, ICAI stated that Disciplinary Directorate had already taken cognizance of the information in the article dated 17-1-2012 in the Times of India –"Sundry Income cushions PwC India". Accordingly, ICAI issued letter dated 9-3-2012 to PwC, New Delhi, Chennai, Bangalore etc . A letter was also written to RBI.

Disciplinary Directorate also sent a reminder to ICAI and a letter to CIT (Kolkata) and to joint secretary (Revenue) Ministry of Finance. The IT deptt informed ICAI that scrutiny proceedings on transfer pricing issues of PwC were pending for A.Y.2010-11 and 2011-12.

As regards failure of PwC Bengaluru to discover Satyam Scandal the US Regulators namely SEC & PCAOB had taken action but the disciplinary proceeding in India were getting prolonged.

Regarding LL to point out high level of NPA of GTB ICAI stated that no formal complaint was filed against PwCPL. ICAI could not take any action under CA Act.

Action was taken against the member of LL, Shri S. Gopal Krishnan, Shri P. Rama Krishna and Shri Manish Agarwal, Shri Kersi Vachha, Shri Amol Ganguli, Shri Partha Ghosh, Shri D.V.P. Rao for Satyam Scam action was taken against various partners of PwC.

Action was also taken against the then CFO of Satyam and also the then head of Internal Audit Cell of Satyam.

Joint Director SFO *vide* a complaint on 3-3-2009 in respect of DSQ Software Limited against CA Nareshkumar Thorad. It was revealed that company had made preferential allotment of shares to various entities in a fraudulent manner.

Stand of the Respondent Firms

A) Respondent No. 5 M/s. Deloitte Haskins & Sells submitted that:-

   i. There is no allegation against it in the SLP. All its partners of were Indians and the firm was registered with ICAI.

   ii. Expert group constituted by MCA gave its report dated 31-1-2017 that big six firms (MAF) were not operating directly in India. Their network partners were rendering

audit services. Indian firms pay Global Network charges to the parent organisation towards sharing of common global costs of human resources and other infrastructures, technology costs. There is a standard practice everywhere. It does not make MAFs subject to the control by Global parent.

iii. MAFs cannot be treated as multinational entities as there is no foreign control through ownership or management. Network partners are run, controlled and managed by Indian nationals.

iv. Reference was made to PMO; letter dated 3-7-2017 addressed to MCA, which incorporated the conclusions of expert groups as follows:-

a) The accounting and auditing standards and practices followed in India should be aligned to international standards and practices with customisation to the extent necessary.

b) The small size of majority of India audit firms being a constraint in facing global competition, consolidation through merger and networking of India audit firms should be encouraged through policy measures.

c) With audit becoming a multi disciplinary function, formation of multi disciplinary audit firms with participation by professionals from other relevant professions should be promoted.

d) It should be ensured that the conducting technical evaluations of India audit firms are implemented.

e) If and when audit and assurance are opened to global competition, the principle of reciprocity should be followed and the interests of India audit firms should be given due consideration."

B) Stand of Respondent Nos. 6 to 11 – PwC Network:-

i. PwC or PW is the brand owned by PwCIL registered in England limited by Guarantee. PwCIL acts as a co-ordinating company within the PwC Network and does not provide any business or audit services. Respondent Nos. 6 to 11 are member entities of PwC network.

ii. PwCIL allows the desirous entities to become members of PwC network if they follow global standards of quality. Uniform and consistent delivery is important.

iii. PwC network is not a global partnership. PwC brand name is based on name licence agreement to exercise co-operation and uniformity amongst member firms.

iv. PwC services BV is incorporated in Netherlands to operationalise global standards of services. It co-ordinates efforts to develop superior global common standards. It does not do any client related work. It recovers charges from network entities as a percentage of their revenue which is used to meet the expenses to develop standards.

v. Services agreement are signed by network entities, services BV works on no profit no loss basis.

vi. Non-refundable grants were provided by services BV for enhancing the standards and capacity of Indian network entities.

Grants are not in the nature of investments. They are current account transactions and not capital account transactions.

vii. The grants were subjected to Income Tax but the charges paid to service BV were disallowed as deduction. Appeals were pending against such assessment. Enforcement Directorate (ED) summons u/s. 37 of FEMA were also issued.

viii. ROC issued show cause notices for prosecution against directors and company secretary of PwCPL in January 2013. CLB allowed compounding of offences on payment of composition amount of ₹ 8,31,000/-.

ix. Auditing services are being carried out by Respondent Nos. 6 to 11 consisting of 185 partners.

x. There are other LLPs which are members of PwC Network in India. All partners are Indian by nationality and registered with ICAI. Directors are not partners. Indian firms of PwC Network operate as independent entities.

xi. Guidelines of the ICAI dated 27th September, 2011 apply to a network if the network has common ownership, control or management, common quality control policies and procedures, common business strategy, use of a common brand name or a significant part of professional resources.

xii. The Expert Group Report of the ICAI recommended the following:

"No person or entity and specially Chartered Accountants can hold out to public that they are operating in India as or on behalf or in their trade name and in any other manner so as to represent them being part of or authorised by MAFs to operate on their behalf in India or they are actually representing MAFs or they are MAFs office/representatives in India, except those registered with ICAI in terms of Clause (Hi) as a network, in accordance with network guidelines as notified by the ICAI from time to time."

[(Clause 7.12 (v) of the Report at pg. 152 of SLP No.1808 of 2016]

xiii. Guidelines allow registration of a network and PwC firms have filed their declaration in accordance with these guidelines and are registered in India as per ICAI regulations.

xiv. Merely because PwC audit firm are part of global PwC Network does not by itself violate any applicable law.

xv. Grants received in F.Y. 2008-09, 2009-10 AND 2010-11 were subject to Income Tax. The network has furnished all the information to ICAI.

xvi. Since all partners are Indians and registered with ICAI, they are personally accountable to ICAI for any professional misconduct. Service BV does not have any stake in the partnership or profits of the firms. Thus, there is no violation of Sec. 25 of the CA Act.

Stand taken by CBDT/ED

The DGIT (Investigation) carried out the investigation with regard to Income-tax implication. It was found that 11 entities belonging to PWC group are operating in India. Four entities have received grants of ₹ 497.64 crore from PwC Services BV during the periods

2009 to 2013. The grants are of two types – one is professional capacity building and business expansion. ₹ 416.39 crore are offered for tax as sundry income. The balance was claimed as capital receipt for expansion of business. ED has examined a number of witnesses though its investigation has not been completed.

Stand of ROC

ROC Kolkata initiated prosecution against the auditors, who compounded the offences. Certain proceedings are still pending.

Stand of RBI

RBI stated that it only issues circulars and frames regulations under FEMA. But it does not conduct any investigation for compliance thereof. Regulation 3 of the Foreign Exchange Management (Investment in Firm or Proprietary Concern in India) Regulations, 2000 is that a person resident outside India cannot invest in a firm or proprietary concern without permission of the RBI. As per para 3.3.2 of the FDI Policy, investment without prior approval of the RBI is not permitted.

Issues for consideration

The Supreme Court observed that based on the foregoing factual position and pleadings. The following issues are identified:-

i. Under the CA Act, a corporate entity or a firm having company as its partner cannot practice as CA.

ii. Code of Ethics prohibits sharing, advertisement, etc. but MAFs by using their international brand violate the Code of Ethics. ICAI has no regulatory control over them. Indian firms using similar brand name are registered. Thus, there is a need to revisit the legal framework and have an effective oversight mechanism to regulate MAF.

iii. Law needs to be amended on the pattern of Sarbanes Oxley Act enacted in the USA to regulate the accountability of auditors.

iv. In respect of the foreign firms operating in India, respective country should offer reciprocity to Indian firms in terms of Section 29 of CA Act.

v. FDI Policy and RBI guidelines framed under FEMA prohibited the investment by a person outside India in the capital of a firm/proprietary concern without permission of RBI.

vi. PwC Services BV have made investments in Indian firms by resorting to circuitous route as explained earlier. The arrangement with Services BV amounts to profit sharing by Indian firms with a foreign entity.

The Supreme Court further observed that

a) Remittances from abroad could be termed as investment even though they are claimed to be interest free loans to the partners.

b) Indian firms though having Indian partners, operate under common brand name from same infrastructure with foreign entity – It is not possible to rule out the contravention of FDI policy, FEMA regulation and CA Act. Appropriate action may have to be taken in pending proceedings at appropriate forum.

Supreme Court noted that the investigation so far carried out by income tax authorities, ROC, RBI authorities, ED, ICAI cannot be held to be complete. ICAI does not claim to have conducted complete investigation with reference to 25 and 29 of the CA Act. ICAI should have taken the matter to logical end. ICAI experts committee has given a report dated 29-7-2011. It does not specifically name the MAFs involved in group A, B, C and D. ICAI ought to constitute an expert panel to update its enquiry. Though the committee analysed available facts and found that MAFs were involved in violating ethics and laws, it took hyper technical view that in absence of complete information and lack of disciplinary jurisdiction, no effective action could be taken.

A premier professional's body cannot limit its oversight functions on technicalities and is expected to play pro-active role for upholding ethics and values of the profession by going into all connected and incidental issues.

Thus, a case is made out for examination not only by ED and ICAI, but also by the Central Government. Having regard to the issues of violation of RBI/FDI policies and the CA Act by secret arrangements.

Having stated this, the Hon'ble Supreme Court underlined the importance of auditing profession for the economy. Failure of auditors have resulted into serious scandals in the past. The oversight mechanism on auditors needs to be revisited from time to time. In the USA after the Enron Anderson Scandal in the year 2000, Sarbanes Oxley Act was enacted, requiring the corporate leaders to personally certify the accuracy of their company's financials. The Act also lays down rules of functioning of audit companies so as to prevent the corporate analysts from benefitting at the cost of public interest. The audit companies were also prohibited for providing non-audit services of companies whose audits were conducted by such auditors. It is obvious that absence of adequate oversight mechanism as the potential of infringing public interest and rule of law which are part of fundamental rights, under Articles 14 to 21. It appears necessary to realize that auditing business is required to be separated from the consultancy business to ensure independence of auditors. The accounting firms could not be left to self-regulate themselves.

It is for the policy makers to provide for adequate safeguards in the context of globalisation. Such safeguards are of paramount importance in the society and economy of the country. Although this court may not involve itself with the policy making, it can certainly look into the adequacy of safeguards for enforcement of fundamental rights. In the present case, it *prima facie* appears that there are violations of statutory provisions and policy framework. Statutory Regulating Provisions should be enforced meaningfully. No vested interest can flout the same by manifesting compliances only in form. Compliance has to be in substance. The law enforcing agencies are expected to see the real situation. In the present case:-

- Compliance by MAFs is only in form.
- Although the face is of Indian firms the real beneficiaries are foreign entities.
- Principle of lifting of corporate veil has to apply when the law is sought to be circumvented.
- In modern jurisprudence the horizon of the doctrine of lifting of corporate veil is expanding.
- Although the company is a separate entity, the courts have recognised several inceptions to the rule, such as fraud, improper conduct, violation of law, etc. Protection of public interest is of supreme importance.
- If a corporate entity is used for flouting the ethics of sharing the fees or ceiling limits on audit, by means of subcontracting or outsourcing, it would be a fit case for lifting of corporate veil. If the premises, phone number/fax number, brand name, controlling entity and human resources are the same, it will be difficult to expect that there is full compliance merely because firms are separately registered. It defeats Sec. 25 of CA Act. Perhaps for this reason, the network firms avoided giving information sought by the committee. Therefore, there is a need to have a separate oversight body.

The mere fact that income tax is paid on foreign remittance cannot establish that the receipt is not an investment which is not permitted. The policy of law cannot be defeated by terming such investment as grant for quality control especially when the grant has been used to acquire a chartered accountancy firm.

Absence of separate oversight mechanism may adversely affect the CA profession and simultaneously the unchecked auditing bodies can adversely affect the economy. Companies doing CA business will not have personal or individual accountability. Persons who are the face may be insignificant and real owners or beneficiaries of prohibited activity may go scot-free. The reports of study group and expert groups show that enforcement mechanism is not adequate and effective.

Experts in all Government should look into this aspect. They may have to think on the pattern of Sarbanes Oxley Act, 2002 and also check-prevent the corporate analysts from benefitting from conflict of interest.

- Check audit companies from providing non-audit services &
- Lay down protocol for auditors.

In US there is another law 'Dodd-Frank Wall Street Reform and Consumer Protection Act, 2010 – to ensure more transparency and accountability of financial institution to reduce the risk of investing. There is Financial Stability Oversight Council (FSOC). The authorities should look into these aspects as well.

Finally, the Hon'ble Supreme Court issued the following directions –

i) Union of India may constitute a three member committee of experts within two months to look into statutory framework to enforce the letter and spirit of Section 25 and 29 of the CA Act.

   – Revisit the code of ethics to appropriately discipline and regulate the MAFs

   – Appropriate legislation on the pattern of Sarbanes Oxley Act, 2002 and Dodd Frank Wall Street Reform and Consumer Protection Act, 2010, consider any other appropriate mechanism for oversight of profession of auditors

   – Conflict of interests of auditor acting as consultant.

   – Set-up and exclusive oversight body for auditors

   – Effective enforcement of FDI policy and FEMA regulations

   For this the committee may examine the study group and expert group reports and also call for suggestions for all concerns.

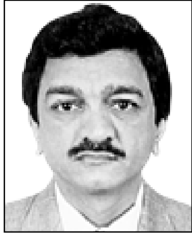
   The report of the committee may be submitted within three months from its constitution.

ii) The ED may complete the pending investigation within three months.

iii) ICAI may further examine all the related issues at appropriate level as far as possible within three months and take such further steps as may be considered necessary.

Conclusion

This is the story of CA profession. I feel, all the professions in our country are more or less sailing in the same boat. They are faced with same or similar challenges. Professionals are considered to be intellectuals and keepers of the conscience. We are expected to provide leadership to the society. CAs claim that they are merely watchdogs and not bloodhounds. But have they discharged even that function diligently and conscientiously? Have other professions also refrained themselves from malpractices. There is a cultural invasion in all walks of life. Question also arises as to what are the elected professional bodies doing? All of us need to introspect. We need to be more vocal and assertive about values and dignity, integrity and credibility of our respective professions. Judiciary cannot really help unless we follow the fundamental rules of ethics religiously. That's the lesson from this decision.



B. V. Jhaveri, *Advocate*

DIRECT TAXES
Supreme Court

S.12A : The CIT has no power to cancel/withdraw/recall the registration certificate granted u/s. 12A until express power to do so was granted by s. 12AA(3). Though the grant of certificate is a quasi-judicial function, s. 21 of the General Clauses Act has no application and cannot be applied to support the order of cancellation of the registration certificate

Industrial Infrastructure Development Corporation (Gwalior) M. P. Ltd. vs. Commissioner of Income-tax, Gwalior [2018] 90 taxmann.com 281 (SC)

1. In this case the appellant assessee was a limited company registered under the Companies Act. On 10-2-1999, the appellant filed an application for registration u/s. 12-A of the Act to the CIT for grant of registration as it was engaged in public utility activity which was for a charitable purpose under section 2(15) of the Act. However, the appellant could not file the application for registration in time and therefore the appellant also made an application for condonation of delay in filing the said application.

2. By order dated 13-4-1999, the CIT (Gwalior) condoned the delay and granted the registration certificate subject to the examination on merits of the claim of exemption after the return is filed. On 27-11-2000, the CIT issued a show cause notice to the appellant to withdraw the registration on certain factual grounds. The appellant filed the reply, however, by order dated 29-4-2002, the CIT cancelled/withdrew the certificate issued to the appellant having found no substance in the stand taken by the appellant.

3. The appellant filed rectification application under section 154 of the Act before the CIT on 4-7-2002 where it was contended that once the CIT granted the registration certificate under section 12A, he had no power to cancel/recall the certificate granted to the assessee. On 20-12-2002, the CIT rejected the rectification application filed by the appellant and held that CIT had the power to cancel the certificate once granted by him and therefore, the order for cancelling the registration certificate was legal and proper.

4. Aggrieved by the said order, the appellant filed an appeal before the ITAT, Agra Bench. By order dated 26-8-2004, the ITAT allowed the appellant's appeal and set aside the order dated 29-4-2002 passed by the CIT.

5. Aggrieved by the order of the ITAT, the Revenue filed an appeal in the Madhya Pradesh High Court at Gwalior Bench. The High Court allowed the appeal filed by the Revenue and set aside the order passed by the ITAT and restored the order of the CIT. The High Court placed reliance on section 21 of the General Clauses Act and held that since there was no express power in the Act for cancelling the registration certificate under section 12A of the Act and hence power to cancel could be

traced from section 21 of the General Clauses Act to support such order. In other words, section 21 of the General Clauses Act is the source of power to pass cancellation of the certification granted by the CIT when there is no express power available under section 12A of the Act.

6. In consequence, the appellant assessee filed appeal before the Hon'ble Supreme Court where following questions had to be considered:

(i) First, whether the CIT has express power to cancel/withdraw/recall the registration certificate once granted by him under section 12A of the Act and, if so, under which provision of the Act?

(ii) Second, when the CIT grants registration certificate under section 12A of the Act to the assessee, whether grant of certificate is his quasi-judicial function and, if so, its effect on exercise of his power of cancellation of such grant of registration certificate?

(iii) Third, whether section 21 of the General Clauses Act can be applied to support the order of cancellation of the registration certificate granted by the CIT under section 12A of the Act, in case, if it is held that there is no express power of cancellation of registration certificate available to the CIT under section 12A of the Act? and

(iv) Fourth, what is the effect of the amendment made in section 12AA introducing sub-clause (3) therein by Finance (No-2) Act 2004 w.e.f. 1-10-2004 conferring express power on the CIT to cancel the registration certificate granted to the assessee under Section 12A of the Act.

7. The Hon'ble Supreme Court held that the CIT had no express power of cancellation of the registration certificate once granted by him to the assessee under section 12A till 1-10-2004. Firstly, there was no express provision in the Act vesting the CIT with the power to cancel the registration certificate granted under Section 12A of the Act. Secondly, the order passed under section 12A by the CIT was a quasi-judicial order and being quasi judicial in nature, it could be withdrawn/recalled by the CIT only when there was express power vested in him under the Act to do so. In the case in hand there was no such express power. The functions exercisable by the CIT under section 12A were neither legislative nor executive but they were essentially quasi-judicial in nature. Thirdly, an order of the CIT passed under section 12A did not fall in the category of "orders" mentioned in section 21 of the General Clauses Act. The expression "order" employed in the said section 21 would show that such "order" must be in the nature of a "notification", "rules" and "bye-laws" etc. For this proposition the Apex Court referred to the decision of *Indian National Congress (I) vs. Institute of Social Welfare & Ors. [2002 (5) SCC 685].*

8. The Hon'ble Supreme Court further held that the order, which could be modified or rescinded by applying section 21 of the General Clauses Act, had to be either executive or legislative in nature whereas the order, which the CIT was required to pass under section 12A of the Act, was neither legislative nor an executive order but it was a "quasi judicial order". It was for this reason held that section 21 of the General Clauses Act had no application in the present case. It was also held that the general power, under section 21 of the General Clauses Act, to rescind a notification or order had to be understood in the light of the subject matter, context and the effect of the relevant provisions of the statute under which the notification or order was issued and the power was not available after an enforceable right had accrued under the notification or order. The said section 21 had no application to vary or amend or review a quasi-judicial order as the same could be generally varied or reviewed when obtained by fraud or when such power is conferred by the Act or Rules under which it is made.

9. The Apex Court relied on the following decisions where common principle emanated was that section 21 of the General Clauses Act does not have application in orders of quasi judicial nature.

i) State of Bihar vs. D. N. Ganguly & Ors. (AIR 1958 SC 1018)

ii) State of Madhya Pradesh vs. Ajay Singh, (AIR 1993 SC 825)

iii) *Ghaurul Hasan vs. State of Rajasthan, (AIR 1967 SC 107) and Hari Shanker Jain vs. Sonia Gandhi, (AIR 2001 SC 3689)*

iv) *Indian National Congress (I) (2002 (5) SCC 685)*

10. The Apex Court further held that an express power was conferred on the CIT to cancel the registration for the first time by enacting sub-section (3) to section 12AA only with effect from 1-10-2004 by the Finance Act 2004 and hence such power could be exercised by the CIT only on and after 1-10-2004, i.e., (Assessment Year 2004-05) because the amendment in question was not retrospective but was prospective in nature.

11. The issue involved in the appeal had also come up for consideration before three High Courts, namely, Delhi High Court in the case of *DIT (Exemptions) vs. Mool Chand Kairati Ram Trust, (2011) 339 ITR 622*, Uttaranchal High Court in the case of *Welham Boys' School Society vs. CBDT, (2006) 285 ITR 74* and Allahabad High Court in the case of *Oxford Academy for Career Development vs. CCIT & Ors. (2009) 315 ITR 382.* All the three High Courts after examining the object of section 12A of the Act and section 21 of the General Clauses Act held that **the order of the CIT passed under section 12A was quasi judicial in nature. Second, there was no express provision in the Act vesting the CIT with power of cancellation of registration till 1-10-2004; and lastly, section 21 of the General Clauses Act had no application to the order passed by the CIT under section 12A because the order was quasi judicial in nature and it was for all these reasons the CIT had no jurisdiction to cancel the registration certificate once granted by him under section 12A till the power was expressly conferred on the CIT by section 12AA(3) of the Act w.e.f. 1-10-2004.**

12. The view taken by the three High Courts was approved by the Apex Court and the appeal of the appellant was allowed and order of ITAT was restored.

Service of S. 143(2) notice: If the assessee is not available to take service of the notice u/s. 143(2), service on the authorised representative is sufficient to draw inference of deemed service of notice on the assessee. The fact that the authorized representative is disowned by the assessee is irrelevant

ITO vs. Dharam Narain Civil Appeal No(s). 2262 of 2018, [arising out of Special Leave Petition (Civil) No. 9174 of 2015] [2018] 90 taxmann.com 325 (SC)

1. In the present case, notice u/s. 143(2) was issued on 16th October, 2006 which was dispatched on 18th October, 2006 by registered post. The material on record indicated that on two occasions the said notice was sent by registered post but could not be served on the respondent–assessee as he was not available and that it was served on the authorized representative of the respondent–assessee on 19th October, 2006.

2. The question, therefore, that arose in the writ petition was whether in such circumstances the requirement under section 143(2) of the Income-tax Act, 1961 was met by the Revenue. The High Court answered the question in the negative taking the view that what was required to be satisfied by the Revenue was service of notice and not mere issuance thereof. Accordingly, the High Court quashed the notice dated 16th October, 2006 and allowed the writ petition filed by the respondent assessee.

3. The Hon'ble Apex Court held that the non-availability of the respondent – assessee to receive the notice sent by registered post as many as on two occasions and service of notice on 19th October, 2006 on the authorised representative of the respondent assessee whom the respondent assessee later disowned was sufficient to draw an inference of deemed service of notice on the respondent – Assessee and sufficient compliance of the requirement of Section 143(2) of the Income-tax Act, 1961.

Cases referred

Asst. CIT vs. Hetal Blue Moon [2010] 3 SCC 259]

CIT vs. Sahara India Savings and Investment Corporation (321 ITR 371)

S. 80-IA contains substantive and procedural provisions for computation of special deduction. Any device adopted to reduce or inflate the profits of eligible business has to be rejected. The claim for 100% deduction, without taking into consideration depreciation, is anathema to the scheme u/s. 80-IA of the Act which is linked to profits. If the contention of the assessees is accepted, it would allow them to inflate the profits linked incentives provided u/s. 80-IA of the Act which cannot be permitted

Plastiblends India Limited vs. Addl. CIT [Civil Appeal No. 238 of 2012, Dated 9th October, 2017]

The singular issue which needs to be considered in these appeals pertains to claim of depreciation under Section 80-IA of the Income-tax Act, 1961 (hereinafter referred to as the 'Act'). Interpreting the provisions of Section 32 of the Act (which prevailed in the relevant Assessment Years) this Court in *CIT vs. Mahendra Mills (2000) 243 ITR 56* held that it is a choice of an assessee whether to claim or not to claim depreciation. As aforesaid, that decision was rendered in the context of assessing business income of an assessee under Chapter IV of the Act which is regulated by Sections 28 to 43D of the Act. Section 32 deals with depreciation and allows the deductions enumerated therein from the profits and gains of business or profession. Section 80-IA of the Act, on the other hand, contains a special provision for assessment of industrial undertakings or enterprises which are engaged in infrastructure development etc. This provision allows certain specific kind of deductions in respect of depreciation. The issue is as to whether claim for deduction on account of depreciation under Section 80-IA is the choice of the assessees or it has to be necessarily taken into consideration while computing the income under this provision.

HELD by the Supreme Court dismissing the appeals:

As is clear from the arguments advanced by Mr. Pardiwala, main thrust of his argument was predicated on the judgment of this Court in Mahendra Mills (2000) 243 ITR 56, which according to us, cannot be applied while interpreting Section 80-IA of the Act. It may be stated at the cost of the repetition that judgment in Mahendra Mills was rendered while construing the provisions of Section 32 of the Act, as it existed at the relevant time, whereas we are concerned with the provisions of Chapter VI-A of the Act. Marked distinction between the two Chapters, as already held by this Court in the judgments noted above, is that not only Section 80-IA is a code by itself, it contains the provision for special deduction which is linked to profits. In contrast, Chapter IV of the Act, which allows depreciation under Section 32 of the Act is linked to investment. This Court has also made it clear that Section 80-IA of the Act not only contains substantive but procedural provisions for computation of special deduction. Thus, any device adopted to reduce or inflate the profits of eligible business has to be rejected. The assessees/appellants want 100% deduction, without taking into consideration depreciation which they want to utilise in the subsequent years. This would be anathema to the scheme under Section 80-IA of the Act which is linked to profits and if the contention of the assessees is accepted, it would allow them to inflate the profits linked incentives provided under Section 80-IA of the Act which cannot be permitted.

S. 153A search assessment: Supreme Court stays operation of the judgment of the Delhi High Court in *Dayawanti Gupta vs. CIT 390 ITR 496 (Del.).* The High Court dealt with the issue whether an assessment u/s. 153A can be made even if no incriminating material has been found during s. 132 search proceedings

Dayawanti vs. CIT [Petition(s) for Special Leave to Appeal (C) No(s). 20559/2017, dated 3-10-2017]

In *Dayawanti Gupta vs. CIT 390 ITR 496 (Del.),* the assessee argued before the Delhi High Court that since no incriminating material was found during or pursuant to the search, additions, made on the basis of block assessment, were unsustainable inasmuch as they revisited finally settled assessments. It was submitted that for completing a block assessment, founded on search proceedings and notice under Section 153A, the assessing officer has to base the order on fresh materials found during the search, in the form of books of account, articles seized, or other similar materials. In this case, the revenue could not substantiate its plea that the assessees had concealed their income, because nothing suspect which could result in an addition to the income assessed during the previous years was in fact seized or taken into custody. Therefore, the four assessments for the block period in question had to be set aside.

The assessee relied on the judgment of the Delhi High Court in *Commissioner of Income tax vs. Kabul Chawla 380 ITR 573* in support of the contention.

However, the High Court rejected the contentions of the assessee with the finding that:

"The lynchpin of the assessee's submissions on this aspect is also that the statements were not recorded during the search but later and that they cannot be considered of any value. This court is unpersuaded with the submission. The search was conducted on 22-3-2006. Various materials: documents, agreements, invoices and statements in the form of accounts and calculations were seized. On April 18, 2006 and May 3, 2006, the assessee's sons (including one of the appellants, Abhay Gupta) recorded statements under oath; the assessee too made her statement under oath, admitting that though returns were filed ostensibly on her behalf, she was not in control of the business. She and all other family members made short statements and endorsed the statements under oath, of those who elaborated the trading and business operations relating to clandestine income. These statements under oath were part of the record and continued to be so. They were never explained in any reasonable manner. Their probative value is undeniable; the occasion for making them arose because of the search and seizure that occurred and the seizure of various documents, etc. that pointed to undeclared income. In these circumstances, the assessee's argument that they could not be acted upon or given any weight is insubstantial and meritless. This Court also notices that the decision in *CIT vs. Anil Bhatia 352 ITR 493 (Del.)* which held that such statements are relevant, though noticed, has not been doubted in any later decision, including Kabul Chawla, which is the mainstay of the assessee's case. Consequently the first question of law is answered against the assessee and in the revenue's favour."

On appeal by the assessee to the Supreme Court HELD:

"Issue notice returnable within four weeks. There shall be stay of operation of the impugned order, in the meantime."

S. 14A/ Rule 8D: Entire law on whether the computation provisions of Rule 8D is retrospective explained in the light of established principles of interpretation of statutes read with verdicts in *Vatika Townships 367 ITR 466 (SC) Gold Coin Health 304 ITR 308 (SC)* and other verdicts

CIT-5 Mumbai vs. Essar Teleholdings Ltd. through its Manager [Civil Appeal No.2165 of 2012, dated 31st January, 2018] [2018] 90 taxmann.com 2 (SC)

The Supreme Court had to consider the following important question of law:

"Whether sub-section (2) and sub-section (3) of Section 14A inserted with effect from 1-4-2007 will apply to all pending assessments? Whether Rule 8D is retrospectively applicable?"

HELD by the Supreme Court:

"39. This Court in the above case held that Rule 1BB shall be applicable even prior to the

enforcement of the rule holding that the said rule merely provides a choice amongst well-known and well-settled modes of valuation. It was held that even in the absence of Rule 1BB, it would not have been objectionable to adopt the mode of valuation embodied in Rule 1BB, namely, the mode of capitalisation of income on a number of years purchased value. The said judgment is, clearly, distinguishable in context of issue which has arisen before us. In the present case, methodology as provided under Rule 8D was neither a well-known nor well-settled mode of computation.

"The new mode of computation was brought in place by Rule 8D. No Assessing Officer, even in his imagination could have applied the methodology, which was brought in place by Rule 8B. Thus, retrospective operation of Rule 8B cannot be accepted on the strength of law laid down by this Court in the above case."

"47. ….. There is no indication in Rule 8D to the effect that Rule 8D intended to apply retrospectively.

"48. Applying the principles of statutory interpretation for interpreting retrospectivity of a fiscal statute and looking into the nature and purpose of sub-section (2) and sub-section (3) of Section 14A as well as purpose and intent of Rule 8D coupled with the explanatory notes in the Finance Bill, 2006 and the departmental understanding as reflected by Circular dated 28-12-2006, we are of the considered opinion that Rule 8D was intended to operate prospectively.

"49. It is relevant to note that impugned judgment in this appeal relies on earlier judgment of Bombay High Court in *Godrej and Boyce Manufacturing Company Limited vs. Deputy Commissioner of Income Tax, Mumbai and Another, (2017) 7 SCC 421,* where the Division Bench of the Bombay High court after elaborately considering the principles to determine the prospectivity or retrospectivity of the amendment has concluded that Rule 8D is prospective in nature. Against the aforesaid judgment of the Bombay High Court dated 12-8-2010 an appeal was filed in this Court which has been decided by *vide* its judgment reported in *Godrej and Boyce Manufacturing Company Limited vs. Deputy Commissioner of Income Tax, Mumbai & Anr. (2017) 7 SCC 421.* This Court, while deciding the above appeal repelled the challenge raised by the assessee regarding *vires* of Section 14A. In para 36 of the judgment, this Court noticed that with regard to retrospectivity of provisions Revenue had filed appeal, hence the said question was not gone into the aforesaid appeal. In the above case, this Court specifically left the question of retrospectivity to be decided in other appeals filed by the Revenue. We thus have proceeded to decide the question of retrospectivity of Rule 8D in these appeals.

"50. In view of our opinion as expressed above, dismissal of the appeal by the Bombay High Court is fully sustainable. As held above, the Rule 8D is prospective in operation and could not have been applied to any assessment year prior to Assessment Year 2008-09."

S. 2(22)(e) Deemed Dividend: The term "shareholder", post amendment, has only to be a person who is the beneficial owner of shares. One cannot be a registered owner and beneficial owner in the sense of a beneficiary of a trust or otherwise at the same time. The moment there is a shareholder, who need not necessarily be a member of the Company on its register, who is the beneficial owner of shares, the Section gets attracted without more. To state that two conditions have to be satisfied, namely, that the shareholder must first be a registered shareholder and thereafter, also be a beneficial owner is not only mutually contradictory but is plainly incorrect. ***Prima facie*****, Ankitech/ Madhur Housing is wrongly decided and should be reconsidered by Larger Bench**

National Travel Services vs. CIT, Delhi, VIII [Civil Appeal Nos. 2068 to 2071 of 2012, dated 18th January, 2018]

The question that arose in the appeals was as to whether section 2(22)(e) of the Act gets attracted inasmuch as a loan has been made to a shareholder, who after the amendment, is a person who is the beneficial owner of shares holding not less than 10% of the voting power in the company, and whether the loan is made to any concern in which such shareholder is a partner and in which he has a substantial interest, which is defined as being an interest of 20% or more of the share of the profits of the firm.

Their Lordships of the Supreme Court held as under:

"17. We are of the view that it is very difficult to accept the reasoning of the Division Bench. It is not enough to say that Ankitech's case refers to the second limb of the amended definition, whereas the present case refers to the first limb, for the simple reason that the word "shareholder" in both limbs would mean exactly the same thing. This is for the reason that the expression "such shareholder" in the second limb would show that it refers to a person who is a "shareholder" in the first limb.

"18. This being the case, we are of the view that the whole object of the amended provision would be stultified if the Division Bench judgment were to be followed. Ankitech's case, in stating that no change was made by introducing the deeming fiction insofar as the expression "shareholder" is concerned is, according to us, wrongly decided. The whole object of the provision is clear from the Explanatory memorandum and the literal language of the newly inserted definition clause which is to get over the two judgments of this Court* referred to hereinabove. This is why "shareholder" now, post amendment, has only to be a person who is the beneficial owner of shares. One cannot be a registered owner and beneficial owner in the sense of a beneficiary of a trust or otherwise at the same time. It is clear therefore that the moment there is a shareholder, who need not necessarily be a member of the Company on its register, who is the beneficial owner of shares, the Section gets attracted without more. To state, therefore, that two conditions have to be satisfied, namely, that the shareholder must first be a registered shareholder and thereafter, also be a beneficial owner is not only mutually contradictory but is plainly incorrect. Also, what is important is the addition, by way of amendment, of such beneficial owner holding not less than 10% of voting power. This is another indicator that the amendment speaks only of a beneficial shareholder who can compel the registered owner to vote in a particular way, as has been held in a catena of decisions starting from *Mathalone vs. Bombay Life Assurance Co. Ltd., [1954] SCR 117.*

"19. This being the case, we are *prima facie* of the view that the Ankitech judgment [340 ITR 14 (Del.)] itself requires to be reconsidered, and this being so, without going into other questions that may arise, including whether the facts of the present case would fit the second limb of the amended definition clause, we place these appeals before the Hon'ble Chief Justice of India in order to constitute an appropriate Bench of three learned Judges in order to have a relook at the entire question."

**CIT, Andhra Pradesh vs. C. P. Sarathy Mudaliar, (1972) 4 SCC 531*

**M/s. Rameshwari Lal Sanwarmal v. Commissioner of Income Tax, Assam (1980) 2 SCC 371*

In *CIT, Delhi-II vs. Madhur Housing and Development Company the Supreme Court in its order dated 5-10-2017* passed in Civil Appeal No. 3961 of 2013 has expressly affirmed the reasoning of the judgment in the case of *CIT v. Ankitech Pvt. Ltd. (340 ITR 14, Del.).*

Paras S. Savla, Jitendra Singh, Nishit Gandhi
Advocates

DIRECT TAXES
High Court

1. S. 68 – Cash credit – penny stock – Apart from suspicion AO did not have any evidence to support his conclusion – Addition deleted

Pr. CIT vs. Prempal Gandhi – ITA 95 of 2017 – Punjab and Haryana High Court

The assessee had purchased certain shares of a company during AY 2006-07 for ₹ 11/- per share and sold the same during AY 2008-09 at a rate of ₹ 400/- per share. The Assessee had treated the said gain on sale of shares as Long Term Capital Gains exempt from tax. The AO treated the said share transaction as sham transaction and added the entire receipt on sale of shares as taxable income. According to the AO the purchase of shares was made in cash for ₹ 11,00,000/- when the shares were in dematerialised form. Further the company whose shares were bought had negligible networth at the time of purchase and that there was a sudden and inexplicable shoot up of price of the shares of the said company in a span of less than 2 years. He accordingly held the transaction as ingenuine and taxed the entire amount received on sale of shares as unexplained income of the Assessee. The said addition was reversed by the CIT(A) and affirmed by the Tribunal on the ground that apart from suspicion the AO did not have any evidence to support his conclusion. On an appeal before the High Court, affirming the order of the Tribunal, it was held that, the Assessing Officer had not produced any evidence whatsoever in support of the suspicion. Further, though the appreciation was very high, the shares were traded on the National Stock Exchange and the payments and receipts were routed through the bank. There was no evidence to indicate for instance that this was a closely held company and that the trading on the National Stock Exchange was manipulated in any manner. As such no substantial question of law arose in the present appeal.

Note: While coming to the above conclusion the Hon'ble High Court heavily relied on the Judgment of the same Court in the case of *Pr. CIT vs. Hitesh Gandhi – ITA No.18 of 2017* wherein the facts were almost similar to that in the case of the above assessee.

2. Disallowance u/s. 40(a)(ia) for short deduction of TDS – TDS deducted u/s. 194C instead of 194J – retrospective amendment to section 9(1)(vi) – Court applied the legal maxim lex *non cogit ad impossibilia* – disallowance deleted

CIT vs. NGC Networks (India) P. Ltd. – ITXA 397 of 2015 – Bombay High Court

In Assessment Year (AY) 2009-10, the assessee paid certain channel placement fee to its cable operators. It had deducted tax at source u/s. 194C of the Income-tax Act, 1961 ["the Act"]

on such payments. However, Assessing Officer (AO) in the draft assessment order u/s 144C disallowed the said fee u/s. 40(a) (ia) of the Act on the ground that the payment fell under the definition of royalty as contained in Explanation 6 to section 9(1)(vi) of the Act which was introduced in 2012 by way of a retrospective amendment. The said disallowance was reversed by the Dispute Resolution Panel (DRP) and pursuant thereto the AO passed the final assessment order u/s. 144C of the Act. Against such order, the Revenue filed an appeal to the Tribunal. The Tribunal, however, dismissed the Appeal of the Revenue relying on its judgment in the case of *M/s. Channel Guide India Ltd. vs. ACIT in ITA No. 1221/M/2006.* It held that the assessee is not liable to deduct the tax at source at higher rates only on account of subsequent amendment made in Act, with retrospective effect from 1976. On further appeal by the Department, the Hon'ble High Court upheld the Tribunal order. It held that a party cannot be called upon to perform an impossible Act i.e. to comply with a provision not in force at the relevant time but introduced later by retrospective amendment. Reliance was placed on decision in *CIT vs. Cello Plast – (2012) 209 Taxman 617,* wherein the Court had applied the legal maxim *lex non cogit ad impossibilia* (law does not compel a man to do what he cannot possibly perform). It further held that in the present facts, the amendment by introduction of Explanation 6 to Section 9(1)(vi) of the Act took place in the year 2012 with retrospective effect from 1976. This could not have been contemplated by the Respondent when he made the payment since the law was subsequently amended at a future date. Thus the Department appeal was dismissed.

3. Transfer pricing – Determination of ALP – Earlier years transactions taken as a base compute royalty ALP

Dabur India Ltd. vs. Pr. CIT – ITA 1142 of 2017 (Delhi High Court)

The Appellant used to provide expertise and also permit the use of its name "Dabur" by a UAE based entity Redrock pursuant to an agreement whereby Redrock paid royalty of 1% to the assessee. Subsequently, the assessee acquired the entire shareholding in Redrock and it was renamed as M/s. Dabur International Ltd. The overseas entity which had then become a 100% subsidiary of the assessee ceased to pay the royalty. The TPO, while framing the assessment, took into account the agreement entered into by the Appellant with Redrock in the earlier orders and computed royalty chargeable from M/s. Dabur International Ltd. @ 4%. The TPO, in doing so, clubbed the rates of royalty @ 3% being the royalty payable on manufacturing items with the support and technical know-how provided by the assessee; and 1% of the products manufactured without the support of the assessee but marketed under the "Dabur brand". The AO accepted the TPO's additions and finalised the assessment by making appropriate adjustment to the tune of ₹ 5,44,69,000/-. The assessee appealed against this addition; the Appellate Commissioner considered the grounds and comparing the assessments completed for the previous years, accepted the TPO/AO's findings and modified the ALP reducing the royalty rate to 2% taking the average of the two categories of transactions. On an appeal to the Tribunal, the order of the CIT(A) was partly affirmed reducing the rate of royalty at 0.75% of the sales using the Dabur brand without the technical know-how and support from the Assessee. The assessee further appealed to the High Court. It was argued that since there was no agreement in operation for the relevant assessment year basis which royalty could be charged by the Assessee, there was no international transaction at all which could be benchmarked. The Hon'ble High Court while dismissing the appeal held that no infirmity can be found with the ITAT's approach. If the assessee's submissions were to be accepted even for the sake of argument then it would mean that the omission by a party to indicate, an initial income, which was concededly being shown in the past as an international transaction, cannot be scrutinised at all. Further it was for the assessee to explain as to why the 'Dabur' brand was permitted to an overseas

entity – of which it is the present sole or principal shareholder. When the ownership of the same overseas entity was of a different pattern, royalty was charged for the use of the Dabur brand. Unless at the entity level there is a complete re-organisation so as to result in a complete identity of the two concerns, royalty arising out of the use of the Dabur brand, had to be treated as an international transaction as it was for all previous years. Further, the assessee's submission with respect to the applicability of second proviso to Section 92CA(2), i.e. that it is entitled to the benefit of the arithmetical mean – not exceeding 5% was also rejected since the assessee, did not offer any adjustment claiming that there was indeed no international transaction. In these circumstances, the question of applicability of the said proviso did not arise. As such the appeal was dismissed.

4. Section 14A disallowance – AO cannot make disallowance under section 14A in excess of total administrative expenditure for earning tax free income. [A.Y. 2008-09]

Pr. CIT vs. Adani Agro (P.) Ltd. [2018] 91 taxmann.com 29 (Gujarat)

During the course of assessment proceedings, the Assessing Officer rejected the offer of the assessee with regard to disallowance of ₹ 10 lakh, offered *suo motu* under section 14A. The AO rejected the explanation of the assessee on the ground that the assessee failed to fully disclose the expenditure for earning the exempt income and based on the format provided under rule 8D. There was no dispute that no direct expenses incurred in earning of tax exempt income, and, as such, no amount was held to be disallowable under rule 8D(2)(i). The total interest paid by the assessee being ₹ 42,18,273, the proportionate interest was disallowed i.e. ₹ 25,27,200 under rule 8D(2)(ii), and finally .5% of average value of investments yielding tax exempt income, which worked out to ₹ 62,94,250, was disallowed under rule 8D(2)(iii). The total disallowance thus worked out to ₹ 88,21,450. On appeal the First Appellate authority upheld the addition made by AO. The assessee being aggrieved by the order of the learned CIT(A) preferred an appeal before the Appellate Tribunal, Ahmadabad. The Tribunal found that the assessee had surplus tax free funds, and therefore, there was no question of disallowance of any interest income. However as far as administrative expenses were concerned, it noted that the entire administrative expenses of the assessee was ₹ 30,22,749/-, out of which, the assessee had offered ₹ 10 lakhs i.e., 1/3rd of the total administrative expenditure for earning income covered under Section 14A of the Act. The Assessing Officer, however, made disallowance based on the format provided under Section 8D of the Rules and found that such disallowance would be to the tune of ₹ 62,94,250/-. The Tribunal was of the opinion that even after completing the format, the disallowance cannot exceed the total administrative expenditure incurred by the assessee. On further appeal by the Revenue, Hon'ble Court held that under no circumstances, can the Assessing Officer attribute administrative expenses for earning tax free income in excess of the total administrative expenditure incurred by the assessee. If it is a case where Assessing Officer disputes, question and disallow the very declaration of the assessee regarding total administrative expenditure, the issue could have been somewhat different. Nevertheless, when the Assessing Officer as in the present case did not disturb the assessee's declaration that total administrative expenses incurred by the assessee for all its activities was ₹ 30,22,749/-, there was no question of disallowing administrative expenses to the tune of ₹ 62,94,250/- under Section 14A. The Appeal was, therefore, dismissed.

5. Penalty u/s. 271AAA – during the course of search the statement of partner was recorded, wherein he has clearly explained entries recorded in seized material and stated that such entries pertained to

'on money' in its building project – tax and interest on such admitted tax has been paid – Penalty under section 271AAA is not leviable

Pr. CIT vs. Swapna Enterprise [2018] 91 taxmann.com 12 (Gujarat)

The assessee, a partnership firm, was engaged in the business of development of housing projects. During the course of search action u/s. 132 certain incriminating materials were seized. Statement of one of the partners of the firm was recorded u/s. 132(4) wherein he had admitted an amount disclosed in seized material as undisclosed income on oath. A notice under section 142(1) was issued to the assessee, in response to which, the assessee furnished return of income declaring income for the year under consideration. The AO subsequently levied penalty at the rate of 10 per cent of the undisclosed income admitted under section 271AAA on grounds that the assessee had failed to substantiate the manner in which the undisclosed income was derived. On appeal, the First Appellate Authority deleted the penalty on the ground that the partner, in his statement, had clearly explained that the unaccounted income represented net taxable income of the projects undertaken by the assessee-firm. In the statement it was clearly explained that the details mentioned in the diary represented net taxable income for the projects and during the course of assessment proceedings, the assessee had filed relevant details in this regard. No evidence was found to show that the assessee had earned the undisclosed income from any other source instead of the projects income. The department being aggrieved by the order of the learned CIT(A) preferred an appeal before the Appellate Tribunal, Ahmadabad. The Appellate Tribunal confirmed the CIT(A)'s order.

The department carried the matter before the Hon'ble Gujarat High Court. The High Court observed that insofar as satisfaction of clause (i) and clause (ii) of sub-section (2) of section 271AAA of the Act is concerned, both the Commissioner (Appeals) as well as the Tribunal had recorded concurrent findings of fact that the partner, during the course of recording of his statement at the time of the search, had stated that the income was earned by accepting on-money in its building project. Therefore, the manner in which the income had been derived has been clearly specified in the statement made by the partner. Insofar as substantiating the manner in which the undisclosed income was derived is concerned, the Tribunal has recorded that it had been pointed out that the undisclosed income was received by the assessee as on-money. It is not the case of the appellant that during the course of recording of the statement of partner any specific questions had been asked to substantiate the manner in which the income was derived.

It cannot be said that the findings recorded by the Commissioner (Appeals) and the Tribunal regarding satisfaction of clauses (i) and (ii) of sub-section (2) of section 271AAA of the Act suffers from any legal infirmity.

Insofar as satisfaction of clause (iii) of sub-section (2) of section 271AAA of the Act is concerned, a perusal of the penalty order reveals that the entire amount of tax and penalty had been paid by 30th July, 2010, whereas the assessment order has been made on 22-3-2013. Admittedly, therefore, the entire amount of tax and interest had been paid, prior to making of the assessment order. Relying on the decision in case of *CIT vs. Mahendra C. Shah, [2008] 299 ITR 305 (Guj.)* had, in the context of Explanation 5 to sub-section (1) of section 271(1) of the Act, held that there is no prescription as to the point of time when the tax has to be paid *qua* the amount of income declared in the statement made under section 132(4) of the Act. There would be sufficient compliance with the provision if tax is shown to have been paid before the assessment was completed. Thus in view of fact that assessee developer had made statement that undisclosed income was earned by way of 'on money' received in its housing project and, moreover, assessee had paid due tax on said income, impugned penalty under section 271AAA of the Act is unjustified.

Neelam Jadhav, Keerthiga Sharma &
Neha Paranjpe, *Advocates*

DIGEST OF CASE LAWS
Tribunal

UNREPORTED DECISIONS

Section 147 – Reopening of assessment not allowed in case it is based on incorrect facts or there is no failure of disclosure of material facts by the assessee

Van Oord Dredging and Marine Contractors BV vs. ADIT – ITA No. 495, 496/Mum/2016 (Mum)(Trib.) dtd. February 28, 2018 – Assessment Years: 2005-06 & 2007-08

Facts

The assessee was a company incorporated in Netherlands. The assessee had received management service fees from its Indian associated enterprise, which was not offered to tax in India on the basis that it did not make available any technical knowledge, skill, etc. and was hence not taxable as per Article 12 of the India-Netherlands Double Taxation Avoidance Agreement. This position was accepted by the Assessing Officer ('AO') in the original assessment u/s. 143(3) of the Income-tax Act ('Act'), completed on March 31, 2008 for AY 2005-06 and January 4, 2011 for AY 2007-08. Subsequently, the AO completed the assessment for AY 2009-10, wherein he taxed management service fee, treating it as royalty. Pursuant to the order for AY 2009-10, the AO issued notices u/s. 148 of the Act on March 30, 2012 and served on April 3, 2012, seeking to tax the management service fee as royalty. The assessee appealed before the Commissioner of Income-tax (Appeals) ('CIT(A)'), who upheld the contentions of the AO. The assessee filed an appeal before the Income-tax Appellate Tribunal ('ITAT' / 'Tribunal').

Held

The Tribunal allowed the appeal of the assessee and quashed the reassessment proceedings. The Tribunal observed that the AO had, under the garb of non-consideration of certain agreements, sought to reopen the assessment based on incorrect facts. The AO had considered the correct agreement in the original proceeding and the AO, in the notice u/s. 148 of the Act, had tried to take a different view on the same facts. Further, the AO has failed to demonstrate that there was any failure on part of the assessee to disclose material facts. Lastly, the ITAT also held that since the AO had not issued notices u/s. 143(2) of the Act after filing of returns in both the assessment years, the assessment orders were liable to be quashed on this ground also. On merits, it was held that the Tribunal, in AY 2009-10, had held that management service fee was not royalty in nature.

Section 14A – Rule 8D – Strategic investments made in previous year or in current year as well as investment in Share Application money to be excluded while computing the addition under Rule 8D

M. Pallonji & Co. Pvt. Ltd. vs. ACIT – ITA Nos. 3739, 3523, 3524, 3740, 3741 & 3525/Mum/2015 (Mum)(Trib.) dtd. February 28, 2018 – Assessment Years: 2008-09, 2009-10 & 2010-11

Facts

The assessee had earned exempt income during the year, and AOhad *suo motu* disallowed u/s. 14A of the Act. However, the AO sought to make an addition as per the method prescribed in Rule 8D of the Income-tax Rules, 1963. The AO disallowed proportionate interest under Rule 8D(2)(ii) and administrative expenditure under Rule 8D(2)(iii). The CIT(A) deleted the addition under Rule 8D(2)(ii) since the assessee had sufficient interest-free funds during the year to make investments, which earned exempt income. Regarding, disallowance under Rule 8D(2)(iii), the CIT(A) held that strategic investments should be excluded from the average value of investment for computing, however, such exclusion would only be restricted to old investments made in the group companies and not include the incremental amount invested in group companies during the year. Further, the CIT(A) also held that investments which did not yield exempt income should be excluded for computing the disallowance. The assessee filed an appeal before the Tribunal.

Held

The Tribunal held that once the CIT(A) had found that the investments made in the group companies were in the nature of strategic investments, then no differentiation could be made between the old investments and the incremental increase made during the year. It was observed that there was no rationale behind the CIT(A)'s inclusion of investments made during the year, while computing the disallowance under Rule 8D(2)(iii). The Tribunal also held that investment made in share application money was not an investment that would yield exempt income and should hence be excluded from the total investments while computing the disallowance u/s. 14A. Further, it was also held that investments which did not yield exempt income should also be excluded for computing the disallowance under Rule 8D.

On another note, the ITAT, following its order for earlier year, held that since the assessee was a service provider, the provisions of section 145A of the Act were not applicable to it. Regarding the disallowance u/s. 37 of the Act of the professional / consultancy fees paid to Kotak Mahindra Bank, who had advised the assessee on how to raise money at the lowest cost, the Tribunal remanded the matter to the AO to examine whether the primary object of the company was investing activity, and if it was, the same was to be disallowed. The ITAT observed that if the objects of a company were manifold and investment activity was only one of them, then the company could not be said to be solely in investing activity.

Section 37 – AO cannot step into the shoes of the businessman and verify whether it was necessary to incur an expense, however, in case the service was being rendered by one of the parties and payment was being routed through an intermediary, then the expense was to be disallowed to that extent

Hindustan Unilever Ltd. vs. DCIT – ITA No. 4179/Mum/2013 (Mum)(Trib.) dtd. February 26, 2018 – Assessment Year: 1985-86

Facts

While completing the original assessment u/s. 143(3) of the Act, the AO made various additions / disallowances, *inter alia*, on account

of disallowance of purchase of 738 MTs of split palm kernel fatty acid from Golden Tobacco Co. Ltd. and payment of bogus service charges of ₹ 2,56,39,000, towards purchase of split palm kernel fatty acid. Being aggrieved, the assessee filed an appeal before the CIT(A). The CIT(A) restored the matter to the AO to examine all the details furnished by the assessee and to allow an opportunity to examine Golden Tobacco Co. Ltd. and cross-examine all witnesses, whose statements were being relied upon by the AO. In the remand proceedings, the AO allowed the purchase of palm kernel fatty acid, but disallowed the payment of service charges to various parties towards payment of palm kernel fatty acid, due to lack of conclusive evidence and alleged that the payment was not incurred wholly and exclusively for the purpose of business and were motivated by extra commercial consideration. On appeal, the CIT(A) upheld the contentions of the AO and observed that the service providers were not engaged in the concerned business, but in different activities, and neither was there any evidence to prove that such service was necessary and was provided to the assessee. Further, it was also observed that the assessee had failed to establish with conclusive evidence that due to shortage of soap making oil in Indian market and non–availability of local substitute at cheaper rate, it had to buy imported oil. The assessee filed an appeal before the Tribunal.

Held

The Tribunal observed that in the remand proceedings, the AO had deleted the addition relating to purchase of palm kernel fatty acid and the Department had accepted that the higher price paid by the assessee for importing it at a higher price was at arm's length, since there was a shortage in the domestic market. As per the service contracts, the service provider had to not only facilitate the import of palm kernel fatty acid, but also supervise the delivery of consignment on arrival, arrange to have storage tanks and pipeline cleaned to the satisfaction of the surveyor as well as arrange for proper sampling and testing. Confirmation from such service providers was also submitted by the assessee and it was also demonstrated that such charges were paid by other reputed manufacturers as well. The Tribunal observed that the AO and the CIT(A) did not comment upon the documentary evidences submitted by the assessee and that the AO could not step into the shoes of the businessman to decide whether such expenditure was for the purpose of business or not. Further, the ITAT also observed that the AO had not allowed the cross-examination of witnesses though the CIT(A) had specifically directed the AO to do so. Though this was a violation of natural justice, since the matter related to AY 1985-86, the Tribunal decided the issue on merits and partly deleted the addition. The ITAT upheld only the disallowance pertaining to payment to one of the intermediaries, though the entire service was being provided by Golden Tobacco Co. Ltd.

No capital gains – Section 45(4) is not applicable where no asset is transferred by the partnership firm to its partners

ITO vs. Fine Developers – ITA No. 5038/Mum/2012 (Mum)(Trib.) dtd. February 28, 2018 – Assessment Year: 2009-10

Facts

Assessee firm was builder and developer of land and a building which was constituted *vide* original Partnership Deed. Assessee purchased land from B Corporation which was stock in trade of assessee firm and shown as such in annual accounts of assessee firm. The AO made addition u/s. 45(4) of the Act on ground that there was purported distribution of land by firm to partners as result revaluation of land in consequence of admission of partner. AO applied the provisions of Section 45(4) of the Act to both situations i.e., admission and retirement of some partners by considering it as transfer of land and computed total capital gains and addition was made as business income. The CIT(A) deleted the addition.

Held

The Tribunal held that the purpose of Section 45(4) of the Act was to bring such transactions which had effect of transfer of capital asset without asset being actually transferred. It was held that the provisions of Section 45(4) of the Act was not applicable as no asset was transferred by assessee firm to partners, and there was no tax evasion device. It could not be said that there was any transfer of asset from assessee-firm to partner to attract provisions of Section 45(4) of the Act as partner continued to be partner and partnership firm continued to exist in eyes of law. Land was stock-in-trade and section 45(4) of the Act was not applicable as assessee had always shown said land as stock-in-trade. If taxable event was transfer of land to partner, then no addition could be made as there was no transfer of land from assessee to partner. If section 45(4) of the Act did not apply as there was no transfer of land, then even business income did not accrue.

Expenses incurred for cancellation and re-registration of property is part of Cost of Acquisition – Eligible for capital gains

Shri Doddapaneni Atchaiah Tenali vs. ACIT – ITA No.1553/Hyd/2016 (Hyd)(Trib.) dtd. February 28, 2018 – Assessment Year: 2009-10

The assessee was an individual and a pensioner, who did not file his return of income. During the financial year the AO received information that the assessee was one of the land owners who had entered into a development agreement for the development of his land and the capital gain had arisen to the assessee as per the agreement and the same had escaped from his returns. Accordingly the AO issued notice u/s. 148 of the Act. The assessee was asked to furnish the required evidence regarding the transfer. The AO found that the assessee had purchased a plot of 10406.54 sq.ft. developed area *vide* a registered sales deed. The assessee claimed that the gains arising out of the development area was Long Term Capital Gains and since he was receiving residential flats as consideration, the LTCG was exempt u/s. 54F of the Act. The AO rejected the claim and found that the earlier sale deeds were cancelled and that no possession was given to the assessee by virtue of those sale deeds registered in 2003 and that the possession was handed over to the assessee only in the year 2006. Therefore, he held that the asset has been held for a short term only and the resultant claim was STCG. Further he concluded that the assessee was not entitled to get deductions under the said section and also considered the cost of acquisition of the land as per the purchase deed and after including the registration charges. The AO adopted the cost of acquisition and computed the taxable income. The CIT(A) upheld the order of the AO.

Held

The ITAT observed that as regards the computation of capital gains arising on account of the joint development agreement, the assessee had included the stamp duty paid by him in both the years 2003 and 2006, in the cost of acquisition, whereas the AO and the CIT (A) have adopted only the stamp duty and other expenses paid by the assessee in the year 2006 as part of cost of acquisition. Further the Tribunal observed that the cancellation and re-registration of the property was not due to any fault of the assessee but due to the facts and circumstances prevailing at the relevant point of time, both the expenses were part of the cost of acquisition therefore the same were allowable for computing the LTCG.

Sinking Fund collected from tenant for maintenance and repairs of property not part of rental income

ITO vs. M/s. Altitus Management Advisors Pvt. Ltd. – ITA No. 4259/Mum/2015 (Mum)(Trib.) dtd. February 28, 2018 – Assessment Year: 2011-12

Facts

Assessee Company was engaged in the business of buying of properties and leasing the same.

During the assessment, the AO noticed that the assessee received a contribution as sinking fund from the tenants during the year and he was the view that the part recovery of sinking fund from the tenants was liable to be brought to tax as income under the head income from house property. The AO contended that fund was solely meant for regular repairs and maintenance to keep the assets functioning and such expenses were always revenue in nature. However, sinking fund was created to meet capital expenditure for replacing an asset and not to meet any routine running and maintenance expenses. Therefore the same could not be considered as rental income. The CIT(A) granted relief to the assessee.

Held

The Tribunal held that the contributions of the tenants of the property towards sinking fund could not be assessed as rental income, and where the tenant had agreed to pay the maintenance charges or accepted to bear the cost of repairs the same, then it should not be a ground for holding that the stipulated rent did not represent annual letting value, especially when there was no evidence or finding to show that the rent received was low compared to the prevailing rent for similar premises in the same locality.

REPORTED DECISIONS

Capital Gains – Section 45 r.w.s 28(i) of the Act – when the sale consideration is not ploughed back in land/Plots, the gains on sale of the plots is to be treated as capital gains

ACIT vs. Narendra J. Bhimani [2018] 90 taxmann.com 329 (Rajkot – Trib); ITA 411/RJT/2012 dtd. January 31, 2018 – Assessment Year 2008-09

Facts

The assessee was an individual, sold certain plots of land and offered the Capital Gains on such sale of plots. The AO observed that the assessee had himself converted the agricultural land into non-agricultural land and divided it into small sized plots with due permission of authorities. The sale of land was made after proper plotting (in more than 30 parts) to different parties. Thus, the sale of above land was in the nature of trade. Hence, the proceeds received from the same were liable to be taxed as profits from business. On appeal, the CIT(A) observed that the profit from the sale of land after plotting it out to secure better price could not be taxed as profit in the nature of trade. The CIT(A), therefore, allowed the appeal filed by the assessee. The Department being aggrieved by the appellate order filed the appeal before the Appellate Tribunal.

Held

The Tribunal held that there was nothing more than the activity of dividing the plots in smaller sized units which had led the AO to believe that the assessee was carrying activity in the nature of trade. The AO had overlooked a whole bunch of factors, which reasonably demonstrated that the assessee was never engaged in the business of dividing the large plots of land into smaller end use units. What was sold by the assessee was the land possessed by the assessee for a long period of time. Due to a fundamental change in the use of land in the areas concerned over the long period, the sellable standard unit size had indeed considerably come down. Thus, in order to get the market price for land, he had to essentially divide the land holding into plot size for which there is end user market. It may have been common to buy the land in the size that the assessee did in 60s as the use of land was agricultural at that point of time, with the passage of time, and rapid urbanisation and this land now being in the residential area, where smaller sized plots were required by the end users. The assessee had no choice but to sell the land plots in smaller size to get the market price. No other approach would have enabled the assessee to get the right price in the end

user market. It was clearly a one off activity for the assessee as the assessee did not go beyond selling what he already held for the long years. Even the sale consideration was not ploughed back in land investments all along the gains on the sale of these plots was treated as capital gains. Beyond any dispute or controversy, these lands were held as capital assets. For all these reasons, the conclusions arrived at by the CIT(A) was upheld.

Deduction – Section 54 of the Act – When there are separate agreements for sale of house and sale of furniture – the claim of deduction under section 54 would be allowable on entire cost

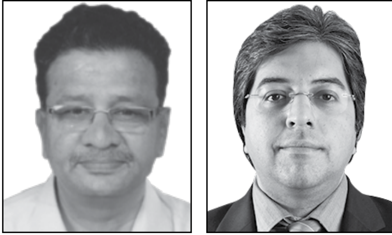
Rajat B Mehta vs. ITO [2018] 90 taxmann.com 176 (Ahmedabad – Trib.) ITA 19/Ahd/2016 dtd. February 9, 2018 – Assessment Year 2011-12

Facts

The assessee was a non-resident, domiciled in New Zealand. The assessee sold his house at Vadodara during relevant year and earned long-term capital gain of ₹ 1.89 crore. Further, he invested ₹ 78 lakh in another property in Vadodara for which he claimed deduction under section 54 of the Act. During the course of assessment proceedings, the AO observed that the assessee had entered into two separate contracts for purchase of house property and the furniture and fixtures therein i.e. ₹ 60 lakh was under contract for the purchase of house property and the remaining payment of ₹ 18 lakh was made under contract for the purchase of furniture and fixtures in the said property. The AO was of the opinion that the assessee had executed separate deed (for sale of furniture and fixtures etc.) to save stamp duty on it. Thus, the assessee was trying to evade income tax. Therefore, the AO declined the deduction u/s. 54 of the Act to the extent of ₹ 18 lakh paid under a separate agreement for furniture and fixtures in the residential property purchased by the assessee. On appeal, the CIT(A) confirmed the action of the AO. The assessee being aggrieved by the appellate order preferred the appeal before the Appellate Tribunal.

Held

The Appellate Tribunal observed that the actual consideration for purchase of the house property was ₹ 78 lakh and the splitting of consideration was an artificial arrangement. In substance and in effect the house was sold for ₹ 78 lakh and it was not open to the assessee, as evident from the contents of the agreement to sell, to buy the house for ₹ 60 lakh and furniture separately for ₹ 18 lakh. Even if the assessee was to buy the house, without the furniture, it would have been ₹ 78 lakh anyway as is was clearly specified in the agreement to sell. Whatever may have been the cause or trigger for the splitting of the consideration, ₹ 60 lakh for the house and ₹ 18 lakh for the furniture and fixtures, such a splitting of consideration had no bearing on de facto consideration for purchase of house property. The agreement to sell had cleared the said unambiguous terms. These two agreements, therefore, could not be considered in isolation with each. It was further observed that the cost of the residential house was ₹ 78 lakh as the assessee did not have any choice about buying or not buying the furniture at the assigned values. The assessee was under an obligation to pay the same amount of ₹ 78 lakh. Whether the assessee was to buy these furniture and fixtures or not, the sale consideration was the same. The assignment of value to the personal effects at ₹ 18 lakh thus could not be considered in isolation with the purchase of the house. Therefore, the assessee was entitled to deduction under section 54 by treating entire amount of ₹ 78 lakh as the 'cost of the residential house' purchased within specified time limit prescribed u/s. 54 of the Act.



CA Tarunkumar Singhal & Sunil Moti Lala, *Advocate*

INTERNATIONAL TAXATION
Case Law Update

A. SUPREME COURT RULINGS

1. TPO is not empowered to examine the commercial expediency of the payment of royalty

Frigoglass India Pvt. Ltd. – TS-31-SC-2018-TP - Special Leave Petition – 41702 / 2017

Facts

1. The assessee, engaged in the business of glass door merchandising entered into an international transaction of payment of management fee and royalty to its AE which it benchmarked under TNMM on an aggregate basis stating that its transactions were closely linked to the manufacture of glass door refrigerators.

2. The TPO rejected assessee's adoption of TNMM and determined the ALP of the management fee and royalty at Nil under the CUP method on the ground that the assessee failed to substantiate the benefit derived by it from the payment of management fee and royalty. The approach of the TPO was upheld by the DRP.

3. The Tribunal deleted the adjustment on royalty payment, stating that TPO erred in judging commercial and business expediency of expenditure while determining ALP at Nil. It relied on the decision of the Delhi High Court in EKL Appliances wherein it was held that so long as the expenditure or payment by assessee has been demonstrated to have been incurred or laid out for the purposes of business, TPO could not disallow the same on any extraneous reasoning. Further, the Tribunal also upheld assessee's combined TNMM as against TPO's CUP as no comparable transaction was brought on record by AO/DRP.

4. The High Court upheld the order of the Tribunal noting that the Tribunal had correctly applied the decision of EKL Appliances.

5. Aggrieved, the Revenue filed an SLP before the Hon'ble Apex Court.

Held

The Hon'ble Apex Court dismissed the Revenue's SLP.

B. AUTHORITY FOR ADVANCE RULINGS

2. Income from salaries received by a non-resident employee are chargeable to tax in the place of rendering of services as per the Income-tax Act, 1961 as well as the DTAA. Accordingly, the Indian employer company would not be liable to deduct tax at source where its employee was rendering services in USA.

Where an employee was resident in two countries and therefore liable to tax on his income from salaries in both countries, he would be eligible to avail credit of foreign taxes paid and therefore the Applicant (employer) would be entitled to reduce the tax payable in India by the foreign taxes paid while deducting tax under Section 192 of the Act.

Texas Instruments (India) Pvt Ltd – TS-38-AAR-2018 - AAR No 1299 of 2012

Facts

1. The Applicant incorporated in India was engaged in the business of digital signal processing and analog technologies. It sent one of its employees viz., Mr. T. N. Santhosh Kumar ('Kumar') on an expatriate assignment to Texas Inc., USA, for a period of two years effective from September 2010, during which he was on the payroll of Texas Inc. Kumar also received a part of the salary, based on a monthly basis, and certain bonuses in India from the Applicant to meet certain obligations in India such as housing loans repayments etc. However, Kumar would be rendering services only in the USA during the said period.

2. For Financial year 2011-12, Kumar would be a non-resident in India but for FY 2012-13, upon his return to India, he would satisfy the conditions for residency in India and would be a resident and ordinarily resident individual in India. He would also be a resident in the USA for the aforesaid years and therefore liable to tax on his entire salary received in the USA as well as in India. In light of the aforesaid facts, the Applicant raised the following questions before the AAR:

"(i) *Based on the above facts, Salary paid by the applicant to the assignee, Mr. T. N. Santhosh Kumar in India, is not liable to be taxed in India in FY 2011-12 having regard to the provisions of the Act and the relevant Treaty. Given the above, whether Texas Instruments (India) Pvt. Ltd. is obliged to withhold taxes on such salary paid in India?*

(ii) *Mr. T. N. Santhosh Kumar is expected to return to India during September 2012 and his residential status in India for the Financial Year 2012-13 would be "Resident and Ordinarily Resident" (ROR). Whether, while discharging its obligation u/s 192 during FY 2012-13, Texas Instruments (India) Pvt. Ltd. may take credit for the taxes paid in the USA for Mr. T. N. Santhosh Kumar as per Article 25 of the Indo-US Treaty."*

Held

1. The AAR dismissed the contention of the Revenue that the salary paid to Kumar was chargeable to tax in India as per Section 5(2) of the Act, since Kumar received the salary income in India. It held that the chargeability of income from salaries was governed by Section 5(2) read with Section 15 of the Act and relying on the decision of the Bombay High Court in Avtar Singh Wadhwan, it further held that since Kumar was rendering services in the USA, the salary accrued in USA and therefore was not chargeable to tax in India. It further noted that even as per Article 16 of the India-USA DTAA, the income earned by Kumar from services rendered in the USA was chargeable to tax only in the USA. Observing that as per Section 192(1) of the Act, tax is required to be deducted by the employer from income which is chargeable to tax under the head income from salaries, it held that since the salary paid to Kumar was not taxable in India, the Applicant was under no obligation to deduct taxes at source.

2. *Vis-à-vis* the second question, the AAR, relying on the decisions of the AAR in British Gas India Private Limited and Coromandel Fertilisers Ltd. held that for FY 2012-13 where Kumar was a resident in both India as well as the USA and tax was payable on salary paid to him in both countries, Article 25 of the DTAA providing for credit of foreign taxes deducted would be applicable and therefore the Applicant

could reduce the tax payable under Section 192 of the Act to the extent of the foreign tax credit available. *Vis-à-vis* the Revenue's concern that a proper verification of the foreign tax credit would not be possible in the instant case, the AAR held that since Section 192 casts an obligation on the employee to furnish to the employer such details of the salary etc. received by him from the other employer/s, the tax paid or deducted there from, and other particulars, and the employer i.e., the Applicant would have to examine and take into account such details before computing the tax deductible.

3. Non-residents are eligible to claim the benefit provided under the First Proviso to Section 112 of the Act.

Honda Motor Co. Ltd. – TS-50-AAR-2018 – AAR No 1200 of 2011

Facts

1. The Applicant, a Corporation under the laws of Japan, along with Hero Investments Pvt. Ltd. and Bahadur Chand Investments Pvt. Ltd. (Indian Partners) established Hero MotoCorpLimited (HHML) as a joint venture company which was a public listed company in India. The Applicant acquired 26 per cent of the shares in HHML by direct allotment of shares in the year 1985, right issue of shares in the year 1987 and bonus shares issued in the year 1995 and 1998.

2. The Applicant entered into share transfer agreements with the Indian Partners in order to sell its stake in HHML, which was held by the Applicant for more than 12 months as on the date of the transfer. As per the terms of the agreement, the Applicant had to convert the shares into dematerialised form and transfer it to an escrow account for which the Applicant incurred expenses towards Fees for the computerisation of share certificates.

"I. *Whether, on the stated facts and circumstances of the case and in law, the tax payable by the Applicant on the long term capital gains arising on the sale of equity shares of the Hero Honda Motors Limited [now known as Hero MotoCorp Limited] (hereinafter referred to as 'HHML'), being listed securities, will be 10% (plus surcharge and cess) of the amount of capital gains as per the proviso to section 112(1) of the Act?*

II. *Whether, on the stated facts and in the circumstances of the case and in law, the Applicant is eligible to claim deduction for expense incurred by the Applicant in connection with the transfer of shares of HHML, as per provisions of section 48 of the Act?"*

Held

1. The AAR upheld the contention of the Applicant that even though it was not eligible to the benefit of indexation under Second proviso to Section 48 of the Act, it was entitled to the benefit of proviso to Section 112 (1) of the Act i.e., taxability @10 per cent, as the applicability of the Second proviso to Section 48 of the Act was not a condition precedent for availing the benefit of lesser rate of tax under the proviso to Section 112 (1) of the Act. Relying on the decision of *Cairn UK Holdings Ltd. vs. DIT, (2013) 359 ITR 268 (Del.)*, it held that the benefit of proviso 112(1) was available to a non-resident.

2. *Vis-à-vis* the second question, the AAR observed that the terms of the Transfer Agreement laid down the requirement of dematerialisation and execution of Escrow Account as conditions precedent for the subject transfer and accordingly held that since it had a direct nexus with the transfer, the deduction of expenses incurred towards the same ought to be granted to the Applicant in terms of Section 48 of the Act as the expenses were 'wholly and exclusively in connection with such transfer'.

4. Where the Applicant, operating as an investment, was granted a valid Tax Residency Certificate by the Mauritian Tax Authorities and the decision making for its activities

were taken by the Applicant's Board of Directors in Mauritius, the control and management could not be said to be with its US Holding company. Accordingly, it was entitled to the benefits of the India-Mauritius Double Tax Avoidance Agreement and capital gains arising from sale of Indian shares was not taxable in India as per Article 13(4) of the DTAA.

AB Holdings, Mauritius II – TS-634-AAR-2017 - AAR No. 1129 of 2011

Facts

1. The Applicant ('AB Mauritius'), a company incorporated in Mauritius in 2008, having a valid Tax Residency Certificate granted by the Mauritius Tax Authority was solely incorporated as a subsidiary company of the 'C' Group, USA to invest in 'S' Sector in India and other Asian Markets and had accordingly invested in an Indian company viz., AB International Pvt. Ltd. ('AB International') [investments made in 2008, 2009, 2013, 2014 and 2015] as well as other companies in Philippines and Indonesia. Its investment activities were carried on from Mauritius and managed by its Board of Directors comprising 3 directors [viz. Mr. S (who was also director in many other Group companies) and Mr. AR and Mr. KPR who were financial consultants resident in Mauritius] who had approved the investments made by the Applicant in AB International. As per corporate strategy of the Group, to which the applicant belonged, in order to improve its business operations in the Asia-Pacific region, another company viz., AB Singapore was incorporated in 2011 (incorporated as the Applicant's subsidiary company) and AB Singapore was to *inter-alia* act as the investment holding and management company for the Group in the Asia Pacific Region.

2. In order to achieve the above objective, the Applicant transferred the shares held by it in AB International to AB Singapore (along with the shares of the other group companies held by the Applicant). In light of the aforesaid facts, the Applicant raised the following questions before the AAR:

I. *Whether on the facts and circumstances of the case, the Applicant will be entitled to the benefits of the Agreement between the Government of Mauritius and the Government of the Republic of India for the avoidance of double taxation and prevention of fiscal evasion with respect to taxes on income and capital gains (''the India-Mauritius tax treaty'')?*

II. *If the answer to Question 1 is in the affirmative, whether on the facts and circumstances of the case, the gains arising to the Applicant from the proposed sale of shares in 'AB' India Private Limited ('AB India') to a Group Company ('Transferee') would not be liable to tax in India having regard to the provisions of Article 13 of the India-Mauritius tax treaty?*

III. *If answer to Question 2 is in affirmative i.e. holding that the gains arising from the proposed sale of shares by Mauritian company are not chargeable to tax in India, whether there will be any obligation to withhold tax under section 195 of the Income-tax Act, 1961?*

IV. *If answer to Question 2 is in affirmative i.e. holding that the gains arising from the proposed sale of shares by Mauritian company are not chargeable to tax in India, whether the transfer pricing provisions of Section 92 to Section 92F of the Act will apply?*

V. *Whether on the facts and circumstances of the case the Applicant will be liable to tax under the provisions of Section 115JB of the Act in relation to income earned from the proposed transaction?*

Held

1. *Vis-à-vis* Question No. I, the AAR dismissed the contention of the Revenue that the

Applicant was a sham company actually owned and controlled by the USA holding company and therefore was not eligible to the benefits of the India-Mauritius DTAA. It observed that i) the Applicant was granted a valid Tax Residency Certificate by the Mauritius tax authorities and that it held a Category 1 Global Business Licence ii) the setting up of the Applicant company, as well as the investments made by it were done through proper banking channels, iii) the flow of funds leading to the investment in AB International was explained iv) AB International recorded the Applicant as a shareholder in its books of account v) 'AB' Singapore made further investments in 'AB' International vi) Mr. S (one of the directors of the Applicant) made 11 trips to Mauritius when important decisions of investment were to be taken and the other two directors situated in Mauritius took active part in the decision making leading up to the Applicant's investments vii) the Mauritius tax Authorities certified that the Applicants place of business was in Mauritius and the returns filed by the Applicant also showed that its Board meetings were conducted in Mauritius. Accordingly, it held that the Applicant could not be considered as a mere name lender. It also noted that the Applicant had duly explained the source of its investments in AB International.

It further dismissed the Revenue's contention that the Holding Company in USA was actually controlling the Applicant and held that it was inconceivable that it would not be involved in any important decision making funding of the Applicant. As regards the revenue's contention that the Applicant had no employee cost and was therefore a sham company, it observed that the company was not a manufacturing company requiring employees or other administrative staff. Accordingly, it held that the Applicant was the legal and beneficial owner of the shares of AB International and further held that since the Applicant had obtained a TRC from the Mauritian authorities, it could not be denied the benefit of the DTAA in light of CBDT Circular No. 789 dated 14-4-2000.

It also dismissed the Revenue's alternate argument that the provisions of Section 93 of the Act would apply to the case of the Applicant and held that since it had concluded that the investments in AB International were not for tax avoidance the provisions of the DTAA would be applicable as opposed to Section 93 of the Act.

2. As regards Question No. II, it held that since the provisions of the DTAA were applicable, the capital gains on sale of shares in AB International to AB Singapore would not be taxable in India.

3. *Vis-à-vis* the applicability of Section 195 of the Act, following the decision of the Apex Court in *GE Technology Centre P. Ltd. v. CIT [327 ITR 456(SC)* it held that since the capital gains arising on sale of shares of AB International were not taxable in India, there was no obligation to deduct tax at source.

4. In respect of Question No. IV, against the Applicant's contention (refer para 4.4) that transfer pricing provisions would not apply, the AAR held that as per section 92, any income arising from an international transaction has to be computed having regard to arm's-length price, if the same was between two or more 'associated enterprises'. It held that there was no such requirement in section 92 (unlike Section 195 of the Act) that the transaction should result in income chargeable to tax under the Act for TP provisions to get attracted. Accordingly, it held that the transaction of sale of shares in the Indian company was subject to benchmarking as per the transfer pricing provisions contained in Chapter X of the Act.

5. In respect of Question No. V, with regard to applicability of section 115JB of the Act on the subject transaction, it held that the provisions of the said section would not be applicable to foreign companies, as per the retrospective amendment to section 115JB by Finance Act, 2016, and the clarification issued by the CBDT dated 24th September, 2015.

5. AB Mauritius – TS-635-AAR-2017 – AAR No. 1128 of 2017

The AAR in another Ruling of the Applicant viz., AB Mauritius on the issue of taxability of sale of shares held in an Indian company viz., AB India to a Singapore based group company viz., AB Singapore [where the questions raised by the Applicant were identical to those raised in the above case], denied the Applicant the benefit of the India-Mauritius DTAA observing that in the facts of the case, the Applicant had merely lent its name to its US based holding company and it was the US based holding company that had actually purchased the shares of AB India. In the instant case, the Applicant claimed to have purchased 99 per cent of shares of AB India from another US based company. However the AAR noted that i) the share purchase agreement for purchase of shares of AB India was jointly entered into by the Applicant along with its holding company ii) the share purchase agreement was signed by the Managing Director of the Holding company and not by the director of the Applicant iii) there was no mention of any consideration payable by the Applicant whereas the Holding company had forgone a debt of USD 384,000 as consideration for purchase of the balance 1 per cent iv) the Board of Directors of the Applicant company were informed of the purchase of shares of AB India one year after the transaction happened and accordingly held that the Holding company was the true owner of the shares in AB International.

Accordingly, it held that as per the India-US DTAA, the capital gains arising from sale of shares in AB India to AB Singapore was taxable in India in the hands of the Applicant's holding company.

As regards the applicability of Section 195 of the Act, it held that since the income was chargeable to tax in India there was an obligation to withhold taxes.

With regard to the applicability of transfer pricing provisions, the AAR held that since the transaction was an international transaction between two associated enterprises, it was to be subjected to the provisions contained in Chapter X of the Act.

Vis-à-vis applicability of Section 115JB of the Act, it held that the provisions would not apply to foreign companies.

C. HIGH COURT

6. The Court admitted Revenue's appeal *vis-à-vis* Tribunal's exclusion of Tata Consultancy Services Ltd. and Infosys Technologies Ltd. as comparable. Further, it held that forex gains / losses could not be treated as part of income and made subject matter of adjustment.

Pr. CIT vs. ST Ericsson India Pvt Ltd - TS-59-HC-2018(DEL)-TP- ITA NO 821 / 2017 – Delhi High Court

Facts

1. The Tribunal excluded 4 companies (viz. Tata Elxsi Ltd., Thirdware Solutions, Tata Consultancy Services Ltd and Infosys Technologies Ltd.) from the set of comparables finalised by the TPO on the ground of functional dissimilarity with the activities carried on by the assessee. It had also included two companies (viz. SIP Technologies and Export Ltd) which was wrongly excluded by the TPO as they earned low margins.

2. Further, the Tribunal had also held that foreign exchange gains / losses could not be treated as a part of income and made the subject matter of adjustment.

3. Aggrieved, the Revenue filed an appeal before the Hon'ble Court.

Held

1. *Vis-à-vis* the Tribunal's exclusion of Tata Elxsi and Thirdware Solutions, the Court upheld the order of the Tribunal noting that the findings with respect to functionality of these entities *vis-à-vis* the assessee were borne out from the

record. Further, it also upheld the inclusion of SIP Technologies and Export Ltd.

2. However, it admitted the Revenue's appeal as regards the exclusion of *Tata Consultancy Services Ltd. and Infosys Technologies Ltd.*

3. *Vis-à-vis* the treatment of forex gains / losses, relying on the decision of the Court in *CIT vs. Cashedge India Pvt. Ltd. – ITA No 279 / 2016,* it held that forex gains / losses could not be treated as part of income and made subject matter of adjustment.

7. No penalty under Section 271G of the Act could be levied on account of part failure to comply with the notice of the TPO requiring the assessee to furnish documents maintained under Section 92D.

Pr CIT vs. MMTC Ltd. – TS-76-HC-2018(DEL)-TP - ITA No 164 / 2018 – Delhi High Court

Facts

1. The TPO issued notice to the assessee on 12-7-2011, requiring the assessee to furnish documentation maintained by it under Section 92D(3) in support of its Transfer Pricing report. The assessee complied with the notice in part i.e., filed part details on 16-8-2011 and filed the balance on 14-10-2011.

2. The AO levied penalty under Section 271G of the Act on account of the assessee's part failure to comply with the notice.

3. The CIT(A), relying on the decision of the Delhi High Court in *CIT vs. Leroy Somer and Controls India Pvt Ltd (2014) 360 ITR 532 (Del.)* (wherein it was held that absent a finding by the Revenue as to which documents were not submitted by the assessee, no penalty could be levied under Section 271G of the Act) deleted the penalty. The Tribunal upheld CIT(A)'s order of deletion of penalty.

4. Aggrieved, the Revenue filed an appeal before the Hon'ble Court

Held

1. The High Court held that since the lower authorities had given concurrent findings and moreover since the assessee had partly complied with the notice, no substantial question of law arose from the impugned appeal. Accordingly, it dismissed the appeal of the Revenue.

8. Exclusion of companies based on the Related Party Filter and based on the fact that they had significant brand presence as compared to the assessee was justified

Pr. CIT vs. M/s. Oracle (OFSS) BPO Services Pvt. Ltd. - TS-67-HC-2018(Del.)-TP - ITA 124/2018

Facts

1. The assessee entered into three categories of international transactions with its AEs, namely 'provision of services', 'recovery of expenses', and 'sale of call manager phones' and benchmarked the transactions under TNMM and arrived at a set of 22 comparable companies the average margin of which was 12.51 percent which was within the +/- 5 per cent range as the assessee's margin was 11.61%.

2. The TPO accepted TNMM as the most appropriate method but excluded 13 out of the 22 comparables due to non-availability of data, which led to a TP adjustment as the revised average margin of the comparables was 22.09%.

3. The DRP conducted its fresh exercise, and after considering the relevant years' data of all 22 comparables (which was by then available before it) rejected four comparable companies.

4. Aggrieved, the assessee filed an appeal before the Tribunal wherein the Tribunal deleted the addition made by the DRP. The Tribunal excluded certain comparables on the ground that they had related party transactions in excess of 25% of their sales and also excluded Wipro Ltd. from the list of comparables on the ground that had a significant brand presence in the market

and could not be deemed to be a comparable entity.

5. Aggrieved, the Revenue filed an appeal before the Hon'ble Court

Held

1. The Court held that the RPT filter was relevant and fits in with the overall scheme of a transfer pricing study. It held that if a particular entity had transactions with its associate enterprise in excess of a certain threshold percentage, the profitability of such a company may be distorted and accordingly upheld the Tribunal's application of the filter.

2. *Vis-à-vis* the exclusion of Wipro Ltd., it held that the brand value of an entity had a significant role in its ability to garner profits and negotiate contracts and that the likelihood of profits derived or attributable to the brand having regard to the consistency of the quality of services that an entity is able to offer was a relevant consideration. Further, it held that although functionally, the two entities may be similar in terms of the services or products they offer, brand does play its own role in price or cost determination and accordingly upheld the exclusion of Wipro Ltd.

3. Accordingly, it dismissed the appeal of the Revenue as no substantial question of law arose therefrom.

9. Pre-amended Section 206AA of the Act does not override Section 90(2) of the Act – rates of tax as provided in the DTAA would prevail over the 20 per cent rate prescribed under Section 206AA of the Act, if more beneficial to the assessee.

Dansico India Pvt. Ltd. vs. Union of India – TS-63-HC-2018 (Del.) - WP 5908 / 2015 – Delhi High Court

Facts

1. The Petitioner, an Indian company, remitted payments to a non-resident company located in Singapore viz., M/s. DuPont Singapore who was not a tax assessee in India. Since the services rendered by DuPont Singapore were in the nature of Fees for Technical services, the Petitioner deducted tax at source @ 10 per cent on payments made by it as per Article 12 of the India-Singapore DTAA.

2. Before, the Hon'ble High Court, the Petitioner challenged the constitutional validity of Section 206AA of the Act (prior to amendment vide Finance Act) contending that the impugned section, which provides for levy of tax @ 20 percent had the effect of undoing the provisions of the DTAA. It further contended that the legislature itself had *vide* Finance Act, 2016 excluded non-residents and foreign companies from the purview of Section 206AA.

Held

1. The High Court approved the findings of the Tribunal in *DDIT vs. Serum Institute of India Ltd. (ITA 792 / PN / 2013)* wherein the Tribunal, relying on the observation of the Apex Court in *Azadi Bachao Andolan (2003) 263 ITR 706 (SC)* that the charging sections contained in the Act i.e., Sections 4 and 5 of the Act were also subordinate to the principle enshrined in Section 90(2) of the Act [i.e., the provisions of the DTAA would override the provisions of the domestic Act where they were more beneficial to the assessee] had held that Section 206AA of the Act could not be understood to override the charging Sections and therefore could not override Section 90(2) of the Act.

2. Accordingly, the Court held that the provisions of Section 206AA of the Act had to be read down to mean that where the deductee i.e. the overseas resident business concern conducts its operation from a territory whose Government had entered into a DTAA with India, the rate of taxation would be as dictated by the provisions of the DTAA.

D. Tribunal Decisions

10. Where the assessee made payments to non-residents for

purchase of software, since neither the copyrights in the software were not transferred to the assessee nor the was the assessee granted access to the "source codes" in the software, the payments made by the assessee could not be taxed as royalty under the DTAA

DDIT vs. Reliance Communication Ltd. – TS-44-ITAT-2018(Mum.) - ITA No 837 / Mum / 2007

Facts

1. The assessee, forming part of Reliance (ADAG) Group, was engaged in the business of telecommunication, for which it entered into various contracts with non-resident entities and made certain payments for purchase of software. The contracts could broadly be categorized as Equipment Contract, Software Contract, Service Contract, GTC Contract and Assignment Agreement. The assessee made applications u/s. 195, requesting the AO to allow it to make payments to the non-residents without deducting tax at source.

2. The AO held that payments made by them to the non-residents were taxable as royalty in India and that the assessee ought to have deducted tax at source before making such payments.

3. The CIT(A) reversed AO's order and held that payment made by the assessees for acquiring copy of the software did not amount to royalty within the definition under Article 12(3) of the DTAA and that they were not required to deduct tax at source.

4. Aggrieved the Revenue filed an appeal before the Hon'ble Tribunal.

Held

1. The Tribunal held that for the purpose of taxation the term royalty ought to be understood in the manner as defined by the Act/tax treaties and dismissed the Revenue's contention that as per Section 14 of the Indian Copyright Act, 1857 reproduction of the work in any material form including the storing of it in any medium by electronic means was covered under the definition of computer programme and that the assessee had stored or reproduced the software in equipment and therefore the payment made by it was royalty.

2. On examination of the definition of Royalty contained in the Act as well as the DTAAs (i.e., Australia, Israel, Sweden, Singapore and USA) the Tribunal held that the definition contained in the Act had been expanded by way of amendments. However, it held that the definition contained in the DTAAs were unaffected by the amendments made in the Act and proceeded to determine whether the payments were taxable as royalty under the respective DTAAs.

3. On a perusal of the agreements entered into by the assessee with the non-residents, the Tribunal observed that the assessee was granted a "perpetual, irrevocable, non-exclusive, unrestricted unlimited with respect to the number of subscribers, non-transferable, 'royalty free licence', for the use of such Software in object code form".

4. Further, it noted some important factors which seemed to be helpful to solve the knotty problem of taxation of royalty payments to the non-residents i.e. whether i) the software was sold in the same manner as wireless network equipment, ii) the software was an integral part of the wireless-equipment, which facilitated running of the said equipment, iii) the subject software had no independent value of its own, iv) copyrights in the software were transferred to the customers, v) access to the "source codes" in the software was granted to the assessee, vi) the payment for software was not related to the productivity, use or number of subscribers, vii) the customers did not have the right to commercially exploit the software, viii) the software supply was in the nature of transfer of copyrighted article and not transfer of "a copyrighted right."

It held that if conditions nos. iv)and v) were not satisfied and the rest of the conditions were satisfied, then it could be safely held that the payments made by an assessees could not be treated as royalty. It further held that if the owner retained absolute rights of the IPRs with itself then the payments made by the user would not be royalty.

5. It observed that in the case of the assessee the conditions iv) and v) were not satisfied and that all the agreements restricted the assessee's use of software for operation of its wireless network only and did not permit it to use it for commercial uses. Accordingly, noting that the assessee was granted a restricted right, the suppliers of the softwares were the sole and exclusive owner of the rights, title and property in Software and the Source Codes and that none of the agreements spoke of transferring of copyright to the assessee, it held that the consideration paid by the assessee to the non-resident suppliers did not amount to 'use of copyright or transfer of right to use of copyright' and therefore could not be taxed as royalty under the DTAAs.

6. Accordingly, it upheld the order of the CIT(A) and dismissed the Revenue's appeal.

11. Referral fees paid by an Indian company to the assessee's branch was in the nature of commission and could not be taxed as fees for technical services.

DCIT (IT) vs. Credit Suisse AG - TS-62-ITAT-2018(Mum.) - ITA No.1247/Mum/2016

Facts

1. The assessee, an entity incorporated in Switzerland, had a branch office in Dubai ('CSDB') as well as in India. An Indian group company made a payment of referral fees to CSDB as CSDB had assisted the Indian company with an issue of convertible bonds. The assessee contended that such referral fee received by CSDB was 'business income' not liable to tax in India since CSDB did not have a 'permanent establishment' in India as per Article 5 of the Indo-Swiss Double Taxation Avoidance Agreement (DTAA).

2. The Assessing Officer however did not accept the stand of the assessee and instead held that the referral fee was liable to be taxed in India as the source of such fee was in India (considering that the referral fee was payable to CSDB in relation to the execution of transaction between Indian Company and referred client). The AO characterised the referral fees as 'fee for technical services' and not 'business income' as contended by the assessee.

3. The DRP upheld the assessee's contention and held that i) the referral fee income in question was not in the nature of 'fee for technical services'; and (ii) that CSDB did not have a 'permanent establishment' in India and thus such 'referral fee' was not liable to be taxed in India as per Article 7 of the Indo-Swiss Double Taxation Avoidance Agreement (DTAA).

4. Aggrieved, the Revenue filed an appeal before the Hon'ble Tribunal.

Held

1. Examining the nature of the referral fee, the Tribunal, relying on the decision of *Cushman & Wakefield (S) Pte. Ltd., 305 ITR 208(AAR)*, held that the referral fee was nothing but commission which was to be taxed as business income and not as fees for technical services.

Since CSDB did not have any PE in India and the assessee's Indian branch had no role to play in the referral activity, the Tribunal held that the referral fee earned by CSDB could not be construed to be attributable to India. Accordingly, it upheld the order of the DRP and dismissed the Revenue's appeal.

CA Ashit Shah and CA Kush Vora

INDIRECT TAXES
GST – Legal Update

The authors have tried to cover GST updates pertaining to law points in particular. The notifications, circulars, orders relating to extension of various statutory due dates are not covered herewith.

A. Central Goods & Services Tax (CGST)

1. Amendment to GST Rules – Thirteenth Amendment Rules (Notification No. 11 /2018 dated 2-2-2018)

Vide Notification No. 11/2018, the Government has rescinded the Notification No. 74/2017 through which effective date of implementation of E-way bill of 1st February 2018 was notified. The new date of implementation of interstate E-way bill is not yet notified.

B. Circulars

1. Circular 31/ 2018 dated 9-2-2018 (Proper officer for Sections 73 & 74 of GST Act)

The said circular issues clarifies that various officers such as superintendent, deputy or assistant commissioner shall be empowered to issue notice under sections 73 and 74 of CGST Act. Also monetary limits have been specified in relation to each designation of officer. The same is tabulated hereunder for ease of reference:

Sr. No.	Officer of Central Tax	Monetary limit for CGST as per S. 73 & 74 of CGST Act	Monetary limit for IGST as per S. 73 & 74 of CGST Act read with S. 20 of IGST Act	Monetary limit for CGST & IGST as per S. 73 & 74 read with S. 20 of IGST Act
1.	Superintendent of Central Tax	Not exceeding ₹ 10 lakh	Not exceeding ₹ 10 lakh	Not exceeding ₹ 10 lakh
2.	Deputy or Assistant Commissioner of Central Tax	Above ₹ 10 lakhs and not exceeding ₹ 1 crore	Above ₹ 20 lakhs and not exceeding ₹ 2 crores	Above ₹ 20 lakhs and not exceeding ₹ 2 crores
3.	Additional or Joint Commissioner of Central Tax	Above ₹ 1 crore without any limit	Above ₹ 2 crores without any limit	Above ₹ 2 crores without any limit

2. **Circular 32/2018 dated 12-2-2018 (Clarification regarding various GST issues)**

The said circular clarifies various positions of department in respect of following topics:

- Hostel accommodation provided by trusts to students
- Fees/ amounts charged while registering various types of complaints
- Classification issue with respect to servies of elephant or camel ride, rickshaw ride, boat ride, etc.
- GST rate on rental services of self propelled access equipment
- Taxability of cost petroleum

3. **Circular 33/2018 dated 23-2-2018 (clarification regarding non-transition of CENVAT credit under section 140 of CGST Act or non-utilisation thereof in certain case)**

As per the powers granted under Section 168 of GST Act, the Government hereby clarifies that disputed credit under erstwhile CENVAT Credit laws should not be utilised till the order-in-original or the last order-in-appeal, holding that disputed credit as inadmissible is in existence. Further, the circular clarifies that credit in the nature of blocked credit as per Section 17(5) should not be transitioned to GST (such as, telecommunication towers and pipelines laid outside the factory premises).

Further in specific cases, wherein disputed credit or blocked credit amounts to more than INR 10 lakh, undertaking has to be submitted to the jurisdictional tax officer that such credit is not availed or utilised.

4. **Customs Circular No. 05/2018 dated 23rd February 2018 (Clarification regarding invoice mismatch in processing of refund claim on account of payment of IGST on exports)**

In case of refund of IGST where tax is paid on exports, huge refunds are stuck on account of various types of mismatches of invoices and other details in GSTR-1, GSTR 3B, shipping bill, etc. Thereby, ZGovernment has clarified the major reasons for mismatch, probable amendments to be made in GSTR-1. Also, alternate mechanism in the form of customs officer interface is proposed to be introduced in order to make necessary corrections. In this regard, concordance statement between GST invoice and export invoice has been provided *vide* the said circular.

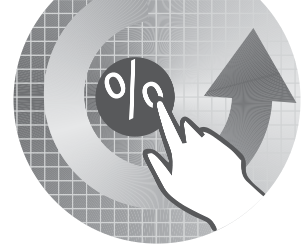
C. GST Portal

1. **Online filing of Letter of Undertaking ('LUT')**

The facility to file LUT online for F.Y. 2017-18 has started on GST portal. Now the assessees may apply for LUT online and there would be no need to visit GST office for the same.

Spiritual knowledge is the only thing that can destroy our miseries for ever; any other knowledge satisfies wants only for a time. It is only with the knowledge of te spirit that the faculty of want is annihilated for ever ...

— *Swami Vivekananda*



CA Naresh Sheth

INDIRECT TAXES
GST – Recent Judgments

1. M/s Continental India Pvt. Ltd. and Another vs. Union of India (2018-TIOLl-04-HC-ALL-GST)

Facts, Issue involved and Contention of Petitioner

Petitioners seeks that the GST Council recommends the State Government to extend time period of filing of GST TRAN – 01 as its application was not entertained on last date, i.e. 27-12-2017 in spite of petitioner having filed his complete application for necessary transactional credit.

The petitioner alleges in petition that despite making several efforts on last date for filing of application, the electronic system did not respond, as a result of which petitioner is likely to suffer loss of input tax credit that it is entitled to.

Petitioner also submitted its application for transitional credit manually on 10-1-2018. The respondents were served with a notice on 19-1-2018 with a copy of the petition. Respondent say that portal is likely to be opened but is unable to say that when the portal is likely to be opened.

Held

The respondents were directed to reopen the portal within two weeks from date of pronouncement of decision. In the event they do not do so, they will entertain the application of petitioner manually and pass orders on it after due verification of the credits as claimed by the petitioner. They will also ensure that petitioner is allowed to pay its taxes on regular electronic system also which is being maintained for use of credit likely to be considered for petitioner.

2. Mohit Minerals Pvt. Ltd. vs. Union of India & 1 (2018-TIOL-06-HC-AHM-GST)

Facts, Issue involved and Contention of Petitioner

Petitioner as an importer pays custom duty on import of non-cooking coal. Value of such imports includes ocean freight. On the same valuation, petitioner also pays GST under the IGST Act, 2017.

Petitioner's grievance was that under Notification No. 8/2017 – Integrated Tax (Rate) dated 28th June, 2017 and Entry 10 of Notification No. 10/2017 – Integrated Tax (Rate) dated 28th June, 2017, it is asked to pay GST at prescribed rate all over again on ocean freight.

Petitioner's challenge has principally three elements viz.,

a) Petitioner has paid GST under IGST Act on the entire value of imports; inclusive of the ocean freight, it cannot be asked to pay GST on the ocean freight all over again under a different notification;

b) In case of CIF contracts, service provider and service recipient both are outside the territory of India. No GST on such service can be collected even on reverse charge mechanism; and

c) In case of High Sea sales, burden is cast on petitioner as an importer whereas, it is not recipient of the service at all. The person who sells goods on high sea basis is recipient of transport services from the exporter/transporter and not the petitioner.

Counsel for petitioner submitted that impugned Notifications are *ultra vires* the Act and are in any case in exercise of excessive delegation of powers of subordinate legislation.

Held

Notice has been issued to Government to respond by 9th March, 2018.

3. M/s Age Industries (P) Ltd. vs. State Goods & Services Tax Department Intelligence Squad No.2, Ernakulam, Kochi-15 (2018-TIOL-07-HC-KERALA-GST)

Facts, Issue involved and Contention of Petitioner

Petitioner are registered under the CGST Act, 2017 and the Kerala SGST Act, 2017. Petitioner sent one consignment of surgical gloves to three parties for quality appraisal on job work basis against delivery challan. Respondent detained the goods in exercise of the power u/s. 129 of the SGST Act. Notice sent by respondent to petitioner stated that goods are detained for two reasons:

a) Since goods were being transported on delivery challan, petitioner should have uploaded a declaration in accordance with Rule 138(2) of the Kerala State SGST Rules before transporting the goods.

b) Goods transported by the petitioner are intended to be supplied to an unregistered firm and that therefore, tax evasion is suspected.

The learned Government Pleader, in the circumstances, did not attempt to support the impugned detention on the said reason. Instead, the learned Government Pleader attempted to support the impugned detention on the reason that the delivery challan that accompanied the goods was not one prepared in accordance with the provisions contained in the State SGST Rules.

Notice issued by respondent to petitioner as provided for u/s. 129 of the Kerala SGST Act contained only two reasons. When notice contained only two reasons, respondent cannot be heard to support the detention on a reason not mentioned in the said notice.

Held

In the result, writ petition was allowed. Impugned detention is held to be illegal and respondent is directed to release the consignment to petitioner forthwith. It is, however, made clear that this judgment will not preclude respondent from initiating proceedings against petitioner for imposition of penalty contemplated under the SGST Act for non-compliance of provisions contained in the State SGST Rules, if such imposition is provided under law.

4. M/s. Kitex Ltd. vs. State of Kerala and Others (2018-TIOL-08-HC-Kerala-GST)

Facts, Issue involved and Contention of Petitioner

Petitioner seeks release of goods detained by respondent u/s. 129 of the CGST Act, 2017 as also the Kerala SGST Act.

An identical matter was disposed of by a Division Bench of this Court in W. A. No. 1802 of 2017 (2017-TIOL-1942-HC-Kerala-VAT), directing expeditious completion of adjudication and permitting release of the goods detained pending adjudication, in terms of Rule 140(1) of the Kerala Goods and Services Tax Rules, 2017.

Held

Writ petition is disposed of directing the competent authority to complete adjudication provided for u/s. 129 of the statutes referred to above, within a week from date of production of a copy of judgment. It is also directed that if petitioner

complies with Rule 140(1) of the Kerala Goods and Services Tax Rules, 2017, goods detained shall be released to him forthwith.

Note: The decisions in following cases are more or less similar to above referred case:

i. *Corestrength Traders India Pvt. Ltd. vs. Assistant State Tax Officer (2018-TIOL-09-HC-Kerala-GST)*

ii. *M/s Gasha Steels Pvt. Ltd. vs. Assistant State Tax Officer (2018-TIOL-10-HC-Kerala-GST)*

iii. *Powermech Diesels vs. Assistant State Tax Officer (2018-TIOL-11-HC-Kerala-GST)*

iv. *M/s Anappuram Steels Pvt. Ltd. vs. Assistant State Tax Officer (2018-TIOL-13-HC-Kerala-GST)*

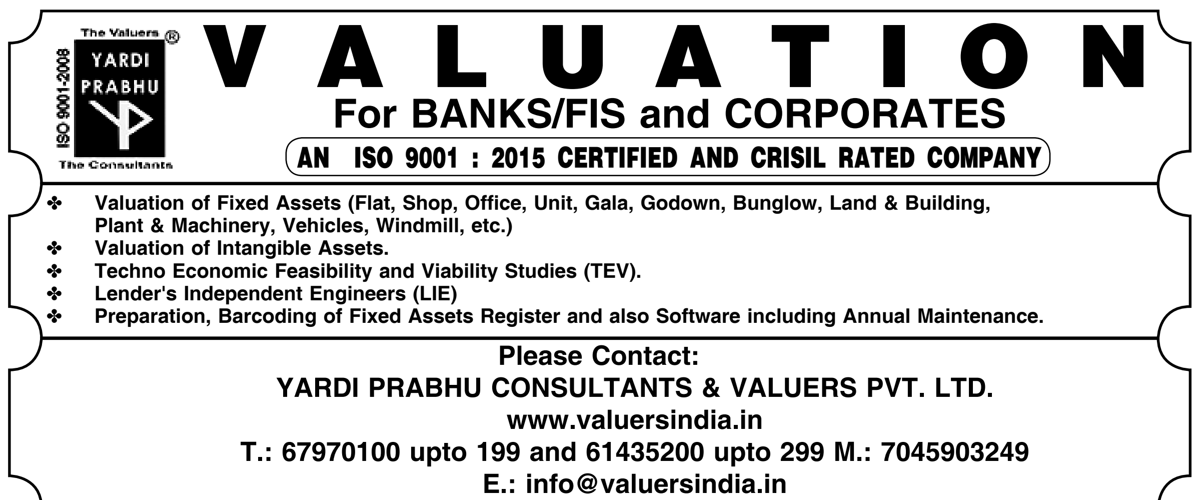
5. M/s. Abicor and Binzel Technoweld Pvt. Ltd. vs. Union of India (2018-TIOL-05-HC-MUM-GST)

Facts, Issue involved and Contention of Petitioner

Petitioner having been granted a provisional registration number under the Central Goods and Services Tax Act, 2017 and the Maharashtra Goods and Services Tax Act, 2017, is not able to access its online profile on the Goods and Services Tax Network. There is no fault or negligence on part of petitioner. Petitioner could not file the necessary return, and particularly Return GSTR 3B, and payment of tax is not possible without this return. This return is not being accepted without payment of late fee for period from October 2017 onwards.

Updates on the case

- On 27th February, 2018, the Bombay High Court directed Commissioners of Central and State GST to meet the representatives of Goods and Services Tax Practitioners' Association of Maharashtra (GSTPAM) to understand various grievances of taxpayers and try to solve them as far as possible without forcing each and every taxpayer to come to Court.
- On 1st March, 2018, the representatives of GSTPAM met the Commissioners and handed over detailed representations in the meeting which were then discussed.
- The Minutes of the meeting dated 1st March, 2018 prepared by GSTPAM were submitted to the Court during the hearing on 6th March, 2018.
- Court allowed time up to 24th April, 2018 to the GST Council and the Commissioners to put proper systems in place and alleviate taxpayer grievances as well as for streamlining the system and ensuring that the systems follow the provisions of law.



CA Rajiv Luthia & CA Keval Shah

INDIRECT TAXES

Service Tax – Case Law Update

Citation: 2018-TIOL-352-CESTAT-DEL

Case: Sir Ganga Ram Hospital, Bombay Hospital and Medical Research Centre, Apollo Hospitals, Max Health Care Institute Limited vs. Commissioner of Central Excise, Delhi I, Indore, Raipur, New Delhi

Background facts of the case

The Appellants are engaged in health care services to the patients and they are managing well-known hospitals/medical centres in various places. To provide the medical services to different patients, the Appellants have engaged professionals and doctors on contractual basis. These doctors are provided space in the hospitals with required facilities to attend to the patients coming to the hospitals, run by the appellants. These doctors are engaged on contract basis and the fees paid to the doctors are computed based on a pre-determined ratio on the amount received by the Appellants from the patients.

The Revenue entertained a view that the "collection charges/facilitation fee" retained by the Appellants are liable to service tax under the category of "Business Support Service" for the period prior to 1-7-2012 and are a taxable service post negative list also.

Arguments put forth

The Appellants submitted as under:

a) In terms of Section 65(104c) of the Finance Act, 1994, doctors are not "business entities" and are not engaged in a business or commerce. Business Support Service is essentially an outsourced service. The doctors have not outsourced any activity to the Appellant hospitals. In fact, the Appellants engaged in the main activity of healthcare services appointed various doctors in furtherance of their health care services. Essentially the service is provided by the doctors to the Appellants not *vice-versa.* The doctors are required to treat the patients who visit the Appellant hospitals which is providing health care services. The doctors are helping the Appellant hospital in providing such health care services and are getting paid for the same.

b) The agreements between the doctors and the Appellants are mainly on revenue sharing basis. The collection charges are part of the amount collected by the Appellants from the patients for providing health care services. It is essentially a revenue sharing arrangement and not a case of one party providing service to another.

c) Health care services are exempt from service tax for the period post negative list 1-7-2012. Health care services were selectively taxed for the period 1-7-2010 to 1-5-2011 and thereafter by notification No.30/2011 ST dated 25-4-2011, health care services were exempt from service tax

The Department Representatives submitted as under:

a) The Appellants are providing infrastructural support to the doctors without which the doctors cannot undertake their activities as professional doctors. For such infrastructural support, the Appellant hospital retained certain portion of the total amount received from the patients. Such consideration retained by the Appellant hospitals, are rightly subjected to service tax for providing support services.

Decision

a) On careful consideration of various terms and conditions and the scope of arrangement, the Bench was of the considered view that such arrangement are for joint benefit of both the parties with shared obligations, responsibilities and benefits. The agreements do not specify the specific nature or list of facilities which can be categorised as infrastructural support to the doctors. The revenue sharing model, as agreed upon between the contracting parties did not refer to any consideration attributable to such infrastructural support service.

b) It is very relevant to note that the Appellant hospitals are engaged in providing health care services. This can be done by appointing the required professionals directly as employees. The same can also be done by having contractual arrangements like the present ones. The patient paid the full amount to the appellant hospitals and received health care services.

c) On reading the statutory provisions for Business Support Service, the Bench noted that the services mentioned therein are "provided in relation to business or commerce". However, the doctors are engaged in medical profession and not business. As examined by Hon'ble Gujarat High Court in Dr. K. K. Shah (supra), though in an income-tax case, the Bench noted that there is a discernable difference between "business" and "profession.

d) Also after introduction of Negative List based taxation w.e.f. 1-7-2012; Notification No. 25/2012 have exempted clinical establishment providing health care services from payment of service tax.

Citation: 2018-TIOL-342-CESTAT-BANG

Case: VeriFone Technology India Pvt Ltd. vs. Commissioner of Service Tax, Bangalore–I

Background Facts of the case

The Appellants are registered with service tax department for providing taxable services of Information Technology Software Service (ITSS) and are also registered with the Software Technology Park of India (STPI) as hundred per cent EOU.

The Appellant filed the refund claims seeking refund of unutilised CENVAT credit paid on input services used for providing the output services exported under Rule 5 of CENVAT Credit 2004 read with Notification No.27/2012-CE dated 18-6-2012. In all these cases, the refund claims were rejected for the reasons that the export proceeds were realised in the Indian rupees and not in convertible foreign exchange.

Arguments put forth

The Appellants submitted as under:

a) The Appellants have realised the entire proceeds in the Indian rupees as permitted by Reserve Bank of India. Also, the Appellants have submitted the Certificate of Foreign Inward Remittances issued by their banker. He also submitted that in view of the exchange rate fluctuations, the Appellants have instructed their bankers to convert the foreign exchange realisation into Indian rupees and credit their account in Indian rupees.

b) The Appellants further submitted that this issue has been considered by the Tribunal in various decisions and it has been consistently held that if the payment is received in Indian rupee for which FIRC issued by the Bank and the payment is routed through foreign bank, then in that case it satisfies the condition of payment in "convertible foreign exchange". The decisions relied upon are as under:

- *BNY Mellon International Operations (I) Pvt. Ltd. vs. CCE, Pune-III: - 2016-TIOL-2828CESTAT-MUM*
- *CST, Mumbai vs. M/s. PMI Organisation Centre Pvt. Ltd.: - 2015-TIOL-2570-CESTAT-MUM*
- *M/s. AGM India Advisors Pvt. Ltd. vs. CST, Mumbai-I: - 2015-TIOL-2775-CESTAT-MUM*
- *M/s. Affinity Express India Pvt. Ltd. vs. CCE, Pune-I: - 2015-TIOL-2441-CESTAT-MUM*
- *Sun-Areas Real Estate Pvt. Ltd. vs. CST, Mumbai-I: - 2015-TIOL-56-CESTAT-MUM*

c) It was further submitted that there is no dispute about the export of services and also there is no dispute that the input services, for which the Appellant claims refund are not used in providing output service.

The Department Representatives submitted as under:

a) The remittances have been received in Indian rupee and not in "convertible foreign exchange" and the same is in violation of the conditions laid under Rule 3(2)(b) of Export of Service Rules, 2005.

Decision

a) The Bench held that this issue has been considered by various Benches of the Tribunal and it has been consistently held that merely because payment is received in Indian rupee, it cannot be said that payment against export has not been received in "convertible foreign exchange" as provided in Export of Service Rules, 2005. Since the Indian rupee is received from the recipient of services through their foreign bank, Bank of America, USA, the receipt of Indian rupee shall be treated as "convertible foreign exchange". Further, it is also clearly certified in the FIRC issued by Bank of America, USA that remittances are in "convertible foreign exchange".

b) Further, in the case of *Nipuna Services Ltd. vs. CCE: 2009 (14) STR 706 (Tri.-Bang.) 2009-TIOL709-CESTAT-BANG* wherein it is held that Revenue is denying the refund for the simple reason that the Appellant themselves had not directly received the payment in foreign currency. In our view, the stand of the Revenue is not sustainable. If Revenue's contention is accepted, it amounts to levying service tax on services exported.

c) It is clear that payment received in Indian rupee for which FIRC issued by

the Standard Chartered Bank and the payment is routed through foreign bank, shall fulfil the condition of payment (convertible foreign exchange) and therefore, the denial of refund on this ground is not sustainable.

Citation: 2018-TIOL-141-CESTAT-MUM

Case: Thermax Engineering Construction Co Ltd. vs. Commissioner of Central Excise, Pune I

Background facts of the case

The Appellants are engaged in Commercial & Industrial Construction Service and are paying service tax on the same. They were issued show cause notice proposing demand on the ground that they have not paid service tax on receipt of advance from their customer. The said advances were later adjusted against the bills received on completion of stages of the contract and tax was paid on 5th of the following month when the invoices for services were raised.

Further a demand was raised on the ground that the Appellants had availed full credit on the amount of service tax on their input services whereas they have retained certain portion of the total amount to be paid to vendors as safeguard against completion of their various projects in the form of retention amount and thus they were required to take only proportionate credit.

It was also alleged that the Appellants were sending their engineers abroad for the supervision, erection & commissioning as per the contract with customer. The customers paid remuneration to the Appellant in Indian currency. The consideration received for services rendered abroad does not amount to Export of Service and hence they are required to pay service tax on the consideration under the category of Consulting Engineers.

The adjudicating authority confirmed the demand on advances received from the customers with interest and penalty equivalent to the demand. The adjudicating authority dropped the demand on the other two grounds. The assessee preferred an appeal against the demand. Further, Revenue preferred an appeal in respect of the two issues dropped by the adjudicating authority.

Arguments put forth

The assessee submitted as under:

a) The customer as per terms and condition of the contract pays generally 10% of the contract value as advance-cum-security payment and they in turn give equivalent amount of Bank Guarantee to their customer. The customer has lien over the said bank guarantee till completion of the contract. Both the advance and the bank guarantee are in the nature of security deposit to ensure contractual commitment of each other. Ultimately service tax stands paid by them on the so called advances at the time of raising of final invoices

b) Further, prior to introduction of section 67A of the Finance Act, 1994 there was no provision to levy service tax even on advances. Hence no service tax can be levied on so called advances. Hence before 18-5-2012 no service tax can be demanded. He relies upon the judgment in case of *Chatturam Holiram Ltd. vs. CIT AIR 1955 SC 619* and *Universal Radiators, Coimbatore vs. CIT 1993 (2) SCC 629* in support of their claim.

c) It was also submitted that the retention of amount out of bill amount was for specific performance of contract. They are placing purchase order on their sub-contractors and take corresponding guarantee from the sub-contractors. The purchase order provides for 5% of retention of bill amount. That service tax amount is paid by them in full to

the sub-contractors and only retention amount is retained. Further entire service tax was paid by the contractors to the Government and accordingly the credit should not be denied. The assessee also relies upon the Circular No. F. 122/3/2010-ST dt. 30-4-2010 and Tribunal order in case of *Maruti Udyog Ltd. 2004 (166) ELT 360 (T)* in support of their claim.

d) The consideration for the contracts wherein the engineers were sent abroad was received by the assessee in convertible Foreign exchange and not Indian rupees.

The learned Departmental Representative stated as under:

a) In case of *M/s. Larsen & Toubro Ltd. - 2016-TIOL-167-CESTAT-DEL*, it was held by the Tribunal that service tax is payable on mobilisation advance with reference to date of receipt of advance and not with reference to rendition of service.

b) That dropping of demand on retention money is not correct as in adjudication order findings of payment of service tax has been given without verification of records.

c) The foreign party has not directly availed the services of the assessee and no consideration was received in foreign currency

Decision

a) In case of advance receipt from the customers the Bench observed that the amount was received by the assessee as security/ guarantee amount. It is obvious that for big contract which spread over years, the service provider needs to have specific performance guarantee from their customer. The assessee in turn of such security amount has issued Bank Guarantee amount to their customer. Thus the amount is guarantee from both the sides. Such amount cannot be considered as advance receipt since it is normal feature of contracts. Even the Hon'ble Supreme Court in case of *Shri Hanuman Cotton Mills and Ors. vs. Tata Aircraft Limited AIR 1970 SC 1986* held that the amount is to be considered as earnest money if following principles are followed:

- It must be given at the moment at which the contract is concluded
- It represents the guarantee that the contract will be fulfilled or, in other words, earnest money is given to bind the contract
- It is a part of purchase price when the transaction is carried out
- It is forfeited when the transaction fall through by reason of failure of the purchaser
- Unless there is anything to the contrary in the terms of the contract, on default committed by the buyer, the seller is entitled to forfeit the earnest money

The Bench observed that in the Appellant case the above principles are equally applicable and hence there is no doubt to our mind that the advance-cum-security bank guarantee to the assessee by the contract awarding party is in the form of earnest money. Thus the same is not liable to tax.

b) As regard appeal filed by the department against dropping of demand on retention money the Bench observed that though the amount against supply of services by the sub-contractors was retained by the assessee but the amount of service

tax was paid in full to the supplier/vendor. The amount was retained by the assessee in terms of understanding between the assessee and their vendors and not due to non-payment. The same was agreed to by both the parties. The Tribunal in similar case of *CCE, Jaipur vs. Hindustan Zinc 2014 (34) STR 440 and Patel Airfreight vs. Commissioner 2014 (35) STR 529 (TRI) = 2014-TIOL-739-CESTAT-AHM* has allowed the credit.

c) Similarly in case of non-payment of service tax on engineers sent abroad we find that it is not in dispute that the services were rendered abroad. It is also not in dispute that the main contractor of the assessee received the consideration in foreign currency, who in turn made payment to the assessee in Indian rupees. In such case we find that the services rendered by the assessee falls under the export of service which is eligible for exemption from service tax.

Citation: 2018-TIOL-42-SC-CX

Case: CCE & ST vs. Ultratech Cement Ltd.

Background facts of the case

The issue involved in the present case was with regards to admissibility of the CENVAT credit claim of service tax paid on Goods Transport Agency Services received post 1st April, 2008 from the place of removal to the buyer's premises i.e. outward transportation and the effect of CBEC Circular 97/6/2007-ST dated 23rd August, 2007 clarifying the term "place of removal" in case situations where the manufacturer/consignor may claim that the sale has taken place at the destination point as per terms of contract/agreement & therefore credit of the service tax paid on the transportation during removal of excisable goods would be admissible.

The present appeal was filed by the Revenue aggrieved by the decision of Karnataka High Court & Bangalore CESTAT allowing the credit of service tax paid on GTA services received by the assessee during the period January, 2010 to June, 2010. The revenue contended before the Karnataka High Court that Tribunal did not verify whether the Board Circular 97/6/2007 dated 23rd August, 2007 was complied with and whether the CENVAT credit would be admissible of the service tax on GTA service used for outward transportation from factory to customer.

The Hon'ble Karnataka High Court observed that:

- It is proved that goods were delivered by the assessee on FOR basis and it was the responsibility of the assessee to deliver the goods to the customer's premises. Hence, the assessee has satisfied all the three conditions as per the Board Circular dated 23-8-2007 i.e. (i) regarding ownership of the goods remains with seller till the delivery of the goods at the purchaser's door step, (ii) seller bearing the risk of or loss or damage to the goods during transit to the destination and, iii) freight charges to be integral part of the price of the goods
- Since, this fact finding of the Tribunal is not challenged by the Revenue, the question of finding of fact shall stand concluded. Based on this fact, Tribunal has found that CENVAT credit of service tax paid on such transport charges was available to assessee.
- The Board Circular is binding on the revenue-appellant and same cannot be challenged by them.

Observations of the SC

a) The definition of "input services" u/r. 2(l) of CCR, 2004 was amended w.e.f. 1st March, 2008; whereby it is clear that those input services are included which are used by the manufacturer, whether

directly or indirectly, in or in relation to the manufacture of final products and clearance of final products "up to the place of removal" .

b) The original definition of "input service" contained in Rule 2(l) of the Rules, 2004 used the expression "from the place of removal". As per the said definition, service used by the manufacturer of clearance of final products "from the place of removal" to the warehouse or customer's place etc., was exigible for CENVAT Credit.

c) *Vide* amendment carried out in the Rule 2(l) of CCR, 2004 effective from March 1, 2008, the word "from" is replaced by the word "up to". Thus, it is only "up to the place of removal" that service is treated as input service. This amendment has changed the entire scenario. The benefit which was admissible even beyond the place of removal now gets terminated at the place of removal and doors to the CENVAT credit of input tax paid gets closed at that place. This credit cannot travel therefrom. The GTA service used for the purpose of outward transportation of goods, i.e., from the factory to customer's premises, is not covered within the ambit of Rule 2(l) (ii) of CCR, 2004. Whereas the word 'from' is the indicator of starting point, the expression 'up to' signifies the terminating point, putting an end to the transport journey.

d) The Court corroborated with the interpretation of the adjudicating authority of Rule 2(l) as "there are 2 clauses in the definition of "input service" which circumscribe input credit by stating that service used in relation to the clearance from the place of removal and service used for outward transportation up to the place of removal are to be treated as input service. The first clause does not mention transport service in particular. The second clause restricts transport service credit up to the place of removal. When these two clauses are read together, it becomes clear that transport services credit cannot go beyond transport up to the place of removal. The two clauses, the one dealing with general provision and other dealing with a specific item, are not to be read disjunctively so as to bring about conflict to defeat the laws' scheme. The purpose of interpretation is to find harmony and reconciliation among the various provisions."

e) The definition of input services should be read as a whole and should not be fragmented in order to avail ineligible credit. Once the clearances have taken place, the question of granting input service stage credit does not arise. Transportation is an entirely different activity from manufacture and this position remains settled by the judgment of Honourable Supreme Court in the cases of Bombay Tyre International 1983 (14) ELT = 2002-TIOL-374-SC-CX-LB, Indian Oxygen Ltd. 1988 (36) ELT 723 SC = 2002-TIOL-88-SC-CX and Baroda Electric Meters 1997 (94) ELT 13 SC = 2002-TIOL-96-SC-CX-LB

f) Further, as regards the applicability of Board's Circular dated 23rd August, 2007 it needs to be kept in mind that the said circular was issued in clarification of the definition of 'input service' as existed on that date i.e. it related to unamended definition. The said circular clarified that the phrase 'place of removal' needs determination taking into account the facts of an individual case and the applicable provisions. The said circular was issued after the judgment of *M/s. Gujarat Ambuja Cements Ltd. vs. CCE, Ludhiana [2007 (6) STR 249*

Tri-D] = 2007-TIOL-429-CESTAT-AHM & in the case of *M/s. Ultratech Cements Ltd. vs. CCE Bhavnagar - 2007- TOIL-429-CESTAT-AHM*, which dealt with the issue prevalent with unamended rule 2(l).

g) Thus, here the important aspect of the matter is that CENVAT Credit is permissible in respect of 'input service' and the Circular relates to the unamended regime. Therefore, it cannot be applied after amendment in the definition of 'input service' which brought about a total change. Now, the definition of 'place of removal' and the conditions which are to be satisfied have to be in the context of 'up to' the place of removal. It is this amendment which has made the entire difference. That aspect is not dealt with in the said Board's circular.

h) If such a circular is made applicable even in respect of post amendment cases, it would be violative of Rule 2(l) of Rules, 2004 and such a situation cannot be countenanced. Thus, CENVAT Credit on goods transport agency service availed for transport of goods from place of removal to buyer's premises was not admissible post amendment in the definition of input service.

Citation: 2018-TIOL-66-SC-ST

Case: CST & others Vs. M/s. Bhayana Builders (P) Ltd. & others

Background facts of the case

Commercial / Industrial Construction service was notified for payment of service tax w.e.f. 10th September, 2004. *Vide* Notification No. 15/2004–ST dated 10th September, 2004, exemption was granted to the tune of 67% of the value of the taxable service under this category subject to the conditions that (i) no credit of duty paid on inputs or capital goods has been taken under CCR, 2004 or (ii) no benefit of exemption notification 12/2003 –ST dated 20th June, 2003 was availed by service provider. This notification 15/2004 was amended *vide* notification 4/2005–ST dated 1st March, 2005 and thereby explanation was inserted which reads as "For the purpose of this notification "the gross amount charged" shall include the value of goods and materials supplied or provided or used by the provider of commercial or industrial construction service for providing such services".

The question for consideration therefore is, whether the value of goods/material supplied or provided free of cost by a service recipient and used for providing the taxable service of construction or industrial complex, is to be included for valuation of the taxable service, under Section 67 of the Act and for availing the abatement benefit of 67%?

This issue was put to test before various Benches of CESTAT, which gave conflicting views. Considering such conflicting decisions of division Benches, all the matters along with the present case of respondent M/s. Bhayana Builders were referred to the LB of Delhi CESTAT.

The LB has decided the issue in favour of the assessee by holding that the value of the goods/materials cannot be added for the purpose of aforesaid notification dated September 10, 2004, as amended by notification dated March 1, 2005. In order to determine correctness of judgment of LB, the matter of present appeals was before Apex Court.

Observations of the SC

a) On analysing the provisions of section 67 of the Finance Act, 1994 pre and post amendment w.e.f. 18th April, 2006 to test this aspect of valuation under question, it is clear that there is no difference in

both the pre-amended and post amended provisions of section 67 and the parties are at *ad idem* to this extent of valuation provision.

b) The following 2 ingredients are to be considered for determining the value of taxable service under section 67 of the Act:

- Service tax is payable on the gross amount charged
- The amount charged should be "for such service provided"

c) The words "gross amount" only refers to the entire contract value between the service provider and the service recipient. Merely by use of the word "gross" the Department does not get any jurisdiction to go beyond the contract value to arrive at the value of taxable services. Further, by the use of the word "charged", it is clear that the same refers to the amount billed by the service provider to the service receiver.

d) The amount charged has to be necessarily a consideration for the service provided which is taxable under the Act. That is there should be a nexus between the amount charged and the service provided. Therefore, any amount charged which has no nexus with the taxable service and is not a consideration for the service provided does not become part of the value which is taxable under Section 67.

e) The cost of free supply goods provided by the service recipient to the service provider is neither an amount "charged" by the service provider nor can it be regarded as a consideration for the service provided by the service provider. In fact, it has no nexus whatsoever with the taxable services for which value is sought to be determined.

f) Explanation 3 to Section 67(1) removes any doubt by clarifying that the gross amount charged for the taxable service shall include the amount received towards the taxable service before, during or after provision of such service, implying thereby that where no amount is charged that has not to be included in respect of such materials/goods which are supplied by the service recipient, naturally, no amount is received by the service provider/assessee. Though Section 67(4) states that the value shall be determined in such manner as may be prescribed, however, it is subject to the provisions of sub-sections (1), (2) and (3).

g) Explanation (c) to section 67(4) defining the term "gross amount charged" relied upon by the Revenue to buttress its stand that payment received in 'any form' or any amount credited or debited' be included for the purpose of arriving at gross amount charged is misconceived.

h) The 'gross amount charges' inclusive of certain other payments would make it clear that the purpose is to include other modes of payments, in whatever form received; be it through cheque, credit card, deduction from account etc. It is in that hue, the provisions mentions that any form of payment by issue of credit notes or debit notes and book adjustment is also to be included. Likewise, the words, 'any amount credited or debited, as the case may be', to any account whether called 'suspense account or by any other name, in the books of accounts of a person liable to pay service tax' would not include the value of the goods supplied free as no amount was credited or debited in any account.

i) Explanation (c) does not expand the meaning of the term "gross amount

charged" to enable the Department to ignore the contract value or the amount actually charged by the service provider to the service recipient for the service rendered. The fact that it is an inclusive definition also does not lead to the conclusion that the contract value can be ignored and the value of free supply goods can be added over and above the contract value to arrive at the value of taxable services.

j) The service recipient can use any quality of goods and the value of such goods can vary significantly. Such a value has no bearing on the value of services provided by the service recipient. Thus, on first principle itself, a value which is not part of the contract between the service provider and the service recipient has no relevance in the determination of the value of taxable services provided by the service provider."

k) The argument of the revenue that "abatement benefit of 67% availed by the respondents in view of notification 15/2004 prescribed that in the entire construction project, roughly 67% comprises the cost of material and 33% is the value of services. And therefore, it was incumbent upon the assessee to include the value of goods/material supplied free of cost by the service recipient as well otherwise it would create imbalance and disturb the analogy that is kept in mind while issuing the said notifications"; it is not a valid argument.

l) The Bench observed that in the first place it would be anybody's guess as to what went in the mind of the Central Government in issuing these notifications and prescribing the service tax to be calculated on a value which is equivalent to 33% of the gross amount in the absence of any basis on record. Secondly, according to these notifications, service tax is to be calculated on a value which is 33% of the gross amount that is charged from the service recipient. Obviously, no amount is charged (and it could not be) by the service provider in respect of goods or materials which are supplied by the service recipient. Thirdly, even when the explanation was added to said notification did not deal with any eventuality whereby value of goods and material supplied or provided by the service recipient were also to be included in arriving at gross amount 'gross amount charged'."

m) Also looking it from another angle and relying on the decision of *CCE, Kerala vs. Larsen & Toubro Ltd 2015-TIOL-187-SC-ST*, it is viewed that the service tax is to be levied in respect of 'taxable services only and not gross amount of works contract' and for the purpose of arriving at 33% of the gross amount charged, unless value of some goods/materials is specifically included by the Legislature, that cannot be added.

n) As per Section 93, the Central Government is empowered to grant exemption from the levy of service tax either wholly or partially, which is leviable on any 'taxable service' defined in any of sub-clauses of clause (105) of Section 65. Thus, exemption under Section 93 can only be granted in respect of those activities which Parliament is competent to levy service tax and covered by sub-clause (zzq) of clause (105) and sub-clause (zzzh) of clause (105) of Section 65 of Chapter V of the Act under which such notifications were issued.

o) Accordingly, revenue appeals were dismissed.

Janak C. Pandya, *Company Secretary*

CORPORATE LAWS
Company Law Update

Case Law # 1

[2018] 206 Comp Cas 341 (Delhi)

[In the Delhi High Court].

HDFC Bank Ltd. vs. Prem Power Construction P. Ltd. and Another

Sending of the notices at the registered office address in terms of the official records had to be regarded as legal and valid and Court proceedings could not be held as "to be not maintainable" because the company had changed its address.

Brief

The present appeal was made by the HDFC Bank Ltd ("Appellant") in relation to the judgment of the learned Single Judge dismissing the winding up petition on the ground that the notice for the winding up was not served properly. The facts are as follows.

1. The appellant had sanctioned fund-based loan of INR 1100 lakhs to M/s. Prem Power Construction P. Ltd. (the "Company") under various facilities.

2. The Company has executed various security documents including the promissory notes, hypothecation of various assets etc.

3. The Directors of the Company also executed the Deed of Guarantee as well the Deed of Corporate Guarantee was executed by the another company called M/s. Prem Softech P. Ltd. ("Corporate Guarantor")

4. Further, various properties owned by the Corporate Guarantor were also mortgaged in favour of the appellant.

5. The Company failed to pay debt and its accounts were declared as Non Performing Assets ("NPA") by the Appellant Bank.

6. The appellant issued notices to the Company for repayment of various amount dues from it.

7. As the amount was not paid, the appellant approached the Debt Recovery Tribunal ("DRT'), which is pending before it.

8. The appellant has also rejected the one time settlement letter from the Company.

9. The appellant had issued winding up notice to the Company, followed by another notice.

10. As the Company has not responded, the appellant had filed the winding up

petition before this Court. The Court has passed an interim order restraining the Company to create any charge, alienating, transferring or parting of possession of any of the immovable assets.

11. As the Company has not responded, the Court has appointed a provisional liquidator.

12. The Company has challenged the said order before the Divisional Bench, which was remanded to the Company Judge.

13. The Company Judge upon hearing has dismissed the petition on the ground of failure and non-service of the winding up notice.

Upon dismissal of the petition, the present appeal was filed. The Court had suggested the mediation, which failed followed by passing of the restrain order. Later on, the Registrar of Companies ("RoC") was directed to remove the status of "Under Liquidation" from its website in the public domain.

The appellant has made the following submission.

1. That the order stating that the service of winding up notice not issued properly, is wrongly recorded and for supporting the same, it has submitted the courier receipts, speed post receipts, tracking reports and the original envelops for the said notice.

2. That under the provisions of the Act, whenever notices are sent by registered post, they are deemed to be served. It has referred the judgments in case of (i) *Kotak Mahindra Bank Ltd. vs. Hermonite Associates Ltd. [2011] 161 Comp Cas 214 (Delhi); (ii) Global Infosystem Ltd. vs. Lunar Finance Ltd. [2012] 130 DRJ 307; (iii) State of M. P V. Hiralal [1996] 7 SCC 523.*

The Company has submitted as below :

a. That it is financially sound.

b. The winding up notice was never served upon it.

c. As per section 434 of the Act, the notice for winding up ought to be delivered at the registered office of the Company and thus reliance on section 51 of the Act related to the service of documents on company by the Appellant is not correct.

d. As the provision has very serious consequences, the deeming fiction as contained in section 27 of the General Clauses Act, 1897 ought not made applicable.

e. It has settled with other banks except the appellant, which is refusing to agree to any reasonable terms.

Judgment

The Court has allowed the appeal. It has concluded that the winding up notices sent by the appellant are in compliance with the requirement under section 434 read with section 51 of the Act and also under clause 27 of the General Clauses Act, 1897.

The Court has passed the Order based on the analysis of the following facts.

1. Appellant contention has merit that prior to filing of winding up petition, it has sent 2 (two) notices to the Company though all possible means like courier and registered post.

2. If, Company's contention is accepted, then it may refuse to accept notice in one or other pretext and ensure that same is returned. The Court had referred the judgment of Bombay High Court in *Cavendish Shipping Ltd., vs. Polaris Marine Management P. Ltd. [2010] 156 Comp Cas 108 (Bom.)* which

has reference of the Delhi High Court Judgment in *Horline Teletubes and Compondents Ltd., vs. Impex Ltd. [2004] 119 Comp Cas 98 (Delhi).*

3. The notices were sent to the registered office of the Company as per address available with the RoC, which were returned with the remarks "not known". The reference was made to the judgment of the Delhi High Court in the case of *Horline Teletubes and Compondents Ltd., vs. Impex Ltd. [2004] 119 Comp Cas 98 (Delhi),* where it was observed that where a statutory notice addressed to the registered office of the company was retuned with the remark that the addressee had left the premises. It was held that the sending of notices at the registered office in terms of the official records had to be regarded as legal and valid and proceedings could not be held to be not maintainable because the company had changed its address.

4. The Supreme Court Judgment in the case of *N. Parameshwaran Unni vs. G. Kannan [2017] 5 SCC 377* was also referred with reference to section 27 of the General Clauses Act, 1897 and section 114 of the Indian Evidence Act, 1872. As per which, once notice is sent by registered post by correctly addressing it to the drawer, the service of notice should be deemed to be effected.

5. In the case of *Jagdish Singh vs. Natthu Singh [1992] 1 SCC 647* and *V. Raja Kumari vs. P Subbarama Naidu [2004] 8 SCC 774,* it was held that notice under section 434 has to be serviced on the company "by causing it to be delivered" the said term has been interpreted in several cases. Thus, in the case of a company being a juristic person, the sending of notice at the registered office as part of "official records" was held to be duly delivered and served even though the registered office was lying closed.

6. That several attempts were made by the Appellant. That Appellant has served notices to the address as available with the RoC and displayed on the public website of the Ministry of Corporate Affairs ("MCA") and the service of recall letter after which one time settlement was proposed by the Company and that observations of the Supreme Court in the case of *N. Parameshwaran Unni vs. G. Kannan* are apt in the present case.

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CORPORATE LAWS – RECENT DEVELOPMENTS

Insolvency and Bankruptcy Code – Recent Changes

Introduction

Insolvency and Bankruptcy Code, 2016 (hereinafter referred to as "Code" or "IBC, 2016") is a path breaking legislation which has consolidated and amended all earlier laws related to insolvency resolution of corporate persons in a time bound manner. Key features of this law are to resolve distress in a time bound manner, maximise value of assets and balance interests of all stakeholders. The Chamber's Journal (a monthly journal of the Chamber of Tax Consultants) had come out with special issue in the month of September 2017 to explain various aspects of the Code in detail. However, in the last six months, the Government of India and Insolvency and Bankruptcy Board of India (IBBI) made certain amendments to this Code/ Regulations and amended other Acts related to insolvency to make it very effective and ensure that it protects the interests of all stakeholders, which this article attempts to highlight.

Key Aspects

I. Insolvency and Bankruptcy Amendment Act, 2017

- IBC Amendment Act 2017 was made retrospective from 23rd November 2017.
- The ambit of IBC, 2016 has been extended to include personal guarantors to corporate debtors and proprietorship firms by amending section 2 of the Code. The individuals who have given guarantee will now be covered under IBC proceedings. Also, now it includes proprietorship firms under IBC which is welcome move considering it is widely used model for conducting business in India.
- Change in definition of resolution applicant under clause 25 to section 5 of IBC, 2016. Earlier it was defined "as any person who submits a resolution plan to the resolution professional". This definition created confusion as section 25(2)(h) mentions that resolution professional shall invite prospective lenders, investors and any other persons to put forward their resolution plans whereas definition of resolution applicant mentions that any person irrespective whether he has been invited by resolution professional to submit resolution plan. To bring consistency between sections new definition of resolution applicant has been amended as follows *"a person, who individually or jointly with any other person, submits a resolution plan to the resolution professional pursuant to the invitation made*

under clause (h) of sub-section (2) of section 25". This definition has facilitated 2 objectives namely, resolution professional is required to review only resolution plans submitted pursuant to express invitation by resolution professional and resolution plan can be submitted by two or more persons jointly. This will facilitate selling of large distressed assets.

- Section 25(2)(h) of IBC, 2016 is also amended to include that the resolution professional must determine *eligibility criteria* for persons to submit resolution plans, with the approval of the Committee of Creditors (CoC), having due regard to the *complexity and scale of operations of the business of the corporate debtor.*

- Section 29A of IBC 2016 has been introduced by way of amendment. This section provides for disqualification criteria for submission of resolution plans. The objective behind introduction of this section is to prevent backdoor entry of unscrupulous promoters and bring transparency in Corporate Insolvency Resolution Process ("CIRP"). It attempts to plug loophole that wilful defaulters can get back his company at discount whereas lenders face huge haircuts.

  Disqualification criteria for following persons are as follows:

  i. an undischarged insolvent.

  ii. a wilful defaulter in accordance with guidelines of RBI.

  iii. who has an account or an account of a corporate debtor under the management or control of such person, classified as non-performing asset and a period of one year has lapsed from date of such classification till date of commencement of CIRP. However, the person shall be eligible to submit a resolution plan if such person makes payment of all overdue amounts with interest thereon and charges related to non-performing asset accounts before submission of resolution plan.

  iv. a person convicted of any offence punishable with imprisonment for two years or more.

  v. a person disqualified to act as a director under the Companies Act, 2013.

  vi. a person prohibited by the Securities and Exchange Board of India ("SEBI") from trading in securities or accessing the capital markets.

  vii. a person who has been a promoter or in the management or control of a corporate debtor in which a preferential or undervalued or extortionate credit or fraudulent transaction has taken place in respect of which an order has been made by the National Company Law Tribunal ("NCLT").

  viii. a person who has executed an enforceable guarantee in favour of a creditor, in respect of a corporate debtor undergoing CIRP.

  ix. a person who has been subject to any disability, corresponding to points (i) to (viii) above, under any law in a jurisdiction outside India.

  x. connected person not eligible corresponding to points (i) to (ix) above. The term 'connected person' means any person (i) who is the promoter or in the management or control of the resolution applicant; or (ii) who shall be the promoter or in management or control of the business of the corporate debtor during the implementation of resolution plan; or (iii) the holding company, subsidiary company, associate company or related party of a person referred to in clauses (i) and (ii) above but not including a scheduled bank, an asset reconstruction company and an alternative investment fund.

- The amendment under section 30(4) provides that CoC must approve the resolution plan by a vote of not less than seventy-five per cent of voting shares of financial creditors *after considering the viability and feasibility of such a resolution plan and such other conditions as may be specified by IBBI.* The CoC cannot approve any resolution plans submitted before 23rd November 2017 by persons disqualified under factors provided under Section 29A of the Act and it may require resolution professional to invite a fresh resolution plan where no other resolution plan is available with it. As a transition relief, cure period of thirty days from date of submission of resolution plan is available to a person, whose account has been classified as a non-performing asset for a period of more than one year, to make payment of overdue amount along with interest and charges thereon.
- Section 35 of IBC which mentions about powers and duties of liquidator, it has been provided that liquidator shall not sell the immovable and movable property or actionable claims of the Corporate Debtor in liquidation to any person who is not eligible to be resolution applicant. This provision safeguards that buyer of distressed assets is eligible and not disqualified under any of the criteria laid down in section 29A of IBC, 2016.

II. Amendments in Insolvency and Bankruptcy Board of India (Insolvency Resolution Process for Corporate Persons) Regulations

Amendment w.e.f. 5th October, 2017

- The resolution plan shall include a statement as to how it has dealt with the interests of all stakeholders, including financial creditors and operational creditors of the Corporate Debtor (Regulation 38(1A)).

Amendment w.e.f. 7th November, 2017

- The resolution plan shall disclose details of the resolution applicant and other connected persons to enable the CoC to assess credibility of such applicant and other connected persons to take a prudent decision while considering the resolution plan for its approval. The resolution plan shall disclose the details in respect of the resolution applicant, persons who are promoters or in management or control of the resolution applicant; persons who will be promoters or in management or control of the business of the corporate debtor during the implementation of the resolution plan; and their holding companies, subsidiary companies, associate companies and related parties, if any.

It shall disclose following details:

a) identity;

b) conviction for any offence, if any, during the preceding five years;

c) criminal proceedings pending, if any;

d) disqualification, if any, under Companies Act, 2013, to act as a director;

e) identification as a wilful defaulter, if any, by any bank or financial institution or consortium thereof in accordance with the guidelines of the Reserve Bank of India;

f) debarment, if any, from accessing to, or trading in, securities markets under any order or directions of the Securities and Exchange Board of India; and

g) transactions, if any, with the corporate debtor in the preceding two years (Regulation 38(3)).

In my view, some of the above conditions have become redundant due to introduction of section 29A which disqualifies persons if they suffer from any of disqualification to submit resolution plan itself. However above regulations also cover *criminal proceedings*

pending if any and transactions if any with Corporate debtor in the preceding two years is required to be disclosed in resolution plan.

- The resolution professional shall submit to CoC all resolution plans which comply with the requirements of the Code and regulations made thereunder along with the details of following transactions, if any, observed, found or determined by him:

  (a) preferential transactions under section 43;

  (b) undervalued transactions under section 45;

  (c) extortionate credit transactions under section 50; and

  (d) fraudulent transactions under section 66

  and the orders, if any, of the adjudicating authority in respect of such transactions. (Regulation 39(2)).

  If person submitting resolution plan is a promoter or in the management or control of a corporate debtor and has undertaken above transactions, then they are not entitled to submit resolution plan as per section 29A.

- Above amendments in regulations will empower CoC to carry out appropriate due diligence by making provision for the required disclosures in the resolution plan.

Amendment w.e.f. 31st December 2017

- A resolution plan needs to identify specific sources of funds to be used for paying the liquidation value due to dissenting creditors. For this purpose, the 'dissenting financial creditor', according to amended regulations, means a financial creditor who voted against the resolution plan *or abstained from voting for the resolution plan, approved by the CoC.* (Regulation 2(1)(e)).

- After receipt of resolution plans, the resolution professional shall maintain confidentiality of the liquidation value and shall provide the liquidation value to every member of the CoC after obtaining an undertaking from the member to the effect that such member shall maintain confidentiality of the liquidation value and shall not use such value to cause an undue gain or undue loss to itself or any other person (Regulation 34(3)). Also, liquidation value and liquidation value due to operational creditors is not required to be disclosed in the information memorandum required to be prepared by resolution professional (Regulation 35(2) clauses j and k are omitted). This amendment in regulations will result in better price discovery for stressed assets. Non-inclusion of liquidation value in information memorandum will enable prospective bidders to focus on arriving at value considering going concern assumption rather than liquidation of Corporate Debtor.

- Resolution applicant shall submit the resolution plan(s) to the resolution professional within the time given in the invitation for the resolution plans in accordance with the provisions of the Code. This will enable the CoC to close a resolution process as early as possible subject to provisions in the Code and the regulations (Regulation 38(1)).

Amendment w.e.f. 6th February 2018

- Definition of liquidation value, fair value and evaluation matrix were added as amendment to regulations.

  Liquidation value" means the estimated realisable value of the assets of the corporate debtor, if the corporate debtor were to be liquidated on the insolvency commencement date (Regulation 2(1)(k)).

  Fair value" means the estimated realisable value of the assets of the corporate debtor, if they were to be exchanged on the insolvency

commencement date between a willing buyer and a willing seller in an arm's length transaction, after proper marketing and where the parties had acted knowledgeably, prudently and without compulsion (Regulation 2(1)(hb)).

Evaluation matrix" means such parameters to be applied and the manner of applying such parameters, as approved by the committee, for consideration of resolution plans for its approval (Regulation 2(1)(ha)).

- The resolution professional within seven days of appointment is required to appoint two registered valuers to determine the fair value and the liquidation value of the corporate debtor. Earlier interim resolution professional was required to appoint registered valuers. This is welcome relief as resolution professional would have sufficient time and information available to appoint registered valuer. The resolution professional and registered valuers shall maintain confidentiality of the fair value and the liquidation value (Regulation 27).

- The resolution professional shall submit the information memorandum in electronic form to each member of the CoC within *two weeks of his appointment as resolution professional* and to each prospective resolution applicant latest by the date of invitation of resolution plan, on receiving confidentiality undertaking (Regulation 36(1)).

- The resolution professional shall issue an invitation, including the evaluation matrix, to the prospective resolution applicants with approval of CoC. Form G has been introduced as format for issue of invitation plans. The resolution professional may modify the invitation as well as the evaluation matrix with approval of CoC (Regulation 36A).

- The prospective resolution applicant shall get at least 30 days from the issue of invitation or modification thereof, whichever is later, to submit resolution plans. Similarly, he will get at least 15 days from the issue of evaluation matrix or modification thereof in case invitation does not include evaluation matrix, whichever is later, to submit resolution plans. Transition relief to comply with this regulation to companies already under CIRP has been provided (Regulation 36A).

- The resolution professional shall publish brief particulars of invitation to resolution plans on the website, if any, of the corporate debtor, and on the website, if any, designated by the IBBI for the purpose. (Regulation 36A)

- The information memorandum shall now include assets and liabilities with *description* as on insolvency commencement date (Regulation 36(2)(a)).

  Description includes the details such as date of acquisition, cost of acquisition, remaining useful life, identification number, depreciation charged, book value, and any other relevant details.

- The CoC shall specify the amounts payable from resources under the resolution plan for payment of insolvency resolution process costs, liquidation value due to operational creditors and liquidation value due to dissenting financial creditors (Regulation 39(3A)).

- The resolution plan shall provide for the measures, as may be necessary, for insolvency resolution of the corporate debtor for maximisation of value of its assets. These may now also include *change in portfolio of goods or services produced or rendered by the corporate debtor and change in technology used by the corporate debtor* (Regulation 37).

- The resolution professional shall submit the resolution plan approved by the CoC to the Adjudicating Authority, *at least 15 days before the expiry of the maximum period permitted for the completion of the corporate insolvency resolution process*. The resolution professional should also certify that contents of resolution plan meet all the requirements of Code and the Regulations. However above timeline is not applicable to company undergoing corporate insolvency resolution process and which has completed the 130th day from insolvency commencement date (Regulation 39(4).

Similar amendments are introduced in Insolvency and Bankruptcy Board of India (Fast Track Insolvency Resolution Process for Corporate Persons) Regulations with reduced timelines for complying with provisions.

III. Amendment in Companies Act, 2013 / Ministry of Corporate Affairs Clarifications / Amendment in SEBI Laws

- MCA has clarified *vide* General Circular No. IBC/01/2017 that the approval of shareholders/members of the Corporate Debtor/Company *for a particular action required in the resolution plan for its implementation plan*, which would have been required under the Companies Act, 2013 or any other law if the resolution plan of the Company was not being considered under the Code, *is deemed to have been given on its approval by the Adjudicating Authority.* Since the Code does not provide for any requirement for obtaining approval of shareholders/members of the Corporate Debtor during CIRP, this clarification clears confusion of resolution professional where the resolution professional is required to confirm that each resolution plan received by him does not contravene any of the provisions of the law for the being in force as per section 30(2)(e) of the IBC, 2016.

- Section 53 of the Companies Act, 2013 prohibited issuance of shares at a discount. The Companies Amendment Act now allows companies to issue shares at a discount to its creditors when its debt is converted into shares in pursuance of any statutory resolution plan such as resolution plan under the Code. This amendment is effective from 3rd January 2018.

- Section 197 of the Companies Act, 2013 required approval of the company in a general meeting for payment of managerial remuneration in excess of 11 per cent of the net profits. *The Companies Amendment Act now requires that where a company has defaulted in payment of dues to any bank or public financial institution or non-convertible debenture holders or any other secured creditor, the prior approval of the bank or public financial institution concerned or the non-convertible debenture holders or other secured creditor, as the case may be, for such payment of managerial remuneration shall be obtained by the company before obtaining the approval in the general meeting*. This amendment is effective from 3rd January 2018.

- Section 247 of the Companies Act, 2013 prohibited registered valuer from undertaking valuation of any assets in which he has a direct or indirect interest or becomes so interested at any time during or after the valuation of assets. *The Companies Amendment Act now prohibits a registered valuer from undertaking valuation of any asset in which he has direct or indirect interest or becomes so interested at any time during three years prior to his appointment as valuer or three years after valuation of assets was conducted by him.* This amendment is effective from 3rd January 2018.

- SEBI notified SEBI (Substantial Acquisition of Shares and Takeovers) (Amendment) Regulations 2017 effective 14th August 2017 which exempts acquisition which is

covered under the resolution plan approved under Section 31 of the Insolvency and Bankruptcy Code, 2016 from the obligation of making mandatory open offer. This will help resolution of companies under distress without such relaxation it would have triggered requirement for open offer.

IV. Proposed Amendments in Income Tax Act through Finance Bill 2018 related to Corporate Insolvency Process

- Clause 22 of the Bill seeks to amend section 79 of the Income-tax Act relating to carry forward and set off losses in case of certain companies. The said section, *inter alia*, provides that where a change in shareholding has taken place in a previous year in the case of a company, not being a company in which the public are substantially interested, no loss incurred in any year prior to the previous year shall be carried forward and set off against the income of the previous year unless on the last day of the previous year the shares of the company carrying not less than fifty-one per cent of the voting power were beneficially held by persons who beneficially held shares of the company carrying not less than fifty-one per cent of the voting power on the last day of the year or years in which the loss was incurred.

  It is proposed to amend the aforesaid section to provide that nothing contained in the said section shall apply to a company where a change in the shareholding takes place in a previous year pursuant to approved resolution plan under the Insolvency and Bankruptcy Code, 2016, after affording a reasonable opportunity of being heard to the jurisdictional Principal Commissioner or Commissioner.

- Clause 35 of the Finance Bill 2018 proposed to amend section 115JB of the Income-tax Act relating to payment of MAT for companies undergoing insolvency process. It now proposes that companies whose application for corporate insolvency resolution process has been admitted by the Adjudicating Authority, *the aggregate amount of unabsorbed depreciation AND loss brought forward* shall be allowed to be reduced from the book profit and the loss shall not include depreciation.

- Clause 43 of the Finance Bill 2018 now proposes to amend section 140 of the Income-tax Act to provide that insolvency resolution professionals shall verify the return of income in case of a company where an application under IBC, 2016 has been admitted.

V. Recent Key Circulars issued by IBBI

- Insolvency Professional (IP) is directed to use in all his communications his name, address and e-mail ID as registered with IBBI, registration number issued by IBBI and capacity in which he is communicating i.e., Interim Resolution Professional or Resolution Professional. In addition to this, insolvency professional may use specific address and e-mail if he considers necessary provided he continues to service the process specific address and e-mail ID for six months from conclusion of his role in the process. (IP/001/2018 dated 3rd January 2018).

- IP is required to exercise reasonable care and diligence and take all necessary steps to ensure that the corporate person undergoing any process under the Code complies with the applicable laws. It is also clarified that IP will be responsible for the non-compliance of the provisions of the applicable laws if it is on account of his conduct. (IP/002/2018 dated 3rd January 2018).

- IP shall not outsource any of his duties and responsibilities under the Code. IP shall not require any certificate from another

person certifying eligibility of a resolution applicant (IP/003/2018 dated 3rd January 2018).

- IP shall render services for a fee which is a reasonable reflection of his work, raise bills / invoices in his name towards such fees, and such fees shall be paid to his bank account. Any payment of fees for the services of an insolvency professional to any person other than the insolvency professional shall not form part of the insolvency resolution process cost. Similarly, any other professional appointed by an insolvency professional shall raise bills / invoices in his / its (such as registered valuer) name towards such fees, and such fees shall be paid to his / its bank account (IP/004/2018 dated 16th January 2018).

- IP is required to disclose his relationship, if any, with (i) The Corporate Debtor, (ii) Other Professional(s) engaged by him, (iii) Financial Creditor(s), (iv) Interim Finance Provider(s), and (v) Prospective Resolution Applicant(s) to the Insolvency Professional Agency of which he is a member, within the time specified under this circular. Also, insolvency professional shall ensure disclosure of the relationship, if any, of the other professional(s) engaged by him with (i) Himself, (ii) The Corporate Debtor, (iii) Financial Creditor(s), (iv) Interim Finance Provider(s), and (v) Prospective Resolution Applicant(s) to the Insolvency Professional Agency of which he is a member, within the time specified under this circular. Four kinds of nature of relationships at any time or during the three years preceding the appointment has been specified in the circular. The insolvency professional shall provide a confirmation to the Insolvency Professional Agency to the effect that the appointment of every other professional has been made at arm's length relationship (IP/005/2018 dated 16th January 2018).

- IP, whether acting as interim resolution professional, resolution professional or liquidator, except to the extent provided in the Code and rules, regulations or circulars issued thereunder, -

  i. shall keep every information related confidential; and

  ii. shall not disclose or provide access to any information to any unauthorised person.

  (IP(CIRP)/007/2018 dated 23rd February 2018).

Conclusion

From above amendments, one may conclude that Government is taking active steps to bring transparency in insolvency resolution process and thereby making entire process more credible and sustainable. Ban on promoters to submit resolution plans with NPA for more than 1 year prior to insolvency commencement seems to be harsh especially for medium and small scale corporate borrowers and might affect valuation of the company. However, jurisprudence related to IBC is evolving which might trigger amendments in future.

Source: IBBI website (www.ibbi.gov.in), IBC Rules, Regulations, Circulars and Press Releases.

> If you want to do a great or a good work, do not trouble to think what the result will be.
>
> — *Swami Vivekananda*

CA Mayur Nayak, CA Natwar Thakrar &
CA Pankaj Bhuta

OTHER LAWS
FEMA Update and Analysis

In this article, we have discussed recent amendments to FEMA through Circulars and Notifications issued by RBI and amendments made to Master Directions:

1. Master Direction – Import of Goods and Services

Under the head, **Follow-up for Evidence of Import,** the master direction was updated as follows –

a) In case an importer does not furnish any documentary evidence of import within 3 months from the date of remittance involving foreign exchange, irrespective of the value of remittance, the AD bank should rigorously follow up for next 3 months. The master direction has now been amended to clarify that such follow-up should be undertaken by various modes of communication at least one of which must include issuing a registered letter to the importer.

b) Further, AD banks are required to report all outstanding import remittances irrespective of amount in IDPMS. The master direction is also updated by incorporating a date notified to discontinue separate submission of BEF statement by the AD banks in respect of importers who have defaulted in submission of appropriate documents evidencing import within six months from the date of remittance using the online XBRL system to the respective Regional Offices of the RBI.

The update was notified on Notification dated 28th April, 2016 stating -

"On operationalisation of IDPMS, all outstanding import remittances, irrespective of the amount involved, will be reported into the system by banks and submission of a separate BEF statement would be discontinued from a date, to be notified separately"

The master direction was accordingly updated as follows:

"In IDPMS, all outstanding import remittances, irrespective of the amount involved, should be reported by the AD Category-I banks. Further, submission of a separate BEF Statement by the AD Category-I bank would be required till the half year ended December 2017 and discontinued thereafter."

Also, the convergence of the above update has been brought to the effect in the Master Direction on Reporting under FEMA, 1999.

[RBI/FED/2016-17/12 - FED Master Direction No. 17/2016-17 modified to incorporate above amendments]

2. Risk Management and Inter-bank Dealings: Revised guidelines relating to participation of a person resident in India and Foreign Portfolio Investor (FPI) in the Exchange Traded Currency Derivatives (ETCD) Market

Currently, persons resident in India and FPIs are allowed to take a long (bought) or short (sold) position in USD-INR up to USD 15 million per exchange without having to establish existence of underlying exposure. In addition, residents & FPIs are allowed to take long or short positions in EUR-INR, GBP-INR and JPY-INR pairs, all put together, up to USD 5 million equivalent per exchange without having to establish existence of any underlying exposure.

RBI has now decided to permit persons resident in India and FPIs to take positions (long or short), without having to establish existence of underlying exposure, up to a single limit of USD 100 million equivalent across all currency pairs involving INR, put together, and combined across all exchanges.

[A.P. (DIR Series) Circular No. 18 dated 26th February, 2018]

(Comments: Consolidating and increasing the limits for ETCD in USD-INR, EUR-INR, GBP-INR and JPY-INR pairs combined will provide a boost to the trading volumes and provide greater access to the rest of the exchange pairs (other than USD-INR). This will help improve the economy as companies and banks may also be able to tap arbitrage opportunities in the market.)

We have discussed below a recent compounding order issued by RBI :

3. C.A. No. 70/2017 in the matter of Pearson Education (Singapore) Pte. Ltd. – Branch Office (Amount imposed under the compounding orders – ₹ 94,91,250/-)

Facts of the Case

The applicant, Pearson Education (Singapore) Pte. Ltd. (earlier known as M/s Addison Wesely Longman (Singapore) Pte. Ltd.) was granted permission by RBI to open a Branch Office ('BO') in India under Section 29(1)(a) of the Foreign Exchange Regulation Act (FERA), 1973 *vide* letter No. EC.CO.FID.2518/10-I-06-02 (B-347) 1999-2000 dated March 1, 2000.

The BO of the company ceased to carry on its activities with effect from August 1, 2005, however, it had kept funds amounting ₹ 13,00,00,000 (₹ 13 crore) in interest bearing Term Deposit with HSBC Limited from November 8, 2013 to February 27, 2015.

Contravention

The contravention sought to be compounded relates to permitted activities of Branch Office in India, under Regulations 6(i) of Foreign Exchange Management (Establishment in India of Branch or Office or other Place of Business) Regulations, 2000 notified *vide* Notification No. FEMA 22/2000-RB dated May 3, 2000, as amended from time to time (hereinafter referred to as FEMA 22 ibid.).

In terms of A.P. (DIR Series) Circular No. 3 dated July 6, 2002, AD can allow term deposit account for a period not exceeding 6 months in favour of a BO of a person resident outside India provided the bank is satisfied that the term deposit is out of temporary surplus funds and the BO furnishes an undertaking that the maturity proceeds of the term deposit will be utilised for their business in India within 3 months of maturity. Further, in terms of Regulation 6(i) of FEMA 22 *"a person resident outside India permitted by the Reserve Bank under Regulation 5, to establish a Branch Office or a liaison Office in India may undertake or carry on any activity specified in Schedule I or, as the case may be, in Schedule II, but shall not undertake or carry on other activity unless otherwise specifically permitted by the Reserve Bank."*

In the instant case, the company had ceased its operations/activities from August 1, 2005,

utilising the proceeds of Term Deposit on maturity after 6 months for its business activity in India does not apply. Further, while the company kept its funds in current account until November 8, 2013, it was not enabled to place the funds in Term Deposit subsequently. Hence, the applicant has contravened Regulation 6(i) of FEMA 22. The aforementioned contravention was regularized by RBI *vide* letter FE. CO.FID.1399/10.82.347/2015-2016 dated March 4, 2016, subject to compounding of contraventions.

Compounding

i) The contravention amount comes to ₹ 13,00,00,000 (Rupees Thirteen crore only) as term deposit and the period of contravention to be 2 years 3 months and 25 days (from November 8, 2013 to March 4, 2016 *i.e. up to the date of regularisation of contravention.*) as the BO was not eligible for placing the Term Deposit;

ii) Also earning an interest of ₹ 1,33,22,010 (Rupees One crore thirty three lakh twenty two thousand ten only) amounts to an undue gain. However on this interest income, and income tax of ₹ 9,50,910 (Rupees nine lakh fifty thousand nine hundred ten only) and ₹ 34,29,850 (Rupees thirty four lakh twenty nine thousand eight hundred fifty only) during assessment years 2014-15 and 2015-16, respectively, aggregating to ₹ 43,80,760 (Rupees forty three lakh eighty thousand seven hundred sixty only) has been paid. Accordingly, a net undue gain of ₹ 89,41,250 (Rupees eighty nine lakh forty one thousand two hundred fifty only) needs to be neutralised.

Taking a lenient view, the RBI officer has calculated the compounding fee based on the Guidance Note on Computation Matrix provided in the Master Direction on Compounding of Contraventions under FEMA, 1999 and arrived at an amount payable of ₹ 94,91,250/-. The calculation is based as under:-

Sr. No.	Reference to Computation Matrix	Amount	Calculation
1.	**Point 3]** **B] LO/BO/PO** (Other than reporting contraventions) ₹ 30,000/- + given percentage 1st year : 0.30% 1-2 years : 0.35% 2-3 years : 0.40% 3-4 years : 0.45% 4-5 years : 0.50% >5 years : 0.75%	5,50,000	30,000 + 13,00,00,000*0.40% (since period of contravention is 2 years 3 months and 25 days)
2.	--	89,41,250	Undue gains i.e. interest (1,33,22,010 (Int) - 9,50,910 (tax) - 34,29,850 (tax)
	Total	**94,91,250**	

CA Gautam Shah

In Focus – Accounting and Auditing

Audit of Advances with Significance on Non-Performing Assets (NPA)

Every day in newspapers, media, internet – one or other news is flashing about stress, frauds and NPAs in banking system. The larger question here is "What is the role of Statutory Auditors?"

Let us first review some key statistic of NPAs in banking sectors to understand gravity of these matters.

The Financial Stability Report, 2017, released by the RBI, states that India's gross NPAs stands at 9.6%. This figure is the sum total of all stressed assets held by lending institutions in the country including co-operatives and small banks in addition to Government and private banks.

India ranks fifth in a list of countries with the worst non-performing asset ratios. Portugal, Italy, Ireland and Greece – four of the PIIGS nations that suffered the most in the Eurozone sovereign debt crisis – are the only countries with higher stressed loans than India. Greece, Ukraine, Italy have 36.3%, 30.5% & 16.4% NPAs respectively. Spain, the fifth of the PIIGS nations, has a non-performing asset ratio of 5.28%. Australia, Canada, Hong Kong, South Korea and the United Kingdom had NPA ratios of less than 1%. China, Germany, Japan and the United States had NPAs of between 1% and 2%. {Source: CARE Ratings}

As per the RBI's Financial Stability Report, basic metals and cement industries are the most indebted, with 45.8% and 34.6% stressed assets respectively. Despite the recent GDP numbers which point to lukewarm growth, the metals industry continues to be hamstrung by slow demand and cheaper imports. The construction, infrastructure and automobile industries also account for a sizeable chunk of banks' NPAs.

The gross NPAs of public sector banks increased by 311.22% from ₹ 1,55,890 crore in 2013 to ₹ 6,41,057 crore in 2017. The gross NPA ratio as a percentage of total assets rose from 3.84% to 12.47%. Likewise, the gross NPAs of private banks witnessed an increase of 269.47% from ₹ 19,986 crores in 2013 to ₹ 73,842 crore in 2017.

List of banks having NPAs above INR 10,000 crore is as follows:

(Rs. in crore)

Bank	Amount	%
State Bank of India	1,88,068	9.97
Punjab National Bank	57,721	13.7
Bank of India	51,019	13.1
IDBI Bank	50,173	24.1
Bank of Baroda	46,173	11.4

Bank	Amount	%
ICICI Bank	43,148	7.99
Canara Bank	37,658	10.6
Union Bank of India	37,286	12.6
Indian Overseas Bank	35,453	23.6
Central Bank of India	31,398	18.2
UCO Bank	25,054	19.9
Oriental Bank of Commerce	24,409	14.8
Axis Bank	22,031	5.03
Corporation Bank	21,713	15.5
Syndicate Bank	20,184	9.96
Andhra Bank	19,428	13.3
Bank of Maharashtra	18,049	18.6
Dena Bank	12,994	17.4
United Bank of India	12,165	17.2

What is Advances and Why Advances?

It is interesting that objective of entity giving advances and taking advances is to earn revenue from those advances. Bank earns interest on those advances while borrower deploys funds in business and generates revenue.

In bank's financial statement, major portion of asset is Advances and major income is Interest/ Discount/Fees on those advances.

To lend money, bank does assessment of credit worthiness of borrower and based on same, the Bank may also provide non-fund based facilities like guarantees, letter of credit etc.

- The Banks have fund based advances (On-Balance Sheet) and non-fund based advances (Off-Balance Sheet)
- Based on bank's assessment of a borrower, the Bank may lend money against security (Secured Advances) or without any security (Unsecured Advances)
- The bank may be sole lender to a particular borrower (Sole Banking) or lending may be done collectively with other banks (Consortium Advances)

For banks while sanctioning and for auditors while auditing, it is very essential to apply same level of check on non-fund based facility since any failure by borrower results in funded obligation of bank.

Every bank frames its credit policy which is approved by its board of directors. The auditor should obtain the latest credit policy of the bank & must acquaint themselves with the credit policy of the bank and composition of its advances portfolio. The auditor should also obtain head office circular/guidance issued to branches during the course of their branch audit.

Each bank has its own procedures for sanctioning, disbursal, supervision and renewal of advances. It is very essential for auditors to review these processes.

Most advances taken by the person are for future expansion or to meet temporary funds mismatch. Since advances given are linked to future business plans of the Company, it is very important for banks to assess projections given by the borrower are reasonable and realistic.

Basics of NPA

A credit facility becomes non-performing "when it ceases to generate income for a bank". The RBI has defined rules linked to record of recovery in borrower's account to classify the account as NPA. Along with financial indicator in accounts, there are many non-financial indicators also which warrants accounts to be classified as NPA.

Financial Indicators for NPA

The RBI has directed the banks to adopt the '90 days' overdue' norm for identification of NPAs from the year ending March 31, 2004

- If interest charged in account or principal repayment, remains overdue for more than 90 days, it gets classified as NPA
- If outstanding balance remains continuously in excess of the sanctioned limit/ drawing power for more than 90 days.

- Credits in account are not enough to cover the interest debited during the same period (90 days)

Note : There is specific relaxation given to MSME entities on February 7, 2018, which have been dealt with separately below.

Non-Financial Indicator for NPA

There are many other non financial parameters which also should be considered while assessing classification of NPA account such as:

- Inherent weakness in account
- For project loan – Delay in completion of project
- Failure to comply with key restructuring conditions
- Erosion in value of security

Critical aspect to consider while auditing Advances and NPAs

a) Special Mention Account Reporting (SMA Reporting)

The RBI has implemented regulation which requires banks to report all advances having any delay in recovery of interest or principal amount.

SMA	Default between (no. of days)
SMA-0	1-30 days
SMA-1	31-60 days
SMA-2	61-90 days

The auditor should obtain above classification of all advances under review. It will give good starting point to assess or identify accounts having stress.

b) Identification at any point in time and not only at month end or quarter end

One critical point to evaluate, whether NPA identification needs to be done only at month end/quarter end or at any point in time. RBI circular does not specifically mention about month end or quarter end, hence bank should have process of NPA identification and classification on daily basis. Once account is classified as NPA, it can be upgraded only on full recovery of all dues. Hence if any account is classified as NPA in middle of month and as at month end, overdues are less than 90 days, still account may continue to be classified as NPA. If bank have practice to identify NPAs only at month-end, above account may get slipped from getting classified as NPA. Hence it is very important for auditors to check bank's process and timing for identification of NPAs.

c) Drawing Power Computation

The bank gives advances to fund working capital requirement of the borrower. The borrower should use those funds for working capital requirement and same should be evident based on stock and debtors statements submitted by them. Any discrepancy in stock and debtors statement indicates stress in borrower's operations or may be divergence of funds. Hence the auditors should carefully review the process for obtaining stock statements, computation of drawing power and entry of same in core banking system.

Working capital borrower account, drawing power calculated from stock statement older than 3 months has to be considered as "irregular" (overdue). If such "irregular" continues for 90 days, account has to be classified as NPA, even though the account is otherwise operated regularly.

The audited Annual Report submitted by the borrower should be scrutinised properly. The monthly stock statement of the month for which the audited accounts are prepared and submitted should be compared and the reasons for deviations, if any, should be ascertained.

Special consideration should be given to proper reporting of sundry creditors for the purposes of calculating drawing power. As a general principle, and with the objective of avoidance of double financing, the unpaid stocks should not

be considered while computing the DP available in the borrower accounts.

In case of consortium accounts, the drawing power calculation and allocation is made by the lead bank and is binding on the member banks.

d) LC/ Guarantee amount parked in separate account

In case debits arising out of devolvement of letters of credit or invoked guarantees are parked in a separate account, the balance outstanding in that account also should be treated as a part of the borrower's principal operating account for the purpose of NPA classification.

e) Asset classification need to be done borrower-wise and not facility-wise

Any one facility to a borrower is NPA, all exposure to same borrower is considered as NPA. It may happen that treasury system of bank is not integrated with advances or NPA system. Hence it is important to check if any investment or derivative exposure to borrower is also considered while assessing overall exposure to NPA and accordingly, classification, provision and income reversal is done for same.

The auditor should also review the facilities enjoyed by such borrower's related or group entities. The NPA classification so made does not automatically extend to such related or group entities, where the classification would have to be judged based on independently, i.e., at the entity level and not at a group level.

f) Asset Shortage

Once the account is classified as NPA, it is important to check bank's process to assess asset shortage i.e., value of security. The Bank needs to get independent valuation of security as per RBI regulations. Further, auditor needs to check process for updation of value of security as per latest report in IT system which is considered for computation of provision for NPAs.

g) Erosion in Value of Securities/ Frauds committed by borrowers

In respect of accounts where there are potential threats for recovery on account of erosion in the value of security or non-availability of security and existence of other factors such as frauds committed by borrowers, such accounts need not go through the stages of asset classification. In such cases, the asset should be straightaway classified as doubtful or loss asset, as appropriate.

h) Inherent weakness

The asset classification of borrower accounts where a solitary or a few credits are recorded before the balance sheet should be handled with care and without scope for subjectivity. Where the account indicates inherent weakness on the basis of the data available, the account should be deemed as an NPA. In other genuine cases, the banks must furnish satisfactory evidence about the manner of regularisation of the account to eliminate doubts on their performing status.

i) Upgradation of loan accounts classified as NPA

If all amounts due (i.e., principal due and interest due) are paid by the borrower in the case of loan accounts classified as NPAs, the account should no longer be treated as non-performing and may be classified as 'standard' account.

Standard accounts classified as NPA and NPA accounts retained in the same category on restructuring by the bank should be upgraded only when all the outstanding loan/facilities in the account perform satisfactorily during the specified period i.e., principal and interest on all facilities in the account are serviced as per terms of payment during that period.

j) Subsequent Recoveries

Currently since there is no specific guidance available from regulator on treatment of subsequent recoveries on assessment of NPA accounts as on reporting date, the status of

account as at balance sheet date need to be considered.

In case there is a recovery in account before balance sheet date which gets evident subsequently then same can be considered as adjusting event as per para 8 of AS-4 for assessment of NPA account as on reporting date.

Recent Important RBI Circulars

I. Relief for MSME borrowers registered under Goods and Services Tax. (RBI Circular dated February 07, 2018)

As a measure of support to small entities who are adversely impacted with cash flow during the transition phase of Goods and Service Tax (GST), it has been decided that the exposure of banks and NBFCs to a borrower classified as micro, small and medium enterprise under the Micro, Small and Medium Enterprises Development (MSMED) Act, 2006, shall continue to be classified as a standard asset in the books of banks and NBFCs subject to the following conditions:

a. The borrower is registered under the GST regime as on January 31, 2018.

b. The aggregate exposure, including non-fund based facilities, of banks and NBFCs, to the borrower does not exceed ₹ 250 million as on January 31, 2018.

c. The borrower's account was standard as on August 31, 2017.

d. The amount from the borrower overdue as on September 1, 2017 and payments from the borrower due between September 1, 2017 and January 31, 2018 are paid not later than 180 days from their respective original due dates.

e. A provision of 5% shall be made by the banks/NBFCs against the exposures not classified as NPA in terms of this circular. The provision in respect of the account may be reversed as and when no amount is overdue beyond the 90/120 day norm, as the case may be.

f. The additional time is being provided for the purpose of asset classification only and not for income recognition, i.e., if the interest from the borrower is overdue for more than 90/120 days, the same shall not be recognised on accrual basis.

II. Resolution of Stressed Assets (RBI Circular dated February 13, 2018)

The Reserve Bank of India ('RBI'), in view of the enactment of the Insolvency and Bankruptcy Code, 2016 (IBC) has decided to substitute the existing restructuring guidelines with a harmonised and simplified generic framework for resolution of stressed assets.

Key points:

Time lines for Large Account to be referred to IBC

i. Aggregate exposure at ₹ 20 billion and above, on or after reference date – March 1, 2018, including accounts where resolution may have been initiated under any of the existing schemes as well as accounts classified as restructured standard assets which are currently in respective specified periods (as per the previous guidelines), RP shall be implemented as per the following timelines:

- If in default as on the reference date, then 180 days from the reference date
- If in default after the reference date, then 180 days from the date of first such default

ii. If RP is not implemented within stipulated timeframe, lenders shall file insolvency

application, singly or jointly, under the Insolvency and Bankruptcy Code 2016 (IBC) within 15 days from the expiry of the said timeline.

iii. When the RP is implemented, the account should not be in default at any point of time during the 'specified period', failing which the lenders shall file an insolvency application, singly or jointly, under the IBC within 15 days from the date of such default.

iv. For other accounts with aggregate exposure of the lenders below ₹ 20 billion and, at or above ₹ 1 billion, the Reserve Bank intends to announce, over a two-year period, reference dates for implementing the RP to ensure calibrated, time-bound resolution of all such accounts in default.

Specified period' means the period from the date of implementation of RP up to the date by which at least 20 per cent of the outstanding principal debt as per the RP and interest capitalisation sanctioned as part of the restructuring, if any, is repaid.

Provided that the specified period cannot end before one year from the commencement of the first payment of interest or principal (whichever is later) on the credit facility with longest period of moratorium under the terms of RP.

Asset Classification

Asset Classification Pre RP	Asset Classification Post RP
Standard	Downgraded as non-performing assets (NPAs), i.e., 'sub-standard' to begin with.
Non Performing Assets	Continue to have the same asset classification

Withdrawal of extant instructions

The extant instructions on resolution of stressed assets such as Framework for Revitalising Distressed Assets, Corporate Debt Restructuring Scheme, Flexible Structuring of Existing Long Term Project Loans, Strategic Debt Restructuring Scheme (SDR), Change in Ownership outside SDR, and Scheme for Sustainable Structuring of Stressed Assets (S4A) stand withdrawn with immediate effect. Accordingly, the Joint Lenders' Forum (JLF) as an institutional mechanism for resolution of stressed accounts also stands discontinued. All accounts, including such accounts where any of the schemes have been invoked but not yet implemented, shall be governed by the revised framework.

Audit Process: Practical Aspects

The key objective or responsibility of Statutory Auditors is to report on that the financial statements of the bank are true and fair and it does not include any material mis-statement. The auditor should consider following key aspects while auditing bank's advances.

Compliance

- The advances reflected in bank's financial statements are as per books of account and same have been sanctioned and disbursed as per bank's policy

- The bank's process to ensure compliance with all circular issued by RBI. The auditor should also have knowledge about all RBI circulars (specifically having impact on financial statements) and ensure compliance with same

Core Banking System

- Considering volume of transactions as well as real time processing of banking transitions, it is important to check bank's control over IT systems and integration of various IT systems.

- The auditor should ensure there is minimal manual intervention in data processed from IT system and in case of manual intervention, it has proper controls like maker-checker/ segregation of duties

NPA Identification

The Bank has system for identification of NPAs. Following key points to be checked:

- All requirements as per RBI regulations are properly captured in system
- Manual intervention in system and controls on same
- Integration of Core Banking. Correctness and Completeness of data captured in system
- Process of NPA identification based on non-financial indicators

As we discussed earlier, advances are primary sanctioned to fund future business projections or working capital requirements of the entity. Primarily, account can slip as NPA due to following reasons.

- First reason, the bank does not carry our proper assessment of projections or credit worthiness of borrowers and due to same, the borrower defaults in future; or
- Second, there is actual slowdown or change in economic scenario, which results in default by borrower.

The question here is, what is role of auditors?

Auditors have responsibility to check documents evidencing compliance with bank's policy & RBI regulations with respect to sanction/ disbursement of advances. After doing so, if borrower defaults in future, whether auditors are made responsible for same is a larger question? The answer depends on facts and circumstances of each case and may not be generalised.

Compliance with Standards on Auditing (SA)

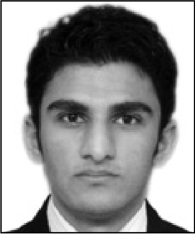
This is the most important aspect of audit and many times it takes back seat since auditors get so busy checking regulations applicable to client and forget compliance with regulations which primarily gives guidance for Statutory Audit.

Objective of Statutory Audit is very specific, hence it is important for auditors to know requirement of SAs.

Whether Statutory Auditors are responsible for each and every advance in the bank? Answer may be "No", since there are principles of materiality and sampling. But it need to be applied as per guidance given in SAs and most important, it needs to be documented properly.

Hence Auditors should first understand nature of business carried out by bank (nature of advances portfolio), IT systems, bank's policies and based on same, auditor should design its audit procedures as per SAs. As Auditors, we check documentation done by banks for sanction/disbursement of loans, in same way it is extremely important to document work executed by auditors for bank audit and there is no exception to same.

For framing above article, reference has been taken from guidance note on bank audit issued by ICAI, relevant RBI Circulars, CARE Ratings report on NPAs and information/statistics about banking system/ NPAs in public domain. Views given in above article are personal views of author.



Rahul Sarda, *Advocate*

BEST OF THE REST

1. Insolvency & Bankruptcy Code – Overriding provisions – Whether power overrides powers of SEBI

The Appellant, being a creditor filed application u/s. 9 of the IBC before NCLT, Mumbai for non-payment of dues by the Respondent, the debtor, under contracts for construction. During the course of hearing, the NCLT observed that SEBI had passed an order against the Respondent for collecting huge moneys from public in the name of holiday plans. The NCLT observed that the Respondent was engaged in the business of owning, developing and operating hotels, clubs and resorts across India by offering different holiday plans and when this came to the notice of SEBI, it alleged that the schemes of the Respondent were in the nature of collective investment schemes (CIS). Thereafter, SEBI passed a detailed order holding that the Respondent had launched CIS without registering itself as Collective Investment Management Company which was like a ponzi scheme. The SEBI *inter alia* restrained the Respondent from alienating or disposing off or selling any assets of the Respondent except for refunding moneys to investors. The NCLT held that provisions of Section 238 of the IBC which gave overriding powers to provisions of IBC over other laws, did not override SEBI Act, and hence, NCLT could not admit the petition in the interest of 51 lakh victims of the ponzi scheme. Furthermore, the NCLT did not go into the merits of the case and dismissed the petition.

On appeal to the NCLAT, the NCLAT upheld the dismissal of the petition but on the ground that there existed a dispute between the parties. In so far as the NCLT's order that the petition could not have been admitted in view of SEBI order operating in the interest of the investors in ponzi schemes, the NCLAT reversed the finding holding that initiation of corporate insolvency resolution process could not be nullified by any order passed by SEBI and the same is not a ground for rejection of petition u/s. 9 of the IBC.

Sobha Limited vs. Pancard Clubs Limited – NCLAT (New Delhi) judgment dated 4th December 2017

2. Insolvency & Bankruptcy Code – Respondent raising "dispute" – Respondent contending that Petitioner was liable to purchase goods from the Respondent which it has not done – Petitioner could not be forced to buy goods from Respondent

The Petitioner-operational creditor had been supplying goods/materials to the corporate debtor. Against entire outstanding payment of the supply of goods/materials, there was an adjustment/set-off as payment/part payment by way of purchase of items by the corporate-debtor. Pursuant to notice of demand as required by section 8(1), the operational creditor filed the petition u/s. 9 for initiation of corporate resolution process against the Respondent-corporate debtor. The corporate debtor filed objections to the petition that there was an oral arrangement between the parties wherein the corporate debtor was supplying 'Yarn' to operational creditor against the price of the chemicals supplied by the operational creditor and by making such adjustments, the outstanding amount was to be paid by the corporate debtor. The aforesaid arrangement was working perfectly, but the operational creditor stopped buying 'Yarn' and backed out from the oral settlement between the parties. It had resulted in huge increase in the

debt being shown towards the corporate-debtor in the account books. The operational debtor claimed that the operational creditor should abide by the arrangement so that the corporate debtor was able to clear the outstanding dues. It was further averred that the amount claimed by the petitioner was not correct as per the books of account being maintained by the corporate debtor.

Held, the operational creditor could not be forced to buy goods from the respondent-corporate debtor and that the operational creditor had every right to claim the outstanding amount which was overdue. The respondent could not raise a voice to say that there was no term fixed for payment for the outstanding amount on the ground that the transactions between the parties continued in the normal course of business since 2012 and that various payments had been made from time-to-time. The above contention could not be said to raising a 'dispute' which may be covered within the definition of the term as defined in section 5(6). Hence, the petition was liable to be admitted.

Kamal Chemicals vs. T. C. Terrytex Limited [2018] 89 taxmann.com 437 (NCLT – Chandigarh)

3. Intellectual Property – Action for passing off – Cannot be successfully maintained in absence of such mark having sufficient goodwill or reputation in India – Territoriality principle

The Appellant was an automobile manufacturer incorporated under the laws prevailing in Japan. The Respondent was a partnership firm engaged in the manufacture of automobile spare parts. A civil suit was instituted by the Appellant seeking a decree of permanent injunction for infringement of trade mark, passing off and for damages against the Respondents in order to protect, among other trademarks, the mark 'Prius' of the Appellant. The Appellant had launched the world's first commercial hybrid car called 'Prius' in Japan in the year 1997 and in other countries like U.K., Australia, the U.S.A. etc. during the year 2000-01. The Appellant also claimed registration of the trade mark 'Prius' in different countries as early as the year 1990 (in Japan) and eventually in other jurisdictions all over the globe. So far as India is concerned, however, the car was released in the year 2009 and until that point of time the Appellant had not obtained registration of the mark 'Prius' in the Indian jurisdiction. However, the car was displayed in the car shows in Delhi and Bangalore held in the year 2009 and it was formally launched in India in the year 2010.

Held, the Courts must necessarily have to determine if there has been a spillover of the reputation and goodwill of the mark used by the claimant who has brought the passing off action. In the course of such determination it may be necessary to seek and ascertain the existence of not necessarily a real market but the presence of the claimant through its mark within a particular territorial jurisdiction in a more subtle form which can best be manifested by the following illustrations, though they arise from decisions of Courts which may not be final in that particular jurisdiction. The trade mark 'Prius' had undoubtedly acquired a great deal of goodwill in several other jurisdictions in the world and that too much earlier to the use and registration of the same by the Defendants in India but there must be adequate evidence to show that the Appellant had acquired a substantial goodwill for its car under the brand name 'Prius' in the Indian market also.

The car itself was introduced in the Indian market in the year 2009-10, the advertisements in automobile magazines, international business magazines; availability of data in information-disseminating portals like Wikipedia and online Britannica dictionary and the information on the internet, even if accepted, will not be a safe basis to hold the existence of the necessary goodwill and reputation of the product in the Indian market at the relevant point of time, particularly having regard to the limited online exposure at that point of time, i.e., in the year 2001. This would show either lack of goodwill in the domestic market or lack of knowledge and information of the product amongst a significant section of the Indian population. Therefore, it could not be said that the brand name of the car "Prius" had not acquired the degree of goodwill, reputation in the market or popularity in the Indian market so as to vest in the Appellant the necessary attributes of the right of a prior user so as to successfully maintain an action of passing off even against the registered owner. Therefore, the action for passing off was not maintainable and appeals were liable to be dismissed.

Toyota Jidosha Kabushiki Kaisha vs. Prius Auto Industries Ltd. & Ors [2018] 2 SCC 1

CA Ketan Vajani & CA Nishtha Pandya
Hon. Jt. Secretaries

The Chamber News

Important events and happenings that took place between 7th February, 2018 and 7th March, 2018 are being reported as under:

I. ADMISSION OF NEW MEMBERS

1) The following new members were admitted in the Managing Council Meeting held on 14th February, 2018.

Life Membership

1	Mr. Mody Kalpesh Chandrakant	ICSI	Mumbai
2	Mr. Jain Chirag Ashok Kumar	CA	Jaipur
3	Mr. Maheshwari Prabhanjan Rameshwar Lal	CA	Mumbai
4	Mr. Trivedi Shreyas Prakash	CA	Mumbai
5	Miss Jain Reema Surjeet Kumar	ICSI	New Delhi
6	Mr. Gokani Ankit Bhagwandas	CA	Jamnagar
7	Ms. Sejpal Vaidehi Dinyesh	CA	Mumbai
8	Mr. Modi Darshan Mahesh	Advocate	Mumbai

Ordinary Membership

1	Mr. Chakrabarty Pinali Dhirendra Nath	ICWAI	Mumbai
2	Mr. Gahrana Aishwarya Mohan	ICSI	New Delhi
3	Mr. Jain Saurav Surendra	CA	Mumbai
4	Mr. Pattathil Vijaykumar	CA	Kerala
5	Mr. Desai Naman Yagnesh	CA	Vadodara
6	Mr. Agarwal Arun Deendayal	CA	Raipur
7	Mr. Chheda Dhiren Nagaji	CA	Mumbai
8	Mr. Shah Sanket Mukesh	CA	Mumbai

Student Membership

1	Mr. Ghelani Mohak Rajendra	LLB 3rd Year	Mumbai
2	Mr. Chhabra Shivam Girish	CS	Pune
3	Mr. Kolah Kaizad Aspi	CA Final	Mumbai

Associate Membership

1	STCI Primary Dealer Limited		Mumbai

II. PAST PROGRAMMES

1. DIRECT TAXES COMMITTEE

Half-Day Workshop on Direct Tax Provisions of Finance Bill, 2018 jointly with WIRC of ICAI was held on 10th February, 2018 at Babubhai Chinai Committee Room, 2nd Floor, IMC. The workshop was addressed by CA Yogesh Thar & CA Gautam Nayak.

2. INDIRECT TAXES COMMITTEE

Workshop on GST Law jointly with BCAS, MCTC, GSTPAM, AIFTP (WZ) & WIRC of ICAI was held on 21st, 28th, 28th February, 2018 and 7th March, 2018 at GSTPAM, Mazgaon Library, 1st Floor, 104, Vikrikar Bhavan, Mazgaon, Mumbai – 400 010. The Workshop was addressed by CA Jigar Doshi, CA Sujata Rangekar, CA Manish Gadia, CA Rajat Talati, CA Naresh Sheth and Mr. C. B. Thakar, Advocate.

3. IT CONNECT COMMITTEE

Workshop on Bitcoin/Crypto-Currencies: Investment, Legal and Tax Issues was held on 16th February, 2018 at Jai Hind College, A. V. Room, 4th Floor, Churchgate. The Workshop was addressed by Mr. Ajeet Khurana and Mr. Meyyappan Nagappan.

4. MEMBERSHIP & PR COMMITTEE

- Half Day Seminar on Budget Analysis - 2018 & E-way Bill under GST jointly with The Kalyan Tax Practitioners Association was held on 17th February, 2018 at Saga Banquet, Spring Time Club, Kalyan West, Mumbai. The Seminar was addressed by CA Devendra Jain and CA Mitesh Katira.
- Seminar on GST Case Studies and Anti-Profiteering in Real Estate & Tourism Sectors jointly with ICAI Goa Branch and GCCI was held on 3rd March, 2018 at Institute Menezes Braganza Hall, Panaji, Goa. The Seminar was addressed by CA Sunil Gabhawalla and CA Naresh Sheth.

5. RRC & SD COMMITTEE

41st Residential Refresher Course was held from 22nd February, 2018 to 25th February, 2018 at Hotel Taj Swarna, Amritsar. Mr. Sudeep Kumar, Commandant, BSF inaugurated the Course with his keynote address. Mr. Madhur Agarwal, Advocate presented the paper on "Recent Developments on Taxation of Undisclosed Income". CA N. C. Hegde presented the paper on "Accounting & Taxation – Convergence or Divergence?" Mr. Ashwani Taneja, Advocate & Ex-ITAT Member presented the paper on "Select Case Studies under Mock Tribunal Approach". Brains' Trustees were Shri R. V. Easwar, Retd. Judge and Shri Saurabh Soparkar, Sr. Advocate.

III. FUTURE PROGRAMMES

1. DIRECT TAXES COMMITTEE

Half-Day Seminar on Charitable Trusts is scheduled to be held on 23rd March, 2018 at Babubhai Chinai Committee Room, 2nd Floor, IMC, Churchgate.

2. INTERNATIONAL TAXATION COMMITTEE

- Two day Intensive Study Course on Foreign Exchange Management Act (FEMA) Jointly with Delhi Chapter is scheduled to be held on 23rd and 24th March, 2018 at India International Centre Lecture Room I/II, New Delhi.
- 12th Residential Conference on International Taxation, 2017 is scheduled to be held from 21st June, 2018 to 24th June, 2018 at The Grand Bhagwati, Indore.
- 4th International Study Tour is scheduled from 28th April, 2018 to 2nd May, 2018 at Hotel Le Meridien, Mauritius.

3. MEMBERSHIP & PUBLIC RELATIONS COMMITTEE

2nd Triangular Box Cricket Tournament jointly with The Malad Chamber of Tax Consultants and The Goods And Services Tax Practitioner's Association of Maharashtra is scheduled to be held on 10th March, 2018 at The Turf Club, Kandivali (East), Mumbai.

4. STUDENT COMMITTEE

- 45th Sir Jamshedji Kanga & Dr. Y. P Trivedi National Moot Court Competition jointly with Government Law College and in association with Jamshedji Kanga Moot and Rotary Club of Bombay is scheduled to be held on 6th & 7th April, 2018.
- Student Orientation Course is scheduled to be held from 8th to 10th March, 2018 at Maharashtra Seva Sangh Hall, Mulund West, Mumbai .

(For details of the future programmes, kindly visit www.ctconline.org or refer The CTC News of March, 2018)

STATEMENT AS PER PRESS AND REGISTRATION OF BOOKS ACT
FORM IV *[See Rule 8]*

THE CHAMBER'S JOURNAL

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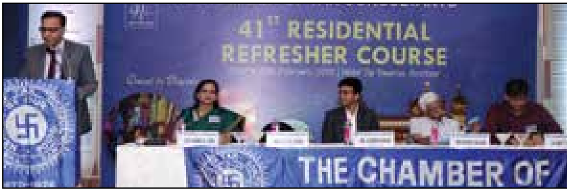
I, Kishor D. Vanjara hereby, declare that the particulars given above are true to the best of my knowledge and belief.

KISHOR D. VANJARA
Signature of the Publisher

Date : 9-3-2018

Residential Refresher Course & Skill Development Committee

41st Residential Refresher Course was held from 22nd to 25th January, 2018 at Hotel Taj Swarna, Amritsar



Mr. Ajay R. Singh, Advocate (President) giving opening remarks. Seen from L to R: CA Charu Ved (Chairperson), Mr. Sudeep Kumar (Commandant, BSF), Mr. Kishor Vanjara (Advisor) and CA Ankit Sanghvi (Convenor)

CA Charu Ved (Chairperson) welcoming the Chief Guest and delegates. Seen from L to R: Mr. Ajay R. Singh, Advocate (President), Mr. Sudeep Kumar (Commandant, BSF), Mr. Kishor Vanjara (Advisor) and CA Ankit Sanghvi (Convenor)

Mr. Sudeep Kumar (Commandant, BSF) inaugurating the Course by lighting the lamp. Seen from L to R: CA Bhavik Shah (Convenor), CA Charu Ved (Chairperson), Mr. Ajay R. Singh, Advocate (President) and Mr. Kishor Vanjara (Advisor)

Inauguration Session. Seen from L to R: CA Mehul Sheth (Vice-Chairman), Mr. Madhur Agarwal, Advocate (Speaker), CA Pranav Jhaveri (Vice-Chairman), CA Bhavik Shah (Convenor), CA Charu Ved (Chairperson), Mr. Ajay R. Singh, Advocate (President), Mr. Sudeep Kumar (Commandant, BSF), Mr. Kishor Vanjara (Advisor) and CA Ankit Sanghvi (Convenor)

Mr. Kishor Vanjara (Advisor) offering shawl to Mr. Sudeep Kumar (Commandant, BSF) Seen in the picture: Mr. Ajay R. Singh, Advocate (President)

Mr. Ajay R. Singh, Advocate (President) offering memento to Mr. Sudeep Kumar (Commandant, BSF)

Mr. Sudeep Kumar (Commandant, BSF) delivering key note address. Seen from L to R: CA Charu Ved (Chairperson), Mr. Ajay R. Singh, Advocate (President), Mr. Kishor Vanjara (Advisor) and CA Ankit Sanghvi (Convenor)

Residential Refresher Course & Skill Development Committee

41st Residential Refresher Course was held from 22nd to 25th January, 2018 at Hotel Taj Swarna, Amritsar

Faculties

Mr. Vipul Joshi, Advocate chairing the session

Mr. Madhur Agarwal, Advocate

CA N. C. Hegde

Mr. Ashwini Taneja, Advocate

Mr. Bassel Bitar, Senior Executive, Corporate Sale – DMCC, Dubai giving presentation of DMCC to delegates. Seen from L to R: CA Vishal Shah, Committee Member, CA Parag Ved (Hon. Treasurer) and CA Ishan Shah (Committee Member)

MOCK TRIBUNAL SESSION

Mr. Ajay R. Singh, Advocate (President) and CA Shailesh Bandi chairing the Mock Tribunal Session

CA Fenil Bhatt as assessee representative

Ms. Neelam Jadhav, Advocate as assessee representative

BRAINS' TRUST SESSION

Rt. Justice Shri R. V. Easwar, Brains' Trustee replying to the queries. Seen from L to R: CA Pramod Shingte (Committee Member), Mr. Ajay R. Singh, Advocate (President), Mr. Saurabh Soparkar, Senior Advocate, Brains' Trustee and CA Bandish Hemani (Committee Member)

Group Discussion at 41st RRC

Gala Dinner at 41st RRC

Residential Refresher Course & Skill Development Committee

41st Residential Refresher Course was held from 22nd to 25th January, 2018 at Hotel Taj Swarna, Amritsar

Visit to Wagah Border and Golden Temple

41st RRC Team

41st RRC Group Photo

Membership & PR Committee

Self Awareness Series Meeting on Stress Management was held on 9th February, 2018 at CTC Conference Room

Dr. Jankhana Hakani addressing the participants

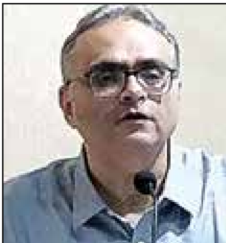
Allied Laws Committee

Study Circle on Will & Succession was held on 16th February, 2018 at CTC Conference Room

Ms. Loshika Bulchandani, Advocate addressing the participants

Pune Study Group

Study Group Meeting on Important Budget Amendments Relating to Corporate Tax and International Tax was held on 17th February, 2018 at ELTIS, Pune



CA Anish Thacker addressing the participants

Study Circle & Study Group Committee

Study Circle Meeting on Provisions relating to Recovery & Stay under Income Tax Act, 1961 was held on 28th February, 2018 at SNDT Committee Room, SNDT College, Churchgate, Mumbai

Mr. Rahul Hakani, Advocate addressing the participants

Indirect Taxes Committee

Workshop on GST Law organised jointly with AIFTP (WZ), BCAS, GSTPAM, MCTC & WIRC OF ICAI for the year 2017-18 was held on 7th, 14th, 21st and 28th February, 2018 at GSTPAM, Mazgaon Library, Mumbai

Speakers addressing the participants

CA Jayesh Gogri

CA Jinit Shah

CA Jigar Doshi

CA Sujata Rangnekar

CA Rajat Talati

CA Manish Gadia

International Taxation Committee

FEMA Study Circle on Bitcoins – Tax & Regulatory Implications was held on 6th March, 2018 at CTC Conference Room

CA Bhaumik Goda addressing the participants

CA Isha Shekri addressing the participants

Direct Taxes Committee

Webinar on Taxation of Private Trusts/Family Trusts and Estate Planning with the help of Private Trusts was held on 7th March, 2018.

CA Paresh Shah addressing the participants

Membership & PR Committee

Seminar on GST Case Studies & Anti-Profiteering in Real Estate & Tourism Sector was held on 3rd March, 2018 at Institute Menezes Braganza Hall, Panaji, Goa.

Mr. Ajay R. Singh, Advocate (President) delivering opening remarks. Seen from L to R: CA Kedar Kenkre, CA Sunil Gabhawalla (Speaker), CA Parimal Kulkarni, CA Vinesh Pikale and CA Pradip Lad

CA Parimal Kulkarni welcoming the President and the speakers. Seen from L to R: CA Kedar Kenkre, CA Sunil Gabhawalla (Speaker), Mr. Ajay R. Singh, Advocate (President), CA Vinesh Pikale and CA Pradip Lad

CA Sunil Gabhawalla addressing the participants

CA Naresh Sheth addressing the participants

Tax workshop on GST impact in tourism and real estate industry

Goa's business paper coverage of GST Seminar

Delhi Chapter

Seminar on The Companies Act, 2013 (as Amended by the 2017 Amendment Act) – Impact Analysis on Unlisted Public Companies & Private Companies was held on 24th February, 2018 at India International Centre, New Delhi

CA Suhit Agarwal (Chairman) delivering opening remarks

CA Vijay Gupta (Vice-Chairman) welcoming the speakers

Faculties

Mr. Satwinder Singh

Mr. Ranjet Pandey

Mr. Amit Peswani

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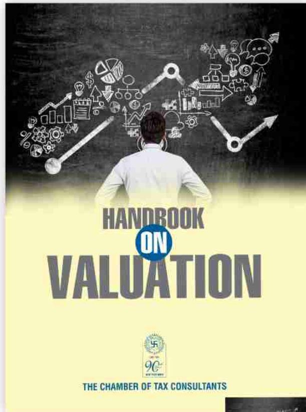

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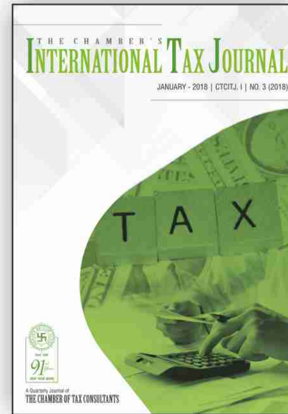

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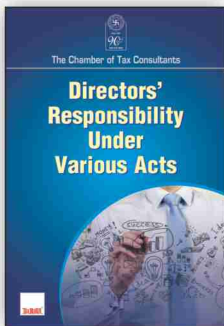

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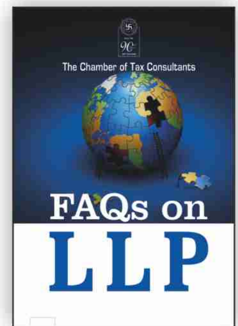

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