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The Chamber's Journal

YOUR MONTHLY COMPANION ON TAX & ALLIED SUBJECTS

December - 2014 Vol . III | No. 3

FINANCIAL SERVICES SECTOR : PART-I

(Banks & Mutual Funds)

Other Contents

- Direct Taxes
- Other Laws
- International Taxation
- Indirect Taxes
- The Chamber News
- Best of the Rest
- Corporate Laws
- Economy & Finance

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DIRECT TAXES COMMITTEE

Full day seminar on Assessment, Reassessment and Settlement Commission held on 8th November, 2014 at M. C. Ghia Hall.

CA Paras K. Savla, President welcoming the delegates. Seen from L to R: S/Shri CA Ketan Vajani, Chairman, Direct Taxes Committee, K. Gopal, Faculty and Rahul Hakani, Convenor.

Faculties

Mr. K. Gopal, Advocate

CA Chetan Karia

Faculties

CA Reepal Tralshawala

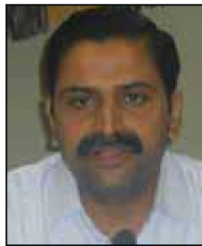
CA Atul Bheda

Section of delegates

STUDY CIRCLE & STUDY GROUP COMMITTEE

Study Group Meeting held on 6th November, 2014 on the subject "Recent Judgment under Direct Taxes" at Babubhai Chinai Committee Room, IMC.

Mr. Nitesh Joshi, Advocate addressing the members.



Mr. Gautam Thacker, Advocate addressing the members.

INTERNATIONAL TAXATION COMMITTEE

Transfer Pricing Study Circle Meeting held on 7th November, 2014 on the subject "Basic Provisions & Issues in Domestic Transfer Pricing" at Kilachand Hall, IMC.

CA Natwar Thakrar addressing the members.

FEMA Study Circle Meeting held on 12th November, 2014 on the subject "Basic Framework of FEMA Law" at CTC Conference Room.

CA Manoj Shah addressing the membes.

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Editorial

This month's Chamber's Journal find place in your hands when the year 2014 is slipping into history. Year 2014 was a very event full year. The dynamics of democracy were felt and witnessed by one and all. Electorates have participated in the democratic process and underlined the fact that the change starts from their fingertips. The new dispensation, after it was put into saddle, presented the first budget in the months of July, 2014. This has not shown any visible signs of changes. However, gradually the difference in approach is visible. The Finance Bill, 2015 will set the course of this government. The Finance Ministry has already started regular consultations with the professional and other trade bodies. The Chamber of Tax Consultant's team is going to make presentation before the Committee. Apart from those suggestions we would like to make only one request to the Hon'ble Finance Minister please keep things simple. The ambitious project of 'Simplification of Tax Laws' can be taken up on some other more appropriate occasion. As of now please make simple changes and don't complicate the already complex statutory provisions.

The present issue of the Chamber's Journal carries Special Story on Financial Services sector. We propose to bring this issue in two parts so that we can cover all the aspects of this topic in an exhaustive manner. I thank all the contributors of articles compiled on the Special Story and regular columns of this issue of the Chamber's Journal for taking out time from their busy schedule for writing these articles.

K. Gopal
Editor

From the President

Dear Members,

Earlier this month Reserve Bank of India has issued dovish fifth bi-monthly monetary policy statement 2014-15. Industry was expecting a rate cut. Governor acknowledged the fact that still the weak demand and rapid pace of recent disinflation are factors supporting monetary accommodation. However, RBI post assessing the Global and Indian economy opted to continue rates without any cut. It reiterated that a change in the monetary policy stance at the current juncture is premature. But a ray of hope is seen. It stated that if the current inflation momentum and changes in inflationary expectations continue, and fiscal developments are encouraging, a change in the monetary policy stance is likely early next year including outside the policy reviews cycle.

One of the factors that helped to slay inflation demon is on account of reduction in crude prices. But many factors viz. maintaining of low crude price during winter, reduction in prices of pulses, cereals etc. post failure of kharif crop in many parts of the country, fiscal deficit within budgeted estimates, successfully achieving of targeted disinvestments process would be responsible for ensuring the inflation demon stays slain. In last few months reversal in bank deposits rate has been seen, but this is yet to be translated into softening of lending rate. Besides interest rate other things would also contribute to disinflation.

With the Modi Government in place, investment mood has moved from despair to hope. But this is yet to give kick start for fresh investments. Further, at Government level many crucial issues are yet to resolved viz. auction of coal blocks, auction of airwaves, banks recapitalisation, kicking of stalled infra projects, passing of key legislative amendment bills, tax uncertainties etc. Nevertheless for tax professionals, waning of the hope would depend upon successful implementation of recent decisions - instructions on non-adversarial tax regime, setting up of High Level Committee to interact with trade and industry on tax laws etc. The recent bold decision for non-appealing against Bombay

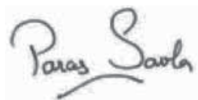
High Court verdict on TP, demonstrates Government's budget assurance of reducing litigation.

Government is being mulling consolidation of public sector banks to build larger players, since past few months. But non-business constraints have kept plan in the shelf. At the same time various regulatory and growth constraints have spurred consolidation between the fragmented private sector banks. In the past too such consolidation has happened, but it was mainly on account of rehabilitation. Consolidation in the banking sphere would create business efficiencies which would benefit customers in the competitive atmosphere.

Recently, Confederation of Indian Industry had organised 8th CFO Summit 2014. Theme of the Conference was 'Playing to win in a VUCA Environment'. The Chamber was the supporting organisation for the event. Industry foresees various bold economic measures and radical ideas with the Modi Government's forthcoming full Budget. Government has kicked-off exercise for discussing pre-budget proposal with various stake holders. The Chamber has also been invited by the authorities who are involved in the exercise of preparation of the Finance Bill, to discuss its pre-budget tax memorandum. The Chamber in its representation has tried to bring to the notice of authorities the various difficulties faced by the assessee. In the month of December, Chamber has organised its 1st Residential Refresher Course on Companies Act, 2013. Another event in coming month is Indoor Sports; wherein members, their family members and their article students can participate. In the coming months various programmes have been lined up by the Chamber. You are requested to refer the Newsletter for the same.

December is the last month of the Gregorian calendar. In the northern hemisphere this month marks the beginning of the winter. On December 21, North Pole would at the farthest point away from the sun and this makes it the shortest day and longest night of the year in northern hemisphere. December 31 marks the final evening of the Gregorian calendar year.

I wish to sign off this year with American Journalist Bill Vaughan's quote *"An optimist stays up until midnight to see the new year in. A pessimist stays up to make sure the old year leaves".*



Paras Savla
President

Chairman's Communication

Dear Esteemed Readers,

We are coming to the close of a very eventful year that 2014 was – from certain amount of pessimism on the growth front in the beginning of year followed by eventful general elections leading to a fairly stable government after a fairly long period of coalition governments. Thus, we end this year with a fair amount of optimism or may I put expectations from the six months old government.

One of the pillars for a strong economy is the health of its financial sector and there are lot of expectations for structural changes taking place in this sector as an enabler for the future growth. With this in view we have selected Financial Sector as a topic of our Special Story. This story will be carried in this and following issue. In this issue the authors have ably dealt with the issues relating to banking and mutual fund industry.

The authors have dealt with the overview of the sector, key issues in regulations of the sectors concerned, auditing and accounting aspects in each of the sectors and the specific taxation issues relating to the said sectors. I would like to place on record appreciation for CA. Anish Thacker for his efforts in designing the structure of the Special Story. I am also thankful to CA. Abhizer Diwanji, CA. Himanshu Vasa, CA. Siddarth Gandotra, CA. Sarvesh Warty, CA. Sunil Kothare, CA. Smita Bhandari, CA. Jayesh Gandhi, CA. Sunil Badala and CA. Bharat Jain for penning the articles for the Special Story and sharing their valuable knowledge with us. I am sure we shall be greatly enriched in our understanding of these sectors through the articles contributed by all these learned authors.

Friends we all had hectic time completing the audits and filing returns of income for assessment year 2014-15 and shall be now going into the busy season of time-barring assessment. The restructuring exercise undertaken by the Income-tax department in the field formation has though provided some temporary relief. We hope that the transition will be quite smooth.

I take this opportunity to wish all the readers a very happy and eventful ensuing year 2015 with a hope that the upcoming year turns out to be a fulfilling year for all.

Sanjeev Lalan
Chairman – Journal Committee

CA Abizer Diwanji

Financial Services Sector in India – History and the Road Ahead

History of Banking Sector in India

Pre-Independence era

Informal form of banking has existed in India for ages

Banking in the form of money lending business has existed in India since the Vedic period. The system of credit in India was fairly advanced with extensive network of banks across India issuing their own bills of exchange or hundis. Given the informal nature of banking, most of the bank dealings were based on mutual trust and dishonouring of hundis was a rare event.

Western style of joint stock banking was introduced in India in the early 18th century

The first joint stock bank in India was Bank of Bombay, which was established in 1720 by an English agency house. However as East India Company's trading activity increased, the first Presidency Bank with government shareholding was established in 1806. Presidency Banks also undertook the tasks of issuing currency notes and discounting of treasury bills to provide monetary accommodation to the Government.

Formal regulations were introduced in the mid-19th century

Enactment of the Companies Act in 1850 was the first regulation covering banks, which was introduced in India. Following this Act, the Presidency Bank Act of 1876 introduced restrictions on certain risky banking activities and gave additional powers to the Government to conduct periodic inspection of books of these banks. Banks were also allowed to be organised as private shareholding companies with limited liability whereby majority of shareholding was held by Europeans.

Rapid increase in the number of Indian owned private banks and co-operative banks

Indian owned private banks came into existence with the establishment of Allahabad Bank in 1865. This was followed by the set up of Punjab National Bank in 1895 and Bank of India was set up in 1906. The Swadeshi Movement of 1906 spurred the establishment of more Indian owned commercial banks including Central Bank of India, Bank of Baroda, Canara Bank, Indian Bank and Bank of Mysore.

However, most of these banks catered mainly to the industrial sector and the individual borrowers had to rely on moneylenders who charged extortionate rates of interest. This spurred the growth of co-operative credit movement with the set up of several urban co-operative banks. Given the critical role played by co-operative credit societies in addressing the needs of lower income population, a new

regulation giving legal recognition to credit societies was passed in 1912.

Rise in bank failures and establishment of Reserve Bank of India

Bank failures in India rose sharply due to fraudulent activities by directors on one hand and gross mismanagement on account of management inexperience on the other. Given the absence of strong regulatory framework, many banks had directed funds to promoters in the form of unsecured loans. Also the establishment of Imperial Bank of India via amalgamation of three Presidency Banks had created a conflict of interest with the Imperial Bank acting as Central Bank and Banker to the Government as well as engaging in commercial banking activities.

In this scenario, Reserve Bank of India was established through an Act passed in 1934 with the dual objective of addressing the issue of bank failures and promoting reach of credit to the agricultural sector. The Reserve Bank of India took over several responsibilities including (a) issuing currency notes and acting as banker to the Government, (b) Acting as lender of last resort for the banking system whereby it required banks to maintain cash reserves, (c) Encouraging the co-operative credit movement to enhance the reach of agricultural credit, (d) Supervisory role with the power to conduct audit and inspection to detect fraudulent activities and (e) Strengthening the banking regulatory framework by proposing new banking regulations to the Government.

Post-Independence era

At the time of independence, the banking sector was mostly privately owned. The banking system was dominated by the Imperial Bank of India and five other large banks i.e. Central Bank of India, Punjab National Bank, Bank of India, Bank of Baroda and United Commercial Bank each holding in excess of ` 100 crores in public deposits.

High level of bank failures were affecting the stability of the financial system

An increasing number of bank failures had also caused financial hardship to lot of depositors and undermined financial savers confidence in the banking system. As such in spite of high household savings rate of 66 per cent of total domestic savings, 89 per cent was invested in physical assets particularly land and gold. Even the financial savings were mainly diverted to postal savings schemes as government ownership provided a certain level of confidence.

Even after the enactment of the Banking Companies Act in 1949, high level of bank failures continued with Reserve Bank of India trying to protect depositor's interest through forced amalgamation of distressed banks with stronger banks as well as de-licensing or liquidation of unviable banks and transfer of their assets and liabilities to other banks. Also, deposit insurance was introduced in India in 1961 to promote depositors' trust in the banking system. The Deposit Insurance Corporation of India started providing insurance cover against deposits in an insured bank up to a pre-determined level.

Promoting the reach of banking to rural areas and flow of credit to the agricultural sector

Flow of credit to agriculture was very limited post-independence, with agricultural sector accounting for around 2 per cent of banking credit vis-à-vis 55 per cent share of GDP in 1950. Reserve Bank also took the approach of giving specific targets for branch openings to banks in order to address the issue of under-penetration of banking in rural areas. Although the number of rural and semi-urban branches increased significantly between 1952 and 1967, the share of agricultural credit remained almost static at around 2 per cent of total banking credit.

Nationalisation of banks

Imperial Bank of India was transformed into State Bank of India

Nationalization of banks in India started with Imperial Bank of India in 1955 following the enactment of State Bank of India Act in 1955. Government vested the ownership of the new entity with Reserve Bank of India to ensure that State Bank of India could operate free from political interference. The nationalization achieved encouraging results in the initial period with government ownership allowing the State Bank of India to compete with other perceived safer avenues of savings such as post office and physical assets.

Nationalisation of banks in two phases (1969 and 1980)

In spite of social control of banks, the banks remained largely metro-centric with five urban centres accounting for around 60 per cent of banking credit. Also, leverage in the banking system had increased significantly due to significant growth in deposits without proportionate growth in capital. To address these issues, government nationalised 14 more banks viz. the Central Bank of India, Bank of Maharashtra, Dena Bank, Punjab National Bank, Syndicate Bank, Canara Bank, Indian Overseas Bank, Indian Bank, Bank of Baroda, Union Bank, Allahabad Bank, United Bank of India, UCO Bank and Bank of India. Nationalisation of banks spurred tremendous increase in deposit mobilisation with 18-20 per cent deposit growth in the following decade.

Further six banks, viz. Andhra Bank, Corporation Bank, New Bank of India, Oriental Bank of Commerce, Punjab and Sind Bank, and Vijaya Bank were nationalised in 1980 taking the total number of public sector banks to 28 (including State Bank of India's associate banks).

The two phases of nationalisation transformed the mainly private sector nature of the banking system at the time of independence to a public sector dominated system with government owned banks accounting for around 91 per cent of the total deposits.

Financial Sector Reforms and Entry of New Private Sector Banks

Reforms aimed at strengthening the financial health of the banking system

At the start of 90s decade, banks were reeling under the dual problem of low profitability and rising non-performing assets. Given years of social control and high level of low yielding reserve requirements (Cash Reserve Ratio at 15 per cent and Statutory Liquidity Ratio at 38.5 per cent) had taken a toll on the profitability of the banks with return on assets for the banking system declining to just 15 bps in F.Y. 90. Several reform measures were introduced such as (a) Phased reduction in reserve requirements, (b) Deregulation of interest rates, (c) Capital infusion by the government and (d) Steps for better recognition and resolution of non-performing assets.

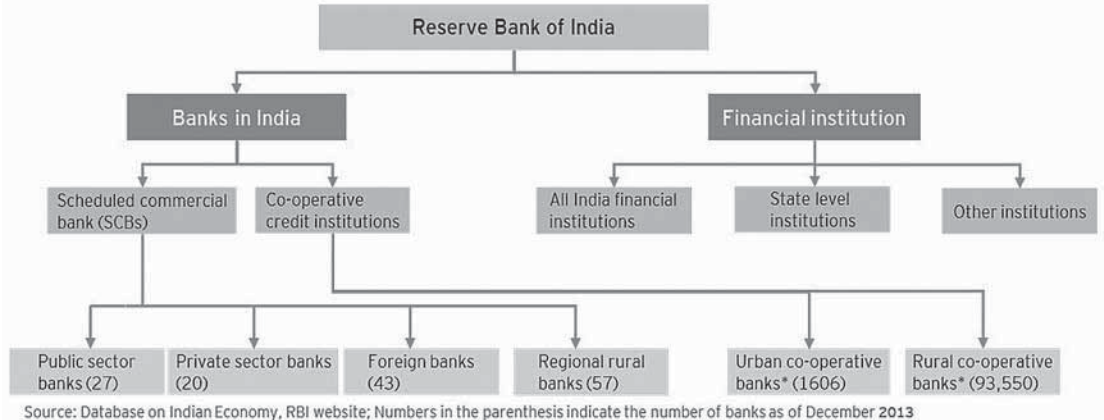
Entry of new private sector banks and emergence of universal banks

To encourage a more competitive environment in the banking sector, Reserve Bank of India decided to allow entry of new private sector banks and liberalise branch licensing for foreign banks. Ten new banks were set up in the private sector by 1998 accounting for around 3 per cent of the banking assets. Following this period competition in the banking sector intensified further with transformation of two large development finance institutions (ICICI and IDBI) into banks.

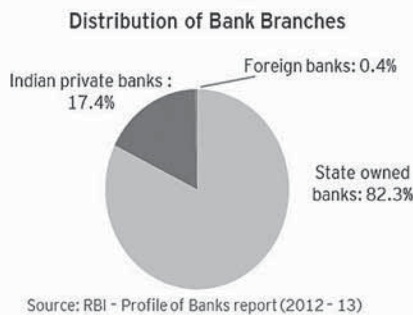
The new private sector banks predominantly adopted the 'Universal Banking' model and entered into various segments of the financial sector through various subsidiaries. This was to take advantage of the severe under-penetration of various financial products and augment the share of non-fund based revenue streams.

Banking Sector in India – Current Scenario and the Road Ahead

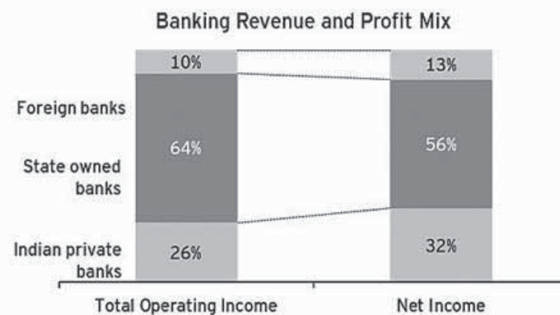
Banking Sector – Snapshot



Source: Database on Indian Economy, RBI website; Numbers in the parenthesis indicate the number of banks as of December 2013



Source: RBI - Profile of Banks report (2012 - 13)



Key Issues in Banking Sector

Basel III implementation by F.Y. 19 would entail significant capital infusion particularly by the Government in PSU banks

Minimum Capital Ratios	FY14	FY15	FY16	FY17	FY18	FY19
Minimum Common Equity Tier I (CET1)	5.0	5.5	5.5	5.5	5.5	5.5
Capital Conservation Buffer (CCB)	0.0	0.0	0.625	1.25	1.875	2.5
Minimum CET1 + CCB	5.0	5.5	6.125	6.75	7.375	8.0
Minimum Tier I Capital	6.5	7.0	7.0	7.0	7.0	7.0
Minimum Total Capital	9.0	9.0	9.0	9.0	9.0	9.0
Minimum Total Capital + CCB	9.0	9.0	9.625	10.25	10.875	11.5

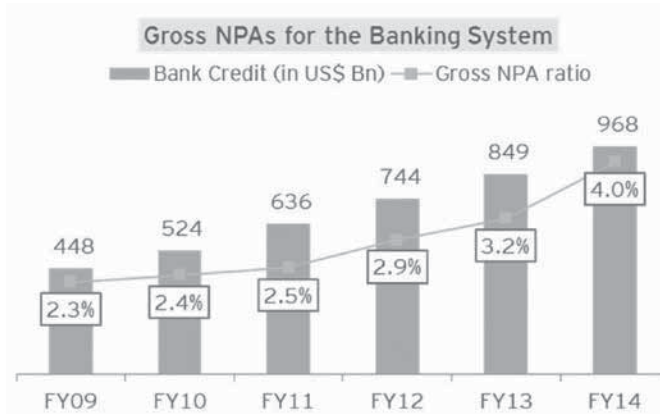
RBI has delayed the timeline for implementation by a year aligning it more closely with Basel deadline of Jan 2019

Minimum core equity requirement will rise drastically from 3.6% under RBI's Basel II norms to 8%

Minimum tier I capital includes hybrid capital instruments

RBI's guidelines are more conservative vis-à-vis Basel norms requiring 100bps higher capital ratio

Significant increase in stressed assets over past three years driven mainly by the Industries sector with bulk of the additions at PSU banks



Improvement in asset quality is also expected due to declining trend in slippages on the back of improving economic environment. Also, sale of NPAs to asset reconstruction companies (ARCs) driven by recent framework on revitalising stressed assets could lead to reduction in NPAs. Following five industry sub-sectors continue to account for a major portion of stressed assets: (a) Infrastructure, (b) Iron and Steel, (c) Textiles, (d) Mining and (e) Aviation.

Financial inclusion

Promoting financial inclusion was one of the main reasons behind the nationalization of banks. However even after several decades of financial inclusion initiatives, the formal banking system has failed to reach the rural population in India. There is widespread recognition that lower income classes could see significant improvement in their lives if they have easy access to basic financial services such as a savings accounts, credit and insurance.

Initiatives to promote financial inclusion

Reserve Bank of India has focused on expanding the reach of physical banking infrastructure through initiatives such as the Swabhimaan and Ultra Small Branches Schemes. It has also been focusing strongly on creating a ubiquitous payment infrastructure that will drive financial inclusion, e.g., a nationwide network of bank branches, ATMs, BC agents with micro-ATMs, universal data connectivity, a national switch and an array of financial service providers including banks, SHGs, RRBs, Telcos, etc., that utilise this platform to provide banking and payment services. Innovative approaches such as “Bank on Wheels,” offering banking services at the doorsteps of rural consumers, have also been taken.

Financial inclusion agenda will receive a further boost with the launch of “Pradhan Mantri Jan Dhan Yojana”. A major scheme aimed towards financial inclusion, Pradhan Mantri Jan Dhan Yojana, was launched on 28th August, 2014 which intends to provide every household with a bank account and insurance cover of ` one lakh. This scheme saw huge response from public as around 15 million accounts were opened on the day of its launch. The objective of this scheme is to provide banking facilities to 75 million unbanked families and bring them into the banking system by opening of 150 million bank accounts (two accounts for every household) in FY15.

Technology could be key driver of financial inclusion

In the last decade, rapid advances made in different fields, such as the spread of digital

connectivity and mobile phones, upgrading of banking technology, and adoption of Aadhaar, along with other accompanying trends including growing urbanisation and a rising middle class, have created attractive opportunities in the Indian financial inclusion landscape. In particular, technology promises to enable hundreds of millions of people to access financial services for the first time due to its wide reach, convenience and low cost of delivery.

Innovation and technology have spurred the onset of new business models in the financial inclusion space. This has resulted in the creation of improved value chains to serve customers including shared service providers, WLA operators, transaction processors, technology service providers, corporate BC agents, etc.

Using data analytics to promote financial inclusion

Access to credit and other financial products is often blocked because low-income customers do not have formal credit histories, although they may have other types of financial activity records such as their mobile usage history or payment of utilities. Alternative data sources reveal unprecedented information, even about customers with no prior exposure to financial services, which enable financial service providers to create new products based on their customers' needs. This data may transform credit and insurance underwriting as more is learned about how risk can be predicted by customers' behaviour. Such advances have the potential to enable many new customers to be considered creditworthy or insurable for the first time, and present huge opportunities to advance financial inclusion.

Over the next few years, financial service providers will have to invest in non-traditional sources of financial or behavioural data such as on mobile usage or purchase records to establish the financial identities and histories of the unbanked. The regulator will also need to develop policies to ensure customers' access and control over personal data generated by digital service records as well as rules for sharing this with third parties.

Innovations in the Financial Sector

Innovations in delivery channels

Branch network remains the main channel for service delivery for banks and NBFCs. However, financial institutions are increasingly looking at transforming on-field executives into mini-branches to bridge the last mile connectivity issue. One of the biggest innovations is the introduction of handheld point-of-sale (POS) machines which leverages the vast coverage of telecom infrastructure and the existing branch network to develop a hub and spoke model for increasing coverage footprint across regions. POS machines can be used to complete basic transactions such as collecting instalments and have security features such as biometrics to prevent leakages.

The establishment of transaction platform such as RTGS, NEFT, the Aadhaar Payment bridge, AEPS and CBS are bringing about large-scale changes in consumer usage. New payment channels such as micro-ATM devices, kiosks and low cost ATMs, together with BC agent banking, are slowly but surely changing established notions of traditional banking.

Trends in risk management

- Group based financial inclusion: Banks and NBFCs are increasingly opting for group based lending programmes such as self-help groups (SHG) and joint-liability groups (JLG) to overcome the problem of lack of collateral and proper documentation. Group based borrowers typically have lower default rates enabling lending institutions to lend to individuals considered below average credit by normal underwriting standards.
- Market intelligence tools and databases: Financial Institutions are looking at leveraging market mapping tools which analyse data regarding income, consumption, asset ownership etc. to identify potential customers. Also, finance companies are increasingly using databases such as CIBIL for credit information and risk management.

Mobile Banking – Strategic mode to deliver banking services

Although affordability and penetration of mobile technology is improving across India, technology- and device-adoption issues persist. Therefore, banks need to leverage cost-effective and efficient mediums to deliver their services, leveraging the right mix of triple play choosing between SMS, WAP and Apps.

Banks need to understand the difference in usage and features, and deliver capability that supports the financial inclusion needs of the rural segment, provide a seamless shopping experience to urban customers on the move, approve payments for corporate customers and provide in-depth information on new products to their employees.

Differentiated Banking – The Way Forward

Most of the new entrants in the banking sector over last two decades have adopted Universal Banking model and have entered several segments of financial services besides banking through various subsidiaries. However, government and Reserve Bank of India has felt that there is a need for niche or differentiated banks to cater to the financial services needs of the unorganised sector and low income households as well as attract wider pool of entities to enter the banking sector. In view to create a variety of niche banks, RBI introduced guidelines for two types of differentiated banks namely Small Finance Banks and Payments Banks.

Small Finance Banks – A boost to financial inclusion

Small Finance Banks are aimed at providing basic deposit products to the underserved section of the population. Also in first 5 years, small bank can undertake lending to small farmers, micro enterprises, unorganised sector etc. with 75 per cent eligible for qualification as priority sector lending and 50 per cent of the loan portfolio constituting of loans up to ` 25 lakh.

The minimum capital required to set up a small bank would be ` 100 crores and the bank would have to have a minimum capital adequacy ratio of 15%. The promoters would have to reduce their stake in phases. The promoters would need to have at least 40 per cent for the first five years while reducing any excess stake above 40 per cent within three years of commencement of operations. The stake should be further reduced to 30 per cent within a period of 10 years and to 26 per cent within 12 years of commencement of business.

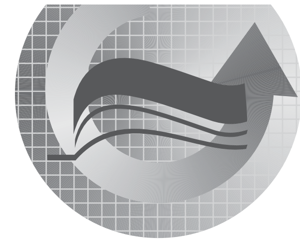
The small banks licensing regime should also encourage many established non-banking financial institutions and micro-finance institutions to opt for conversion into a small finance bank.

Payments Banks – Widening the pool of entrants in the banking sector

The primary objective of introducing payments banks is to provide low value – high volume transaction services to the migrant labour force, small businesses and unorganized sector entities. The minimum capital required to set up a payments bank would be ` 100 crores and the bank would have to have a minimum capital adequacy ratio of 3%.

Payments Bank can collect deposit of only up to ` 1 lakh per customer and can distribute simple financial products in addition to issuing debit cards. However, on the assets side payments banks have to invest at least 75 per cent of their deposits into SLR securities and up to 25 per cent in deposits of scheduled commercial banks.

The Payments Banks licence is likely to attract entrants ranging from telecom companies, issuers of prepaid instruments (PPIs), supermarket entities and established non-banking financial companies.



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An Overview of key banking regulations

One of the most regulated entities in the Indian landscape are Banks. Banks are subjected to multiple regulations. The Reserve Bank of India is the primary regulatory body for all banks in India which is responsible for managing the operations of the entire financial system. While there are different types of banks, we have made an attempt to dwell upon some of the important regulations that impact commercial banks in India.

Background

Like a number of laws in India the banking related laws to a very large extent though not entirely is based on the English Banking Law. Banking law in general is a part of the law merchant, or as it is sometimes known *Lex Marcatoria*. Lex Marcatoria began to take its shape in the 19th century and it was based upon the customs of merchants. Gradually these customs were ratified by the court of law and became general law. Needless to add there were additions made from time-to-time.

In the good old days until the country had a Banking Law, the courts in India applied the English law relating to negotiable instruments when the contesting parties were Europeans. However when the defendants were Indians, since none of the laws were adequate in the matter of hundies etc, depending upon the communities the defendant belonged to, their respective customs were followed. One of the earliest attempts to regulate the bills of exchange and promissory notes among Indian merchants is The Negotiable Instruments Act, 1881.

The next important legislation was the Bankers Books Evidence Act, 1891. It is a special Act giving certain privileges to Banks as regards the mode of proving entries in the books and the production thereof in the court of law. Under this law a certified copy of the original can be produced in the court of law in legal proceedings, though an original is available, which is an exception to the requirements of the Indian Evidence Act.

The post-independence India has witnessed a vibrant evolution in various sectors viz industrial, service etc., which has made India more noticeable globally. This has resulted in growth in trade which has resulted in the financial services sector to broaden and deepen itself. Consequently the Indian Banking law has also changed to meet such challenges.

** Views expressed herein are personal and not necessarily those of authors employer.*

In the year 1969, the concept of social control was introduced on Banking Companies and so were 14 major banks nationalised. 6 more banks were nationalised on 15 April, 1980. In the more recent past we have seen three tranches of private enterprises getting licences to operate as banks in India.

Legal Framework governing the Banking Sector

The legal framework which Governs the banking industry include:

Umbrella Acts

- Reserve Bank of India Act, 1934: Governs the Reserve Bank functions
- Banking Regulation Act, 1949: Governs the financial sector

Acts governing specific functions

- Public Debt Act, 1944/Government Securities Act (Proposed): Governs Government debt market
- Securities Contract (Regulation) Act, 1956: Regulates Government securities market
- Indian Coinage Act, 1906:Governs currency and coins
- Foreign Exchange Regulation Act, 1973/Foreign Exchange Management Act, 1999: Governs trade and foreign exchange market
- Payment and Settlement Systems Act, 2007: Provides for regulation and supervision of payment systems in India

Acts governing Banking Operations

- Companies Act, 1956: Governs banks as companies
- Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970/1980: Relates to nationalisation of banks
- Bankers' Books Evidence Act
- Banking Secrecy Act
- Negotiable Instruments Act, 1881

Acts governing Individual Institutions

- State Bank of India Act, 1954
- The Industrial Development Bank (Transfer of Undertaking and Repeal) Act, 2003
- The Industrial Finance Corporation (Transfer of Undertaking and Repeal) Act, 1993
- National Bank for Agriculture and Rural Development Act
- National Housing Bank Act
- Deposit Insurance and Credit Guarantee Corporation Act

The Reserve Bank of India Act 1934

The origin of the Reserve Bank can be traced to 1926, when the Royal Commission on Indian Currency and Finance – also known as the Hilton-Young Commission – recommended the creation of a central bank to separate the control of currency and credit from the Government and to augment banking facilities throughout the country. The Reserve Bank of India Act of 1934 established the Reserve Bank as the banker to the Central Government and set in motion a series of actions culminating in the start of operations in 1935. Since then, the Reserve Bank's role and functions have undergone numerous changes – as the nature of the Indian economy has changed. Today's RBI bears some resemblance to the original institution, although the mission has expanded along with the deepened, broadened and increasingly globalised economy.

The Reserve Bank of India is entrusted under the Banking Regulation Act to be solely responsible for the regulation and supervision of banks. The Reserve Bank of India is the umbrella network for numerous activities, all related to the nation's financial sector, encompassing and extending beyond the functions of a typical central bank. The primary activities of RBI are as follows:

- **Monetary Authority** – This responsibility is exercised through monetary policy which refers to the use of instruments under the control of the Central Bank to regulate the availability, cost and use of money and credit. The goal is achieving specific economic objectives, such as low and stable inflation and promoting growth.
- **Issuer of Currency** – The Reserve Bank is the nation's sole note issuing authority. Along with the Government of India, they are responsible for the design and production and overall management of the nation's currency, with the goal of ensuring an adequate supply of clean and genuine notes. The Reserve Bank also makes sure there is an adequate supply of coins, produced by the Government. In consultation with the government, they routinely address security issues and target ways to enhance security features to reduce the risk of counterfeiting or forgery.
- **Banker and Debt Manager to Government** – Managing the government's banking transactions is a key RBI role. Like individuals, businesses and banks, Governments need a banker to carry out their financial transactions in an efficient and effective manner, including the raising of resources from the public. As a banker to the Central Government, the Reserve Bank maintains its accounts, receives money into and makes payments out of these accounts and facilitates the transfer of Government funds. They also act as the banker to those state Governments that have entered into an agreement with them.
- **Banker to Banks** – Like individual consumers, businesses and organisations of all kinds, banks need their own mechanism to transfer funds and settle inter-bank transactions such as borrowing from and lending to other banks and customer transactions. As the banker to banks, the Reserve Bank fulfils this role. In effect, all banks operating in the country have accounts with the Reserve Bank, just as individuals and businesses have accounts with their banks.
- **Regulator of the Banking System** – Banks are fundamental to the nation's financial system. The Central Bank has a critical role to play in ensuring the safety and soundness of the banking system and in maintaining financial stability and public confidence in this system. As the regulator and supervisor of the banking system, the Reserve Bank protects the interests of depositors, ensures a framework for orderly development and conduct of banking operations conducive to customer interests and maintains overall financial stability through preventive and corrective measures.
- **Manager of Foreign Exchange** – With the transition to a market-based system for determining the external value of the Indian rupee, the foreign exchange market in India gained importance in the early reform period. In recent years, with increasing integration of the Indian economy with the global

economy arising from greater trade and capital flows, the foreign exchange market has evolved as a key segment of the Indian financial market.

- **Maintaining Financial Stability** – Pursuit of financial stability has emerged as a key critical policy objective for the central banks in the wake of the recent global financial crisis. Central banks have a critical role to play in achieving this objective. Though financial stability is not an explicit objective of the Reserve Bank in terms of the Reserve Bank of India Act, 1934, it has been an explicit objective of the Reserve Bank since the early 2000s.

- **Regulator and Supervisor of the Payment and Settlement Systems** – Payment and settlement systems play an important role in improving overall economic efficiency. They consist of all the diverse arrangements that we use to systematically transfer money—currency, paper instruments such as cheques, and various electronic channels.

- **Developmental Role** – This role is, perhaps, the most unheralded aspect of RBI's activities, yet it remains among the most critical. This includes ensuring credit availability to the productive sectors of the economy, establishing institutions designed to build the country's financial infrastructure, expanding access to affordable financial services and promoting financial education and literacy.

The Reserve Bank of India bases the various powers that it has derived both out of The Reserve Bank of India Act, 1934 and The Banking Regulation Act, 1949 have the right to penalise Banks in India which may include a fine and/or imprisonment.

The Banking (Regulation) Act, 1949

Owing partially to the abuse of powers by some people controlling a few banks and to safeguard the interest of the depositors and to ensure that the economic interest of the country is taken care, The Banking Companies Act, 1949 was passed. It must be clarified that the provisions of The Banking Companies Act, 1949 are "in addition to, and not, save expressly provided, in derogation of the Companies Act, 1956 and any other law for the time being in force" *[State of Kerala vs. M.T Devassia, AIR 1977 SC 331 : (1977) 1 SCC 363 : (1978) 48 Comp Cas 19].* The provisions contained in the RBI Act, 1934 in relation to banking regulation were repealed on enactment of this Act.

The title of the Act which was Banking Companies Act, 1949 was changed to Banking Regulation Act by the Amendment Act 23 of 1965.

The provisions of this Act are applicable to Nationalised Banks, Non Nationalised Banks and Co-operative Banks

Banking

Section 5(b) of the Banking Regulation Act, 1949 defines "Banking" to mean the accepting, for the purpose of lending or investment, of deposits of money from the public, repayable on demand or otherwise, and withdrawable by cheque, draft, order or otherwise.

Banking Company

Section 5(b) of the Banking Regulation Act, 1949 defines "Banking Company" as any company which transacts the business of banking in India. The explanation to section 5(c) states that any company which is engaged in the manufacture of goods or carries on any trade which accepts deposits of money from the public merely for the purpose of financing its business as such manufacturer or trader

shall not be deemed to transact the business of banking within the meaning of this clause.

Form of business in which a Banking company can engage

The following are some of the activities that a Banking Company may engage in as stated in section 6 of the Banking Regulation Act, 1949.

- Borrowing, raising or taking of money
- Giving advance – secured or otherwise
- Dealing in the business of bills of exchange, hundis, promissory notes, drafts etc
- Granting and Issuing letters of credit, bank guarantee and indemnity
- Selling and dealing in bullion, and foreign exchange
- Dealing and underwriting of securities of various kinds on own account and on account of constituents and others
- Providing safe deposit vaults
- Collecting and transmitting money
- Managing, selling and realising any property that may come into the possession of the bank in satisfaction or part satisfaction of any of its dues
- Acquiring, holding and dealing with any property or any right, title or interest in any such property that may form the security or part of the security for any loans or advances or which may be connected with such security
- Undertaking and executing trusts
- Acquiring, constructing, maintaining and altering of any building for the purpose of the bank
- Acquiring and undertaking the whole or part of the business of any person or bank / company if its nature of business is as per the allowed business for the bank
- Doing all such other things as are incidental or conducive to the promotion or advancement of the business of the bank
- Any other business the Central Govt. may by notification specify as a allowed business

Banks are prohibited to do any other business. Further Section 8 of the Banking Regulation Act, 1949 specifically prohibits a banking company from buying, selling or bartering goods except in connection with the realisation of a security held by it. It also prohibits a banking company from engaging in any trade of buying/selling or bartering of goods for others except in connection with collecting or negotiating bills of exchange or in connection with undertaking the administration of estates as executor, trustee or otherwise.

Capital Requirements

Sections 11 to 13 of the Banking Regulation Act, 1949 lays down the minimum paid up capital and reserves. Reserve Bank of India through the guidelines for new private sector banks in India have laid down from time-to-time the requirements of capital. The following are the requirements with respect to capital as declared in 2013 when the last round of application for new banks were invited.

The initial minimum paid-up capital for a new bank shall be ` 500 crore. A Non-Operative Financial Holding Company (NOFHC) shall hold a minimum of 40 per cent of the paid-up voting equity capital of the bank which shall be locked in for a period of five years from the date of commencement of business of the bank. Shareholding by NOFHC in the bank in excess of 40 per cent of the total paid-up voting equity capital shall be brought down to 40 per cent within three years from the date of commencement of business of the bank. The shareholding by NOFHC shall at

all points continue to be 40%. However the holding should be brought down to 20 per cent of the paid-up voting equity capital of the bank within a period of 10 years, and to 15 per cent within 12 years from the date of commencement of business of the bank

The bank shall be required to maintain a minimum capital adequacy ratio of 13 per cent of its risk weighted assets (RWA) for a minimum period of 3 years after the commencement of its operations subject to any higher percentage as may be prescribed by RBI from time to time. On a consolidated basis, the NOFHC and the entities held by it shall maintain a minimum capital adequacy of 13 per cent of its consolidated RWA for a minimum period of 3 years.

Branch Licensing Requirements

Under the revised policy framework, the RBI moved from the system of granting approvals for one branch at a time to the system of aggregated approvals, on an annual basis. The RBI has given general permission to open branches based on certain conditions. One of the important conditions is that at least 25 per cent of the total number of branches opened during a financial year must be opened in unbanked rural centres, i.e, centres which do not have a brick and mortar structure of any scheduled commercial bank for customer based banking transactions. This is one of the important steps taken by RBI towards financial inclusion.

Exposure Limits

Recognising that risk concentrations could be a very important cause for problems in banks, RBI advised banks in India to fix internal, Board-approved limits on their exposures to specific industries or sectors and also prescribed prudential regulatory limits on banks' exposure to single and group borrowers.

There are prudential limits on single and group borrower exposures as per which banks are allowed as on date, to lend up to 15 per cent of capital funds to a single borrower and up to 40 per cent of capital funds to a borrower group. This can be increased by an additional 5 per cent and 10 per cent, respectively for lending to infrastructure. In addition, banks have been allowed to consider enhancements in exposures to a borrower (single as well as group), in exceptional circumstances, up to a further 5 per cent of capital funds, with the approval of their Boards.

Capital Market Exposure

With a view to insulating banks from exposure to capital market volatility, prudential norms were prescribed for capital market exposure. The aggregate exposure of a bank to capital markets has been restricted to 40 per cent of its net worth as on end March of the previous year. Within this overall ceiling, a bank's direct investment in shares, convertible bonds / debentures, units of equity-oriented mutual funds and all exposures to Venture Capital Funds should not exceed 20 per cent of its net worth.

Real Estate Exposure

Banks are expected to monitor their exposure to commercial real estate (which has been defined in detail) so as to limit the risk of any downturn in this sector. Although no regulatory limit is specified in this regard, RBI has delegated the powers to fix the limits to the Banks Boards and it keeps a close watch on each bank's exposure to the real estate sector through off-site surveillance and initiates corrective actions as necessary.

Statutory Requirements

Banks have to hold significant amount of their assets in liquid assets as they are required to maintain cash reserve ratio – CRR, currently 4 per cent – and statutory liquidity ratio –

SLR, which is currently at 22 per cent – both, as a proportion to their 'net' liabilities, to provide the safety of depositors and other stake holders of the banks. Liquidity support for managing day-to-day liquidity needs of the banks is available only against SLR securities held over and above the statutory minimum of 22 per cent. Thus, the excess SLR maintained is always available as a source of liquidity buffer. Reserve Bank can also lower the SLR requirement in a distress scenario, to make liquidity available to the banks against their resulting excess SLR.

Investment Portfolio

As per the prudential norms banks are allowed to invest in government securities, other approved securities, shares, debentures and bonds, subsidiaries, joint ventures, commercial papers, mutual fund units among others. Banks are required to frame their own investment policies, keeping in view their overall investment objectives, which are required to be approved by the Board of Directors. Under the prudential norms applicable, banks have to classify their entire investment portfolios into three categories (to be decided at the time of investing) – Held to Maturity (HTM), Available for Sale (AFS) and Held for Trading (HFT). The qualifications for each classification, upper limits and rules for transition from one category to the other differ.

Priority Sector Norms

Banks in India are required to meet prescribed targets for lending to the priority sector in pursuance of the overall objective of financial inclusion.

The overall ceiling on priority sector lending has been fixed at 40% for domestic banks. These targets are calculated as a percentage of adjusted net bank credit (ANBC) or credit equivalent amount of off-balance sheet exposures, whichever is higher. The enclosed Annexure gives a reflection of the PSL requirements.

Domestic schedule banks that have shortfalls in the priority sector or agriculture lending target are required to make a contribution to the Rural Infrastructure Fund Development Fund (RIDF) established by National Bank for Agriculture and Rural Development (NABARD).

Interest rate regulations – Deposits

Reserve Bank of India has deregulated the savings bank deposit interest rate. In other words, the banks are now free to determine their savings bank deposit interest rate.

They have also deregulated the interest rates on Non-Resident (External) Rupee Deposits and Ordinary Non-Resident (NRO) Accounts. Banks are free to determine their interest rates on savings deposits and term deposits of maturity of one year and above under Non-Resident (External) Rupee (NRE) Deposit accounts and savings deposits under Ordinary Non-Resident (NRO) Accounts. However, interest rates offered by banks on NRE and NRO deposits cannot be higher than those offered by them on comparable domestic rupee deposits.

Interest rate regulations – Advances

Reserve Bank of India required the banks to switch over from benchmark prime lending rate (BPLR) system to the system of Base Rate in July 2010. The Base Rate system is aimed at enhancing transparency in lending rates of banks and enabling better assessment of transmission of monetary policy. The key guidelines issued by RBI are as follows:

- Base Rate shall include all those elements of the lending rates that are common across all categories of borrowers. Banks may choose any benchmark to arrive at the Base Rate for a specific tenor that may be disclosed transparently. Banks are free to use any other methodology, as considered appropriate, provided it is consistent

and are made available for supervisory review/scrutiny, as and when required.

- Banks may determine their actual lending rates on loans and advances with reference to the Base Rate and by adding such other customer specific risk premium.
- All categories of loans should be priced only with reference to the Base Rate. In other words, rate of interest should not be below Base Rate. However, the following categories of loans could be priced without reference to the Base Rate: (a) Differential Rate of Interest advances (e.g. loans to specified SC/ST category) (b) Loans to banks' own employees including retired employees (c) Loans to banks' depositors against their own deposits.
- Changes in the Base Rate shall be applicable in respect of all existing loans linked to the Base Rate, in a transparent and non-discriminatory manner.

Corporate Governance

Reckoning the importance of having diversified ownership of banks to ensure that there is no dominance by any shareholder or group of shareholders, directly or indirectly, as also to ensure that significant owners of banks are 'fit and proper', RBI issued comprehensive guidelines of ownership and governance as also 'fit and proper' requirements for directors. Under the extant guidelines, any transfer of a bank's shares amounting to five per cent or more of its total paid up equity capital is required to be approved by RBI before the bank can register the transfer. For holdings beyond 10 per cent prior approval is required. Large industrial houses cannot have ownership of a bank beyond 10 per cent.

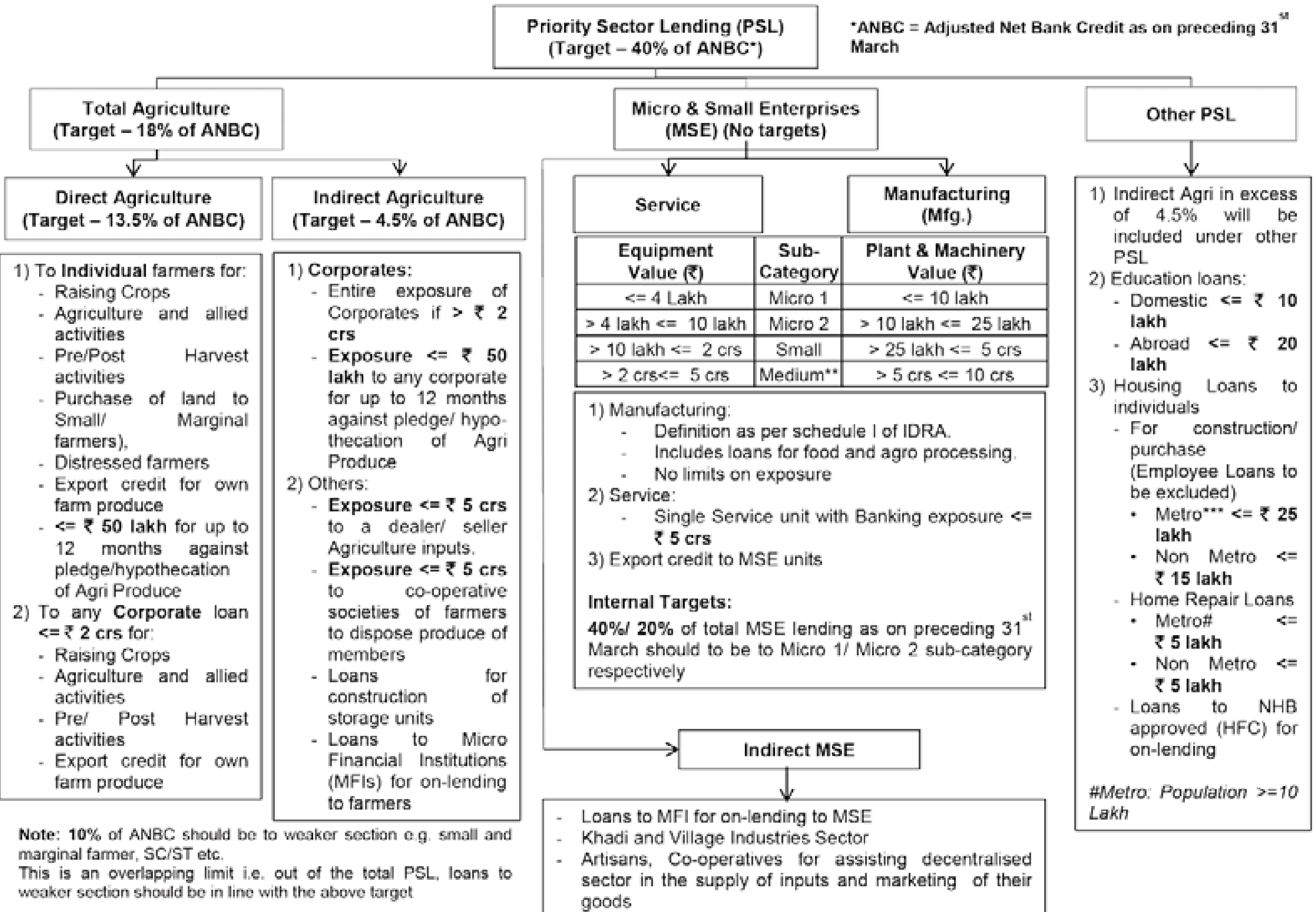
The RBI has taken various steps to improve corporate governance standards in banks. The private sector banks are required to set up Nomination Committees to oversee 'fit and proper' status of board of directors through appropriate due diligence and obtain periodical deed of covenants from the directors. To facilitate induction of fresh minds and ideas, an upper age limit has been prescribed for non-executive directors in private sector banks. Further, the post of the Chairman and Managing Director in private sector banks has been split into a part time Chairman, who would provide strategic vision for the banks and a Managing Director, who, as the Chief Executive, would be responsible for the day-to-day management of the bank.

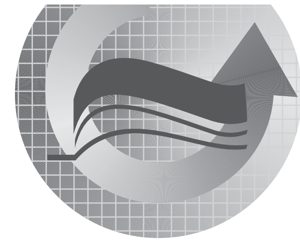
Compensation of CEOs

The Reserve Bank has been mandated by statute to regulate executive compensation in private sector banks. It is the statutory responsibility of RBI to ensure that the remunerations of bank CEOs and whole time directors are not excessive. In terms of Section 35B of the Banking Regulation Act, 1949, the banks in the private sector and foreign banks in India are required to obtain the approval of the Reserve Bank for remuneration payable to their CEOs while the remuneration of public sector bank CEOs is fixed by the Government of India.

The RBI ensures that executive compensation, whether it is in the form of cash or stock, is appropriate, taking into account the financial position of the concerned bank and also the industry practice. The RBI has instructed the boards of the private sector banks to fix remuneration package of CEOs at a reasonable level in light of industry practice in India. Further, the annual bonuses of CEOs of private sector banks are capped at a certain percentage of their base salary. The Remuneration Committees of banks, consisting of independent directors, are made responsible for implementation of compensation structure in banks.

Annexure 1 : Priority Sector Requirements





CA Sarvesh Warty

Issues in Audit and Tax Audit of Banks

Banking in India is dominated by nationalised banks who account for around 73% of the banking assets in India. The private sector banks account for around 21% of the assets and the remaining 6% are with the foreign banks.

Banking entities are highly complex in nature because of their set up, significant regulatory compliances and susceptibility to changes in external environment. Therefore, audits of banking entities need to be executed by experienced auditors having knowledge of the industry.

Information Technology

Given the volume and speed at which transactions need to be carried out, banks have several IT systems which cater to different businesses of a bank, like treasury, retail banking, investment and corporate banking, trade finance, etc. These systems are generally purchased from different vendors hence communication between systems is not always on a real time basis or in many instances there is no direct communication between systems giving rise to several reconciliations and reliance on spreadsheets. Further, while a lot of these systems may be from renowned vendors, the implementation of these systems at each bank may differ, giving rise to data integrity and visibility issues thus making it difficult for auditors to see the complete audit trail and validate data integrity. As an auditor it is important that an understanding of the data flow from initiation of transaction till reporting is obtained at the planning stage for all significant processes which impact the preparation of the financial statements and related reports to ensure compliance with accounting standards and regulations.

Given the dependency on these IT systems, it is also critical to involve skilled IT auditors to validate the design and operating effectiveness of IT general controls like access controls and programme change controls. In case there are any major failures in the design or operative effectiveness of these IT general controls, substantive audit work increases manifold. The assistance of such IT auditors is also key in understanding and testing effectiveness of IT dependent controls like calculation of interests, etc.

Loans and advances

Loans and advances is generally the largest component of the balance sheet of a bank. These loans consist of corporate lending products like term loans, cash credit and overdrafts, bill discounting and packing credit and retail lending products like housing loans, auto loans, personal loans, loans

against shares, credit cards, etc. The Reserve Bank of India (RBI) has laid down detailed guidelines on income recognition, asset classification and provisioning with respect to advances which need to be mandatorily followed by all banking entities in India.

Each bank is required to have a credit policy which has to lay down specifications with respect to appraisal and approval of new advances and renewal of existing advances, exposure limits, process of obtaining security documents, provisioning policies, etc. These policies need to be approved by the board of directors of the respective banks and are also reviewed by RBI during their annual financial inspection.

The auditors need to verify compliance with such policies including checks on whether a proper credit assessment was carried out and the loan was sanctioned by the appropriate authorities. This assumes even more significance after recent events where high ranking officials of banks were found to have taken bribes to approve loans to corporates with weak credit ratings. While it may be difficult for auditors to question decisions of granting credit facilities to particular borrowers, but it is important to perform procedures to check for a sample whether the policies set by the bank were duly followed by reading the credit assessment documents, approval documents and minutes of meetings where large corporate loans are approved to ensure that conditions set out by the approving authorities are appropriately captured and complied.

Another cause of concern and a major area of fraud seen in the industry is around security documentation. There have been several instances where fraudulent submissions of legal documents with respect to security against loans sanctioned have come to light in the recent past. The auditor should verify if all actions as required by its approved credit policy including legal checks are performed by the bank before accepting security documents. A physical verification of a sample of these documents in their original form should be carried out by the auditor during the course of his audit. Similarly, it is noted that the stock and book debts statements submitted are inflated by borrowers to obtain higher limits on their working capital facilities. The auditor should verify if regular stock audits are carried out by banks through their empanelled auditors to verify the submissions made by the borrowers with respect to submission of stock and book debt statements. The auditors should also correlate the levels of stock and book debts submitted with the last available audited financial statements of the respective borrowers to check consistency.

It is a well-known fact that in the last few years there was stress in the economy which has led to an increase in non-performing assets within the banking industry. Provisioning on non-performing assets not only impacts the profitability and capital adequacy of a bank but also in many cases impacts performance appraisals of key managers within banks. Hence there is a tendency to avoid classification of accounts as non-performing. Lately, most banks use computer generated overdue reports to identify non-performing assets and accordingly a proper testing by the auditors of such overdue reports is necessary. It is essential that the auditor verifies whether all conditions prescribed by RBI for classifying an asset as non-performing are captured in the overdue reports and perform necessary steps including IT control testing using IT auditors if necessary.

To hoodwink these overdue reports, certain management personnel resort to "ever greening". Through ever greening, bankers avoid classification of a loan as non-performing even though the borrower is unable to repay its dues. There are various ways of ever greening; however the most

common way is to sanction a new loan to the borrower and use those funds to repay the overdue portion of an existing loan. Thereby a repayment of an old loan is shown by the bank providing its own funds without any repayment from the borrower. In certain cases, especially near balance sheet date, funds are received in borrower accounts through an external source such that the overdue status of the borrower does not cross 90 days and after balance sheet date, these funds are transferred back to the source it came from. The auditors should carefully scrutinise conduct of the account and scrutinise the source of repayments in case of borrowers who are stretched for liquidity and are on the verge of crossing the 90 days overdue status. Amounts disbursed by banks to a borrower or their group companies near repayment dates of the borrower's other overdue loans must be carefully scrutinised to check for traces of ever greening. Such matters should be brought to the attention of those charged with governance including independent directors of banks after discussion with the management of the bank. Further, a check of the movement of funds in the account after balance sheet date must also be carried out to ensure that repayments are not temporary.

Restructuring is another common way to avoid classification of an account as non-performing. A restructured account is one where the bank, for economic or legal reasons relating to the borrower's financial difficulty, grants to the borrower concessions that the bank would not otherwise consider. Restructuring would normally involve modification of terms of the advances / securities, which would generally include, among others, alteration of repayment period / repayable amount/ the amount of instalments / rate of interest (due to reasons other than competitive reasons). Considering the stress in the economy, RBI had granted concessions with regard to classification of restructured accounts as standard subject to fulfilment of certain criteria. The basic objective of RBI to grant such concessions was to preserve economic value of units and not ever greening of problem accounts. Auditors need to carefully look at viability of restructured accounts to eliminate the possibility of ever greening. Further, compliances with all conditions which need to be fulfilled for a restructured account to be maintained in the standard category must be verified to ensure appropriate reporting.

Another issue noted specially in retail advances is with respect to borrower wise classification of advances. RBI norms require that all facilities granted by a bank to a borrower (including investments and derivatives) should be classified as non-performing if even one facility is irregular and breaches the overdue conditions set by RBI for classification of non-performing accounts. In absence of unique customer identification numbers, it becomes difficult for identification of all facilities of a single borrower. This is generally noted where the set-up of the banking operations is decentralised and accounts of the same borrower in different branches of the same bank are not linked in the IT system. This problem is further accentuated when various facilities are maintained in different IT systems without any linkages. Auditors must be cognisant of these facts and must ensure that the bank puts in place processes to identify such common borrowers across different branches and IT systems.

Deposit

Acceptance of deposits is another major area in a bank. Since deposit gathering involves direct contact, this activity is mainly run from the branches. Incentives of staff and managers mainly at the branch levels are generally linked to deposit gathering. A special focus is given to CASA (Current Account and Savings Accounts) deposits because the cost

of those deposits to the bank is minimal. The main risk in deposit products relates to the adherence to the Know Your Customer (KYC) guidelines. While auditing this area, care should be taken that the policies of the bank with respect to KYC should be adhered.

Along with deposits, branch employees cross sell various products like insurance and mutual fund investment products to customers promising handsome returns to earn commission income for the bank. There have been many instances of miss-selling of such products as well as banking frauds in the past and auditors must scrutinise the complaint register at branches as well as those centrally maintained through phone banking or internet banking to check if such practices are rampant.

The compliant register is also a good indicator to identify systemic lapses which may lead to penalties or other operational losses.

Investments

Statutorily, banks are required to have a minimum investment of a certain percentage of their liabilities in government securities. Additionally, banks invest in corporate bonds, shares, mutual fund units, pass through certificates, security receipts, etc. Valuation of these investments is guided by RBI guidelines using methodologies prescribed by the Fixed Income Money Market and Derivatives Association of India (FIMMDA). Auditors should familiarise themselves with the methodologies for valuation and test assumptions and calculations made by the bank. In case of complex valuations, auditors should consider using the help of experts to validate valuations.

Further, RBI has laid down many guidelines with respect to classification of investments in different categories like held to maturity, available for sale and held for trading. Auditors should familiarise themselves with these guidelines and the restrictions on holdings, transfers, valuations and accounting aspects with respect to investments.

Forward contracts and derivatives

Banks enter into forward contracts and derivative instruments with their clients to assist them in hedging risks relating to interest rate and currency. Banks also enter into such transactions to hedge their own risks.

Auditors should understand the system of recording these transactions and must also test controls over authorisation and data flow. A critical aspect of these transactions is obtaining counterparty confirmations. There have been several cases in the past where customers have complained against banks for miss-selling derivative products and alleged that the risks were not explained appropriately. RBI has issued guidelines on products that can be offered to customers and what precautions should be taken before offering such products. The auditors must familiarise themselves which such guidelines while auditing banks to validate compliance.

Generally, these transactions are recorded on a mark to market basis. While valuation of forward exchange contracts can be tested using spreadsheets, valuation of derivative contracts such as interest rate swaps, cross currency interest rates swaps, options, etc. involves using complex valuation models and it is recommended that auditors should use the services of valuation experts to gain comfort on the valuation of such products.

Certain banks adopt hedge accounting principles and do not account for some designated derivative transactions on a mark

to market basis. Auditors should assess the designation of the derivative contracts as hedges and also assess their effectiveness to hedge the risk of the underlying transaction and adherence to rules other prescribed by RBI.

Suspense accounts

Suspense accounts in banks are generally in the nature of inter branch or inter system account which are used to route transactions between branches or different systems that the banks use. Auditors should look at the reconciliations between these accounts and carefully analyse unreconciled balances to ensure proper recording or provision. Weak controls over this area could result in operational losses and possible frauds. Other suspense accounts are in the nature of clearing (including cash management) accounts. A similar reconciliation is performed for such accounts.

Interest income and expense

Interest income and expense are the largest components of the profit and loss account of banks. Calculation and recording of interest is automated in most banks and given the volume of transactions, it becomes difficult to perform test of details on interest income and expense. Auditors should test controls over calculation and recording of interest and validate the IT general controls which impact the interest line items. A detailed and granular analysis of interest income and expense should be carried out where interest is broken up into each product and a comparison of such interest must be made with the average balance of that product (loan or deposit) to assess reasonability of interest charged/received. Periodic movements in interest rates as determined by the bank must reflect in such analysis. This detailed analysis can provide insights into incorrect calculation/accrual of interest.

Commission income

Banks earn commission on various products like letters of credit, bank guarantees, demand drafts, processing fees etc. Given the volume of these transactions, auditors should test controls over recording of such commission and also perform a detailed analysis similar to the analysis on interest. Due consideration should be given to amortisation of such commission in line with the prevalent accounting standards. Banks also record commission income on advisory and structuring transactions. Large one off income recorded should be scrutinised and auditors must challenge income recognition based on the contracts after considering the requirements of the prevalent accounting standards.

Taxation

Taxation is an important area in a bank. Certain specific quirks with respect to banking should be taken into account while auditing tax provisions made. Auditors should familiarise themselves with the requirements of the Income-tax Act, 1961 (the 'Act') especially with respect to allowances of loan loss provisioning. Further, there many judicial pronouncements on various issues such as disallowances under section 14A of the Act, treatment of provisions on depreciation of investments, disallowances of provisions on loan loss, etc. Given the volume of tax free returns on investments, the disallowances under section 14A of the Act as well as the application of rule 8D are highly debated and while certain recent judicial pronouncements may guide the auditors; caution should be exercised while looking into this area.

The other major area of debate was creation of a deferred tax liability on special reserves maintained by banks for compliance with section 36(1)(viii) of the Act. Varied practices were followed by banks with respect to the

creation of deferred tax liability, however RBI provided guidelines on this matter and the auditors should ensure that the same are followed.

New regulations

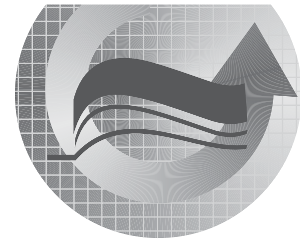
The Companies Act, 2013 (the 'Companies Act') has brought in its own challenges and reporting on internal financial controls is a major change which is expected to be more cumbersome for banking companies than others because of the sheer size of operations and number of processes that are needed to run a bank. The impact of related party transactions and corporate social responsibility requirements cannot also be undermined. Auditors should engage into conversations with their banking clients and assess the risk of non-compliance and the impact on their reporting.

RBI has also introduced many new regulations have a significant impact on reporting in financial statements. The introduction and transition to Basel III norms for capital adequacy computation involves judgment and auditors need to understand the intricacies with respect to quantification of the various risks and capital eligible for Basel III norms. Further, to measure liquidity, RBI has introduced the Liquidity Coverage Ratio ('LCR'). LCR is a measure of the liquidity maintained by a bank to meet its obligations for the next 30 days. This ratio needs to be disclosed in the financial statements and there are certain judgments that need to be exercised while calculating this ratio. Auditors should discuss these matters with their banking clients in advance to avoid last minute situations where it might be difficult to devote time to such activities.

On the provisioning side, RBI has mandated excess provisions on borrowers who have a high unhedged foreign currency exposure. RBI has provided detailed guidance on the calculation of such provision and banks need to gather data from its borrowers to assess the quantum of such provision. RBI has also introduced a central repository to capture and share loan overdue information among banks. Based on the information shared, banks have to form joint lenders forum in cases where the overdues are over 60 days and agree and implement a strategy to recover the dues in a joint manner. Failure on part of the banks could lead to additional provisioning against such borrowers at the defaulting banks. Auditors must familiarise themselves with such requirements and look at evidence to assess adequacy of provisions made.

Issues in tax audit

Tax audit of banking companies have more or less the same complexity as that of any large organisation. The issues with respect to gathering of data for the purpose of TDS verification and reconciliation to books of account remains an issue at many banks because of the multicity of systems and volume. Verification of compliance with section 269T of the Act poses its challenges as information is not always available with banks. Further, disclosure of disallowance under section 14A becomes a challenge because of the differing views in the banking industry. Form No. 3CD also requires disclosures of gross profit, net profit and other ratios which cannot be calculated for banking companies because of the nature of their operations. Auditors should disclose reliance on management representations and matters that cannot be disclosed in the way required by Form No. 3CD in the explanatory notes.



CA Sunil Kothare*

Direct Tax and Transfer Pricing Issues faced by banks

Introduction

The discussion on first part of this topic can be divided into four distinct parts viz. the bank's own tax matters, in areas relating to application of withholding taxes, in matters concerning client's financial transactions where the bank is a facilitator and the bank's role as a reporting agency in respect of financial transactions. The second part of the topic is generally connected to the bank's own tax matters. In this article, the focus will be largely on the bank's own tax matters.

Bank's own tax matters

(a) Income recognition

In the business of lending, the biggest challenge is to determine the stage of recognition of income. Is the income in respect of interest on loans, fees, etc. to be recognised in accordance with the contract? The answer is generally in the affirmative on the basis of the two certainties required under the accrual principles i.e. certainty of measurement (this comes generally from the contractual arrangement) and certainty of ultimate realisation (a matter of prudent commercial evaluation). For banks, the regulatory directions from the Reserve Bank of India in respect of income recognition under prudential norms have been recognised in Section 43D(a) which provides that the income by way of interest from bad or doubtful debts will be recognised in the year of credit to profit and loss account or in the year of realisation whichever is earlier. Section 43D and Rule 6EA also give statutory recognition to the Reserve Bank of India's guidelines in this respect.

(b) Broken period interest

As part of their SLR holdings or otherwise, banks tend to own a large size portfolio of government securities or of other bonds. In the past, the issue of whether the interest accruing between the last coupon date and the actual purchase of the securities by the banks should be treated as part of cost of acquisition of the security and the full interest received at the next coupon date should be taxed has been the subject matter of litigation. This matter was finally set at rest by the Supreme Court in the case of Citibank N.A. in 2008. Although some tax officials continue to take up this issue, immediate relief is available in First Appeal and with the new dispensation, further appeals are not being recommended by the Department.

(c) Income attribution

This is an area of challenge for banks which have transnational operations. A bank domiciled in India may face this issue in other countries whereas foreign banks operating in India will face this issue in India. This is better illustrated by examples. If State Bank of India were to offer from its Nairobi Branch investment in Indian mutual funds or buying of insurance in India to its clients in Nairobi, the mutual fund commission or the bank assurance distribution fees could end

* *Views expressed herein are personal and not necessarily those of author's employer.*

up being paid to State Bank of India in India. The Kenyan tax authorities could well demand that some (or all) of the commission or fees should be taxed in Kenya on the basis that the clients buying those offerings are based in Kenya. This could become even more complex, if the Nairobi Branch also assists NRIs in Uganda, although remotely i.e. without visiting Uganda, to take such products. What portion of the commission/ fees in the latter case is subject to tax in Uganda (location of client), in Kenya (location of servicing branch), in India (location of the product 'manufacture'). The complexities could multiply if the example were to be changed to give clients access to mutual funds in Singapore and insurance companies in the US. The overlay on all this is that the home country i.e. India would, subject to foreign tax credit rules in India, tax the entire income. Many jurisdictions restrict offshore bankers from selling financial services to clients onshore. This regulatory restriction sometimes acts as a blessing in disguise by simplifying the attribution problem. For example, Canada does not allow an offshore banker to sell financial products to persons within Canada without obtaining registration in Canada. India has similar restrictions e.g. insurance agents or equity brokerage houses require registration. For foreign banks operating in India, a simplified version of the challenge on attribution is to determine what portion of the earnings from clients' External Commercial Borrowings (ECBs) would be taxed in India (the client location) and the lending branch which may not always be the home country location and which risks its capital. The same issue arises where the lender is not a branch but a subsidiary incorporated in the lending jurisdiction. In determining the quantum of attribution, the regulatory restrictions of the other jurisdiction play a great role as they may indicate what functions necessarily have to be performed in the lending jurisdiction.

(d) Deduction in respect of bad debts

Unlike other taxpayers, banks have a special provision relating to deduction of bad and doubtful debts. They are one class of taxpayers who also get a deduction in respect of provision for doubtful debts. The relevant statutory provisions appear in sections 36(1)(vii) and 36(1)(viia) respectively. Since the guidelines relating to determination of non-performing assets (NPAs) are laid down by the RBI, banks generally do not face the issue of whether the year of claim of bad/doubtful debts deduction, is inaccurate or premature although in the past this was one major issue. As section 36(2) requires a debt to be written off whereas the legal process requires the bank to have the ability to show the quantum of debt along with up to date amount of interest at the contracted rate, banks maintain memorandum records tracking debts which are written off for tax purposes. In the event of recovery at a future date, the recovery amount is offered to tax under section 41(4). The test of reasonable steps for recovery is embedded in every bank's credit risk management approach and is not discussed at length here.

Banks are amongst the few taxpayers who get a deduction under section 36(1)(viia) in respect of provision for doubtful debts. Any deduction so allowed is used to set off any bad debts claimed in a later year so that the benefit under section 36(1)(viia) is an accelerated deduction and not a double deduction in respect of the same loss. For the purpose of this accelerated deduction, section 36(1)(viii) makes a distinction between

(A) Foreign banks, where the accelerated deduction is available up to five per cent of the total income before deduction under this section and under Chapter VI-A or the amount of provision for doubtful debts, whichever is lower; and

(B) Scheduled banks locally incorporated or a co-operative bank, where the deduction is available up to 7.5% of the total income before deduction under this section and under Chapter VI-A and up to 10% of the average rural branch advances. There are special rules which make it more complex but those need not be discussed here.

Some of the issues that have been the subject matter of litigation are whether an advance is to be treated as a rural branch advance, how some of the

special rules are to be applied, how the safeguard against double deduction has to be computed. All of these make the actual computation quite complex.

The issues of whether provision in respect of standard assets is deductible has till very recently come up and under the new RBI guidance for provisioning, the question of deduction in respect of floating provision will come up.

(e) Deduction on respect of mortgage portfolio

As part of the drive to encourage banks to finance industrial development, agriculture, infrastructure and housing, section 36(1)(viii) allows banks get a deduction in respect of special reserve created up to 20% of the profits from the business of providing long-term finance (repayment period not less than five years). The deduction is available for each year till the stage where the special reserve reaches twice the amount of paid-up capital and general reserves of the bank. The RBI and the ICAI have insisted that banks created deferred tax liability (DTL) in respect of such deduction. As a result, the DTL erodes the capital computed for the purpose of capital adequacy.

(f) Non-deductible expenditure – Section 14A

Several banks hold a portfolio of tax free securities and also have large equity stakes in subsidiaries. Although the investments in subsidiaries are almost always made out of own funds, the banks face a sizeable disallowance under section 14A, as this fact is, more often than not, ignored by the tax officials and Rule 8D is applied without addressing the threshold question of whether Rule 8D can be triggered in its entirety. In respect of the portfolio of tax free securities, the banks may not always be in a position to demonstrate that the investment has indeed come from interest free borrowings or from own funds. It may be noted that banks maintain a very strong control on tenor matching for assets-liabilities. It is expected that if the RBI and the Government approve of the bank holding company structure, this issue will be addressed to a large extent.

(g) Interest paid to or received from Head Office

Foreign banks operating in India and Indian banks operating outside India face this issue. In India, the issue has been settled by the Supreme Court in ABN Amro's case deciding that the interest paid is deductible in computing branch profits and that the branch in India is not required to deduct tax at source on such interest nor is the interest taxable in the hand of the Head Office again. The Revenue continues to pursue the matter in appeal for other banks. On the flip side, the issue is whether when the branch in India receives interest from Head Office, the interest is subject to tax in India. Most banks would prefer to take the view that it is not taxable as it is interest from 'self', the Revenue believes that the interest is taxable in India. This is an issue in several other jurisdictions as the computation of the income of a permanent establishment is generally to be done on a stand-alone basis.

(h) Mark to market (MTM)

Many banks will adopt a mark to market of their portfolio of securities excluding the portfolio marked as 'held to maturity' (HTM). In rising interest rate situations, this will give rise to losses and where interest rates drop, this will be give rise to gains. This gives rise to the question of whether the loss is tax deductible and the gain is subject to tax on MTM basis or does it have to be crystallised before falling within the tax net. The same issue arises in respect of foreign exchange forward rate contracts booked with the customers. Given the high cost of long drawn tax litigation, many banks are moving to the situation of offering such MTM gains to tax and claiming deduction in respect of the MTM losses. The Revenue has been disputing the latter but the appellate fora have been largely holding in favour of the banks.

(i) Transfer pricing

These issues arise in several jurisdictions, as several countries across the globe implement transfer pricing regulations. Under income attribution (above), I have referred to the question of how much income arising from an ECB is to be taxed

in India. The solution to this is to have a transfer pricing model in place. Over the last few years, the approach has been to have 20-25% of the fee income as being subject to tax. This method allows the lending branch to correctly recognise the return on capital deployed.

Another area is that of correct value of income that should be recognised in respect of derivative transactions. This issue is addressed in a simple manner where each country treasury operates as a separate professional counterparty and becomes a major issue where the revenue are split on the basis of a model other than professional counterparty basis.

The next area of contention is the level of mark up to be paid on support services, an issue commonly seen in the IT/ ITeS sectors. The other common issue is that of pricing of funds by tenor in respect of inter-branch placement or borrowing and the use of benchmark (LIBOR/ US Fed/ SIBOR/ any other).

The missing piece in the transfer pricing analysis is the value to be adjusted in normal price for reduced risks. Banks are in the business of lending and borrowing and, therefore, have to factor in credit risk when dealing with other banks. When they deal with their own Head Office/ branches, such credit risk stands defeased. There is no clear answer to this question.

As we enter into 2015 and later, pricing of capital in line with Basel III norms and the impact of BEPS and Country-by-Country Reporting will be the new issues that banks will face in transfer pricing.

Bank's role in withholding taxes

The bank's role is deducting tax at source is no different from that faced by any other payer of income although there are certain concessions made e.g. interest on savings accounts and recurring deposit accounts do not attract TDS and for interest on fixed deposits, the threshhold is ` 10,000 of annual interest. Banks have, in addition, to file additional reports e.g. quarterly return of deposits in Form 26QAA in terms of section 206A(1) and Rule 31ACA.

Bank's role as facilitator of client transactions

The RBI requires banks to act as gatekeepers and has brought this out quite often that banks should ensure that the relevant amount of Indian taxes are paid. In the latest of such directions in AP (DIR) Circular 43 dated December 2, 2014, the RBI has reiterated its instructions from AP (DIR) Circular 151 of June 30, 2014. It has directed banks to follow the mandate of the CBDT and obtain Forms 15CA and 15CB for cross border remittances.

The advent of GAAR could affect client cash flows and also needs to be factored into lending risk analysis.

I have kept out of the current discussion, the issues that come up when recovery notices in respect of client tax dues are issued to banks.

Bank's role as agency for reporting financial transactions

Over the years this role has expanded largely from the tax domain. It started with Annual Information Report (AIR) under section 285BA and was largely restricted to reporting payments in respect of credit cards and cash deposits in savings accounts. In actual practice, the scope of information requests has gone much beyond. It is not unusual for banks to be handling several hundred such reporting requirements annually from tax authorities. Section 285BA, as amended by Finance (No. 2) Act, 2014, expands this role to include also reporting under Foreign Accounts Tax Compliance Act (FATCA) and the OECD's Common Reporting Standards (CRS). The first reporting under the former is due in 2015 and for the latter in 2017.

Conclusion

The direct tax and transfer pricing issues faced by the banks are ever evolving owing to tax and non tax regulatory changes brought in by Basel III norms, BEPS, GAAR, FATCA, CRS (to name a few). The work is hard but there is never a dull moment.

CA Smita Bhandari

Key Indirect Tax Issues faced by Banks

Introduction

The taxability of financial services has been grappled with even under international GST laws of various developed countries. Internationally, therefore one finds several practices being followed with regard to taxation of financial services – while the EU VAT law provides the widest exemption to financial services (most margin incomes and fee based incomes are exempted), in recent VAT laws such as Singapore, Australia, South Africa, fee based incomes are increasingly being made taxable. India has pone of the widest coverage of financial services where all fee based income is taxable along with some margin based incomes. The reason for these divergent practices emerges from the fact that the financial services industry is complex with new products emerging all the time and also the lack of a comprehensive mechanism to tax financial services, which is easy to administer.

As a result of this, several issues have emerged in the Indian context as to the coverage of financial services, classification of place of supply of financial services, valuation of financial products, etc, in the banking space. Some of these recent issues are being discussed below which have a large impact on the banking industry.

(a) Non-taxability of 'interest' – Scope under service tax

Since the introduction of service tax on banking services, interest has always been kept outside of the purview of taxation. This is a principle not only followed in India but also in most of the international VAT/GST legislations.

In the Indian context, 'interest' on loans has been excluded from the value of taxable services under the Service Tax (Determination of Value) Rules, 2006. Further, Notification 29/2004-ST dated 22nd September, 2004, exempted certain interest/discounts earned in the context of specific products such as bills discounting/ bills of exchange, cash credits facility and overdraft facility. Despite these various exemptions, what constitutes 'interest' was neither defined under the service tax law nor much jurisprudence was available on the same in the service tax context; Until recently, where 'interest' has been defined under Section 65B(30) of the Finance Act, 1994 (Finance Act) under the Negative List regime of taxing services to mean *'interest payable in any manner in respect of any money borrowed or debt incurred (including a deposit, claim or other similar right or obligation) but does not include any service fee or other charges in respect of the moneys borrowed or debt incurred or in respect of any credit facility which has not been utilised'.*

However, for the past period several issues have been raised as to what is the scope of the 'interest' which is excluded from the purview of service tax.

The banks and NBFCs have been interpreting interest to include not only interest on loans

where a percentage charge is made for recovering the time value of money lent in a vanilla lending transaction, but also similar interest and discounts that are earned, such as those under a bill discounting arrangement, etc. The department however, has come up with a more restrictive meaning of interest for the defining the scope of exemption under the erstwhile service tax laws. The department has contested that based on the reading of the erstwhile law, while lending was a taxable activity, specific aspects (being revenues) were exempted from service tax viz, interest on loans and the interest/discount earned on specific products set out under Notification 29/2004 and any other interest/discounts are taxable.

So, for instance, in case of Collateralised Borrowing and Lending Obligation – CBLO (which is a money market instrument that represents an obligation between a borrower and lender for a future date, which can be traded in the secondary market), the interest earned by the lender has been questioned as being a taxable revenue not eligible for the exemptions under service tax. To simplistically explain, if today a company with excess funds wants to lend to a borrower (generally a bank, mutual fund, insurance company, etc.) for short-term, where securities are provided as collateral, the same can be done through CBLO – where a borrower needs ` 100, he would borrow at a discounted amount of ` 98 with a promise to return ` 100 at the end of the loan term.

This differential is similar to a bill discounting where the discount is nothing but interest for the amount lent. However, given that the legal provisions do not define "lending" or "interest", the question arises is that can a wider interpretation be adopted of the term 'interest on loans' for keeping interest/ discount of all financial products out of the purview of service tax. While the intent of the legislature appears so, especially since the translation of this exemption under the Negative List regime has resulted in a much wider exemption (under Section 66D(n)(i) of the Finance Act), the courts seem to have a divergent view on the matter. On a similar fact pattern on a CBLO transaction, the Mumbai CESTAT has granted stay to the assesse in the case of *M/s HDFC Bank Ltd vs. Commissioner of Central Excise – Thane II*[1]

However, in another recent case of *M/s. UCO Bank, Kolkata vs. Commissioner of Service Tax, Kolkata*[2], a similar debate arose as to the scope of the interest exemption when read along with Notification 29/2004. On the question of taxability of interest earned on bill discounting, the Tribunal has prima facie held that while the same would not be covered under the exclusion of 'interest on loans' under Rule 6(2) of the Valuation Rules, the interpretation of Notification 29/2004 should be wide to include interest/discount on bill discounting (bill discounting is specifically covered product under the said Notification). A resultant corollary of the above ruling, is that even though the said interest on bill discounting is not taxable, since the Tribunal's view is that it is exempt under Notification 29/2004 and not zero valued under the Valuation Rules, a corresponding reversal of credits is necessary (prior to introduction of Rule 6(3B) under the CENVAT Credit Rules, 2004).

Similarly, a long standing matter of debate is the treatment of penal interest which is typically levied in case where the borrower defaults in payment of loan installments. Though the same is penal in nature but the intent of such charging the penal interest is on account of the fact that the credit rating of the borrower has fallen on account of the non-payment and therefore, the risk taken by the lending bank increased, which results in the bank asking for a higher rate of interest. The law is silent with regard to treatment of such interests and whether the same would be eligible for the service tax exemption.

1 TS-535-Tribunal-2014 (ST)
2 TS-439-Tribunal-2014(Kol)-ST

However, the more larger worry is that a narrow interpretation of the term 'interest' only brings into question many more financial service offerings which are otherwise classified as interest from lending by banks and therefore, not taxable. Further, the divergent views of various Tribunals (although presently at stay application stage), plagues the industry with uncertainty on the issue of interpretation of 'interest'.

(b) VAT on sale of repossessed vehicles

The traditional business of banks has been accepting deposits and lending money. Under secured lending for financing the purchase of vehicles, the borrower enters into a loan-cum-hypothecation agreement with the bank, whereby the vehicles bought by the borrower is hypothecated to the bank as security against the loan. Though the ownership of the goods remains with the borrower at all times, in case of default in payment of the loan installments by the borrower, the banks have the recourse to repossess the vehicles and have the same auctioned/sold in market for recovery of its dues ie the unpaid loan installments.

The critical facts to consider in case of sale of repossessed vehicles are the following facts:

(i) The bank generally holds a power of attorney to act as agent for the purpose of sale of the vehicles on behalf of the borrower in case of a default

(ii) Where there is any sale by the bank of a repossessed vehicle the same is auctioned in open market (through an auctioneer or website, etc.) and sold to the highest bidder (buyer)

(iii) The sales proceeds received from the sale of vehicle is typically credited to the bank account of the borrower (in case the borrower has one with the bank or in a separate account of the bank created for the purpose)

(iv) The bank recovers its due installments from such sales proceeds and where there is any excess amount, the same is passed onto the borrower

(v) In the context of sale of vehicles, under the Motor Vehicles Act, 1988 and allied rules and regulations, the seller is required to register the transfer with the State Transport Authorities/Regional Transport Authorities (STA/RTA). This form is signed by the borrower basis which the transfer of the vehicle to the buyer is registered with the RTA/STA.

In light of these facts, the question in point therefore is who is the person selling the vehicles – who qualifies as the 'dealer' under the VAT laws, effecting the sale and liable to pay VAT? A straitjacket answer in light of the established principles becomes difficult in the present situation due to the fact that the goods in question are not owned by the lender i.e. bank. Even when the borrower makes a default in repayment of the amount, the bank only acquires the right to sell the goods for the limited purpose of recovering the dues and acts only as a bailee for such goods. Therefore, who is the seller/ 'dealer' – is it the borrower who owns the vehicle or is it the bank who is facilitating the sale and has a conditional charge over the sale proceeds (in the event of a default in loan repayment)?

The VAT authorities appear to have concluded in various jurisdictions on this issue and initiated assessments/made demands from banks on this issue. What is critical to note is that the moment the sale is held to be effected by the borrower and not the bank, most of these transactions would fall outside the purview of VAT given that these are likely to be below the taxable threshold under VAT laws.

Under the VAT provisions, a 'dealer' is generally defined to mean any person who carries on the business of buying, selling, supplying or distributing goods, directly or otherwise, whether for cash or for deferred payment, or for commission, remuneration or other valuable consideration. While this being a general provision, the definition also takes in its ambit,

sale or purchase of goods, as an incidental business activity, in order to encompass occasional sales/purchase transaction within its sweep. Banks registered with the RBI are specifically covered under dealer definitions by way of a 'deeming fiction' under the State VAT laws. But even if a bank qualifies as a 'dealer', unless the sale of the repossessed vehicles is effected by the bank, one cannot conclude that it is taxable in the hands of the lending bank.

In *Karnataka Pawn Brokers Association vs State of Karnataka & Others*[3], the Hon'ble Supreme Court has held that transaction of sale could occur even though the seller does not have title to the goods. The risk also significantly increases on account of the decision of the Supreme Court of India in *Federal Bank Limited and Others vs. State of Kerala*[4] and others, wherein it was held that sale of pledged or hypothecated goods would be considered as sale for consideration and hence subject to VAT. In a more recent ruling of the Calcutta High Court, in the case of *Tata Motors Finance Limited vs. AC of Sales Tax Central Section, Investigation Wing, Kolkata*[5], the Hon'ble High Court upheld the levy of VAT on sale of repossessed assets in the hands of the bank[6]. Though a Special Leave Petition has been filed before the Hon'ble Supreme Court of India in the above matter, the final decision of the Court is still pending on the same.

While there is merit to argue the case both from an assessees' and the tax authority's perspective, the strength of such arguments can only be tested once each of these arguments are deliberated and concluded upon by the Courts. Therefore, the banking industry at large is looking forward to the decision of the Hon'ble Supreme Court of India in the Tata Motor Finance case (supra).

(c) A rethink by the service tax department on taxability of money transfer services under an inward remittance

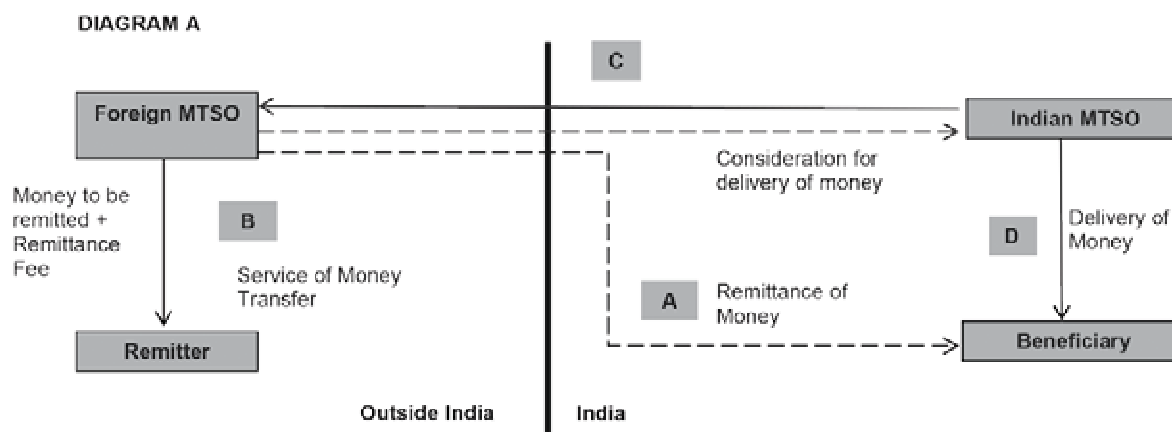
In a typical inward remittance transaction 4 parties are involved:

(i) a foreign remitter who desires to send money to a person in India

(ii) the foreign money transfer service operator (MTSO)/ foreign bank, who is approached for remittance of this money

(iii) the Indian money transfer agent/ Indian bank, who receives the money from the foreign MTSO/ bank for remittance in India

(iv) the Indian receiving party, who is the beneficiary receiving the money in India.



3 (1998) 111 STC

4 (2007) 006 VST 736

5 2013-VIL-85-Cal

6 Also see decision of the Hon'ble High Court of Orissa in State Bank of India vs State of Odisha (214 VIL 117 ORI)

After due analysis of this issue and several representations from trade and the NRI fraternity, the Central Board of Excise and Customs had clarified through Circular No 163/ 14/ 2012 – ST, dated 10 July 2012 (at the time of introduction of the new Place of Provision of Service Rules, 2012 (PoPSR)) on the taxability of various legs of the above transaction. The Circular clarifies as under:

(i) Transaction A: This was the actual remittance of money and was clearly not a 'service' but a transaction in money, where money merely was exchanged from one hand to the other.

(ii) Transaction B: Based on the new place of supply rules introduced under the PoPSR, since the first transaction between the foreign remitter and foreign MTSO/ Bank was between two parties outside India, the fee was not taxable in India.

(iii) Transaction C: On the transaction between the foreign MTSO/ bank and the Indian MTSO/ bank, the place of supply was under Rule 3 of the PoPSR viz based on location of the service recipient; and since in this case the client/service receiver of the Indian MTSOs/banks service was the foreign MTSO/ bank outside India, the said fees were not liable to service tax.

(iv) Transaction D: Given that there is no privity of contract between the Indian MTSO/ bank and the beneficiary nor any taxable service, the same was not a service transaction liable to service tax.

Two years forward, upon a fresh fact finding exercise initiated by the Board, it has revisited its own above analysis on the ground that the earlier circular was based on an understanding that the transaction between the foreign MTSO/ bank and Indian MTSO/ bank was on a principle to principal basis. However, this was contrary to their new found facts that the Indian MTSO/ bank was an "agent" of the foreign MTSO/ bank, which therefore, warranted a reclassification of this last leg of the transaction under the PoPSR. The new Circular No. 180/06/2014-ST, dated 14th October, 2014, supersedes the Board's earlier clarification to state that since Indian MTSO/ bank is an agent of the foreign MTSO/ bank, it is an 'intermediary' who facilitates the money transfer service by the foreign MTSO and the Indian beneficiary who is receiving the money. Therefore, being an 'intermediary', the service is classifiable under Rule 9 of the PoPSR where the place of supply is to be determined based on the location of the service provider. Since in this transaction the service provider ie the Indian MTSO/bank is in India, the service is taxable in India.

An 'intermediary' has been defined under Rule 2(f) of the PoPSR to mean a 'broker, an agent or any other person, by whatever name called, who arranges or facilitates a provision of a service (hereinafter called the "main" service) or a supply of goods, between two or more persons, but does not include a person who provides the main service or supplies the goods on his account'.

Some of the examples cited by the CBEC under the Education Guide for an 'intermediary' include travel agents, tour operators, commission agents for services.

Interestingly, the Board appears to have based its revised conclusion primarily on the ground that the service agreement between the foreign MTSO/ bank and the Indian MTSO/ bank is commercially referred to as an agency contract where the Indian MTSO/ bank is coined as an 'agent' of the foreign MTSO/ bank; as against the actual function of the Indian MTSO/ bank in this transaction. Therefore, it becomes paramount to understand who qualifies as 'agent'.

The term 'agent' is not defined under the Service tax laws. However, under the Indian Contract Act, an "agent" is a person employed to do

any act for another or to represent another in dealings with third person. As per the Black's Law dictionary, the term "agency" means a fiduciary relationship created by express or implied contract or by law, in which one party (agent) may act on behalf of another party (the principal) and bind that other party by words or actions. Similar interpretations of the term 'agent' have been upheld by various courts such as in case of *CIT vs. Singapore Airlines Ltd., KLM Royal Dutch Airlines and Ors*[7].

In a typical inward remittance, the Indian bank is not just facilitating the provision of the remittance service between the foreign bank and remitter, but is actively engaged in provision of a part of the remittance service itself, where he not only adds value to the remittance service but is liable in case there is any deficiency in delivery of the remittance activity at the India level. The wide scope of an 'intermediary' service, as defined under the PoPSR, does not help in concluding on this issue, but adds to the confusion since the definition is fairly wide in using terms such as "arranges" or facilitates" provision of service or supply of goods between 2 parties.

The lack of clarity in law as well as the fact that the department is relooking at an already clarified matter (on the ground of a fresh understanding of facts) potentially retrospectively, not only leaves the banking and money transfer fraternity amidst undue litigation but also burdens the industry with potential tax costs for the past 2 years, given that service tax can no longer be recovered from customers for the past transactions.

Conclusion

The above issues on indirect taxes are only scratching the surface as far as the banking industry is concerned. Several issues keep emerging due to not only lack of clarity in law and the lack of jurisprudence, but also the enthusiasm of the tax administrator in interpretation of the legal provisions in the context of the banking operations. As India awaits one of its biggest touted indirect changes – with the introduction of Goods & Services Tax, the industry is hopeful that most of the issues under the existing laws should be ironed out.

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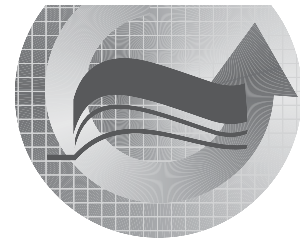


CA Jayesh Gandhi

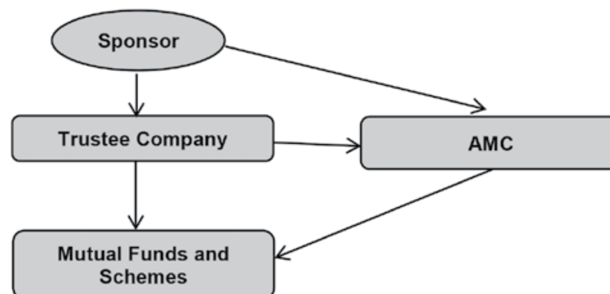
Mutual Funds and Asset Management Companies – Accounting and Audit Aspects

Preamble

The concept of Mutual Fund in India was introduced by Unit Trust of India. For many years, it was the sole organisation providing opportunity to investors to investment in funds. However, the real growth of the industry started in 1992 where formal regulation was formed. Considering this, one may say that Mutual fund industry in India is less than 25 years old. At present, there are 45 Mutual funds managing around ` 11 trillion Assets Under Management (AUM). Compared to developed economy, the penetration is quite low.

Mutual fund is a pool of money contributed by individuals / entities to invest in a predetermined security like stocks, bonds, money markets, government securities etc. It is managed by fund managers appointed by Asset Management Company (AMC), who is responsible for investing the money into various securities and oversight by the Trustees.

Typical structure of Mutual Fund



- Sponsor holds a controlling stake in Trustee Company and AMC
- Trustee is the governing body of the Mutual Fund and the schemes
- Trustee appoints AMC to manage the assets of the Mutual Fund and operate its schemes
- Mutual Fund is registered as a trust under the Indian Trust Act, 1882

Mutual Fund industry is regulated by SEBI through SEBI (Mutual Funds) Regulation (Regulation). The first regulation was introduced in 1992 and which was subsequently revised in 1996. The industry has also formed self-regulated body which is an Association of Mutual Funds in India (AMFI). AMFI deals with common issues faced by the industry as a whole.

There are various types of schemes floated by the Mutual funds. Scheme may be open ended (open for subscription and redemption to investor on daily basis) or may be close ended (which restricts subscription and redemption in the scheme and is generally for a specific period).

On the basis of investment criteria, there can be below mentioned broad categories of the schemes:

- Equity Scheme
- Debt Scheme
- Balanced Funds (Mix of equity, fixed income & sometimes precious metals)
- Exchange Traded Fund (Available to trade on recognised stock exchange)
- International Schemes (Schemes investing in securities of other countries)

To cater the need of different investors, scheme may have various options such as Growth, Dividend, Bonus, Dividend re-investment etc.

Recently, SEBI has mandated that each scheme should have two plans namely Direct (where investors will invest without any intermediaries) and Regular (where investors will generally be routed through intermediaries and mutual fund bears cost of distribution).

Financial reporting framework

As per SEBI Regulations, mutual funds are required to follow the accounting policies and standards as specified in Ninth Schedule to SEBI Regulations so as to provide appropriate details of the scheme wise disposition of assets of the funds at the relevant accounting date and performance during the period together with information regarding distribution and accumulation of the income accruing to the unitholders, in true and fair manner. Eleventh Schedule of the regulation provide specific format of Balance sheet, Revenue account and other disclosures required in financial statements of mutual fund schemes.

As per the Expert Advisory Committee (EAC) of the Institute of Chartered Accountants of India (ICAI), a mutual fund is required to comply with the accounting standards issued by the ICAI generally, except for those requirements of the Accounting Standards for which specific accounting policies and standards have been prescribed by the SEBI Regulations.

Specific accounting concepts

Due to the nature of mutual fund industry, certain general accounting concepts (GAAP) may not be applicable for certain areas or it may require modification. Some of the important accounting concepts specific to the industry are discussed below:

- Recording of Investments – As per SEBI Regulations, all investments should be recorded on the trade date in the books of account. It means that accounting shall not be carried out on the basis of settlement date, which is acceptable otherwise.
- Investment valuation – Investment valuation is primarily governed by SEBI (Mutual Funds) Regulations and circulars issued by SEBI and carried out on daily basis. The valuation of Investment is marked to market on the basis of fair valuation principle and the same gets reflected in the Revenue account. It must be kept in mind that AS-13 is not applicable to the mutual fund due to specific exclusion in the standard. At the same time, as per the requirement of the Regulation, unrealised appreciation on the balance sheet date needs to be transferred to unrealised appreciation reserve as an adjustment to surplus for the year.

- Net Asset Value (NAV) – NAV is the total market value of investments, increase by other current assets and reduce by liabilities. Funds have to calculate and declare NAV per unit on each business day. Correctness of NAV for each day is of importance, as subscription / redemption of units are carried out based on NAV.

- Recording of Unit capital – Unit capital should be recorded on a daily basis. The total NAV per unit needs to be bifurcated into following three elements:

  o Face value of unit

  o Unit Premium Reserve is like a Securities Premium account. As per SEBI Regulation, when units of open ended mutual funds are sold/re-purchased, a part of sale proceeds that represents unrealised gains shall be credited/debited to UPR

  o Income equalisation – The balance portion which represents the realised gain/loss

  SEBI has mandated that for working out Unit Premium Reserve (UPR), the balance in UPR and unrealised appreciation reserve should be considered. UPR and unrealised appreciation reserve is not available for distribution of dividend. Identification of amount to be transferred to UPR is major challenge faced by the industry.

- Load – It is penalty levied on investor, when they desire to invest/disinvest in a scheme. SEBI has prohibited charging of entry load on new transactions. Exit load can be charged if provided in the scheme information document. However, the amount collected needs to be credited to the respective schemes. This amount is treated as an additional income of the Scheme, the benefit of which goes to continuing investors. Exit load is charged if the units are redeemed before the specified period.

- Income recognition – Interest income is accrued on a daily basis on the basis of coupon rate. Dividend income is recorded on ex-dividend date. Profit/loss on sale of investments is calculated on trade date by applying weighted average cost of investments.

- Accrual of expenses – SEBI Regulations prescribes maximum limit up to which expense can be charged to the different schemes. In addition to that Scheme Information Document (SID) provides indicative rate of expenses to be charged for each scheme. Generally, accrual is carried out daily on the basis of rates fixed by AMC within rate specified in SID. Nature of expense is fungible within the overall specified limit.

Key Accounting & Audit Issues

- Expense accrual under Regular and Direct Plan

  As per SEBI Regulation, an investor can choose to directly invest in the Scheme. Units issued to such investor get processed under direct plan. Investment routed through distributor gets processed under Regular Plan.

  There is different expense ratio charged for Regular plan and Direct plan. The difference is on account of distribution expense which is not incurred for the direct plan. Due to this, return on investment is always higher in direct plan as compared to regular plan for the same scheme. Previously it was possible to charge different expense ratio to different plans made for different class of investors such as institutional, super-institutional etc. However, the same is discontinued by the SEBI, considering interest of smaller investors.

  Audit issue

  It is important for auditors to verify that no distribution expenses have been charged

to the direct plan. There is no clarity as to whether distribution expenses which is borne by the AMC and not by Scheme needs to be considered for differential expense ratio between regular and direct plan.

- Fungibility in Total Expense Ratio (TER)

  Fungibility in TER was introduced in September 2012. Prior to this period, Regulation had a sub-limit for management fees within an overall total expense limit. Mutual funds are now allowed to charge various expenses to the schemes within overall limits specified in the Regulation and there is no sub-limit for management fees. The change is aimed at providing flexibility to the mutual funds in incurring various expenses incurred by them, including management fees.

  Scheme accrues expenses based on the TER fixed by AMC, for working out daily NAV. Regular monitoring of actual expenses incurred and appropriate estimation of probable expenses will allow AMCs to charge appropriate management fees on regular basis. At the end of financial year, actual expenses incurred can only be charged.

  In an attempt to increase mutual fund reach, AMCs are allowed to charge an additional TER up to 30 bps for capital inflows from beyond top 15 cities (B-15 cities), if certain conditions are met. Further, the amount charged to the scheme will have to be reversed in case there is an outflow of the same within a period of one year from the date of investment. There has to be proper system to monitor appropriate accruals and its reversals, if required.

  Audit Issue

  Expense gets accrued at plan level for NAV purpose however actual expenses are accounted at scheme level in the books of account. It is important for auditors to ensure that expenses are allocated appropriately. The regulator has allowed fungibility of expenses. However, there is no clarity as to whether differential management fees can be charged to regular and direct plan.

- Subscription reconciliation

  There is an important element of reconciliation for subscription of unit capital. Allotment of units is carried out by registrar and money in respect to the same is received in the bank account of the schemes. Further, entries in the books of account are posted based on the details provided by the Registrar. It is therefore important to carry out appropriate reconciliation between the units issued, money received and units accounted by the Scheme. This is required to be carried out on regular basis to avoid accumulation of unreconciled balances.

  Commission to distributors

  Mutual Funds pay various types of commissions to its distributors such as upfront brokerage, trail brokerage, incentives etc. Commission to the distributors is one of largest expenses of a Scheme.

  Claw-back clauses have become a part of the commission structures in order to bring in more discipline in selling and distribution practices and to achieve the objective of linking commission to term of investment by investors. It is seen that commission structures are complex and it varies for each fund, type of scheme and distributor.

Audit issues

- o Commission generally gets computed on periodic basis. Its structure is communicated by the AMCs to the RTA on periodic basis. RTA needs to ensure that the same is followed.
- o Computation is carried out by the RTA system based on the predefined logic in the system. Auditors need to verify and confirm that system controls are in place.

- o There is a practise of payment of advance commission and amortisation of the same over a period. It is argued that such payment provide an enduring benefit to the funds and could qualify for amortisation, as distributors maintain relationship with the client and also provide services to investors over the amortisation period. Auditors need to evaluate correctness of amount and accounting rationale of such amortisation.

- • Investors' education and awareness fund

  As per the Regulation, Mutual Fund shall annually set aside 2 basis points of daily net asset for investor education and awareness initiatives. The same is required to be considered as part of TER.

  Audit issues

- o Regulation does not define the activities that fall within investor education programme.
- o In case of close ended schemes, mutual funds can face a situation wherein, an accrual for investor education was created but scheme got matured before the utilisation of such accrued expenses.
- o Expense accrued may be maintained in a pool account. Auditors need to evaluate end use of such accumulated amount. Generally, expenses are incurred on seminars, posters and banners to educate investors about the benefit of long-term investment. It cannot be used as an advertisement for any scheme.

- • Disclosure of expenses in the financial statements

  As there is a restriction of charging expenditure beyond a particular percentage of the AUM to a scheme, actual expenditure over such limit is borne by AMC/Trustee. There are varied practices followed to record expenses in the books of account of the Scheme. In certain cases, excess expenses are directly recorded in the books of AMC and in certain cases expenses are recorded in the books of Scheme and then transferred to AMC. There is no clarity on how expenses need to be disclosed in the books of Scheme. In my view, it is preferable to disclose gross amount of expenditure incurred for the Scheme and recovery made from AMC/Trustee by way of a separate line item in the revenue account of the Scheme, to provide proper information to the unit holders.

- • Investment valuation

  Investments shall be valued based on the principles of fair valuation. It is duty of trustees to make sure that valuation policy is fair, as daily NAV is calculated based on the same. Traded equity securities shall be valued at closing price on the principal stock exchange. Thinly traded equity securities shall be valued on the basis of specific guidelines laid down in the Regulation. Debt securities with maturity of more than 60 days as on the valuation date gets valued based on the price provided by CRISIL & ICRA, entrusted by AMFI for providing the prices, so that it can be uniformly followed by all fund houses. Debt securities maturing up to 60 days as on the date of valuation generally gets valued on amortisation to yield. It is compared with the benchmark yield (provided by CRISIL & ICRA) to ensure variance between the prices is within reasonable limit.

- • Applicability of Accounting Standards

  As mentioned earlier, mutual fund should follow accounting standards unless it is contradicting with the Regulation. I would deal with two accounting standards, applicability of which to mutual fund may be debated.

  Accounting Standard 18 – As per SEBI Regulation, disclosure is required to be given in respect to payments made to the associates. In addition to this, to comply with AS-18, transactions with sponsor group, AMC and trustee company are also disclosed as Related Party Transactions.

There can be argument that as the Regulation requires specific disclosures for Related Party, AS-18 may not be followed. Further, AMC or trustee company does not hold beneficial interest in Schemes of Mutual Fund, unless they have invested in the scheme.

Accounting Standard 3 – Cash Flow Statement (CFS) is also required to be disclosed for schemes which meet the criteria provided in the Standard. There may be argument that format of financial statements and disclosures prescribed in the Regulation does not mandate CFS disclosures and therefore it is not required.

It must be noted that AMCs are formed as a company and therefore, Notified AS as per The Companies Act are applicable.

Disclosures in the Financial Statements

Due to frequent changes in unit capital and consolidation of different plans for one scheme, Revenue Account may not provide clear picture of the performance of plan in which an investor would have invested. The Regulation, therefore, provides for certain important disclosures as part of scheme's financial statements. Some of these are:

- Return percentage for different period
- Historical Per Unit Statistics i. e. high and low during the year, opening and closing NAV per unit
- Expense ratio charged
- Dividend paid during the year
- Investments made in thinly traded / non-traded securities

Reliance on controls

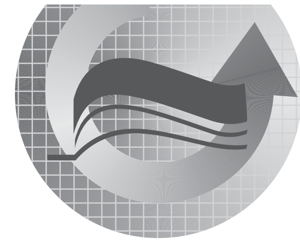
Due to the voluminous nature of business and transactions involved, it is very important for management to have proper controls in place and equally important for auditors to verify effectiveness of such controls. Some of the important controls to be verified by the auditors are:

- Maker checker controls in place for creation / updation of security master, expense masters, brokerage structures
- Maker checker controls to ensure dividend has not been distributed out of unit premium reserve
- Application controls to ensure predefined logic for computation of brokerage, profit/ loss on sale of investments, computation of NAV per unit is appropriate and effective
- Application controls to ensure NAV has been applied appropriately to unit capital transactions, based on the date and time of receipt of application
- Application control to ensure proper reconciliation of money received and units issued.

Many mutual funds have outsourced their accounting to the external fund accountants. Auditors may place reliance on ISAE-3402 report (Assurance Reports on Controls at a Service Organisation) issued by the fund accountant entity and which covers controls tested by the independent auditors in respect of various areas such as Recording of Investments, Investment valuation, Recording of income, NAV computation, Reconciliations etc. At the same time Auditors of Mutual Fund shall carry out test check of various types of accounting areas.

Conclusion

Mutual fund industry is well regulated in India. Several times it is felt that industry is over regulated, compared to other types of entities in financial sector. It is important to provide level playing field to the industry for better growth and investor's penetration. At the same time care should be taken to protect interest of investors and to ensure that mis-selling is not adopted. Accounting and auditing of Fund requires different skills and experience of the industry.



CA Sunil Badala & CA Bharat Jain

Issues in Direct and Indirect Taxes faced by Mutual Funds/AMCs

Introduction

The mutual fund industry in India operationalised in 1963 with the formation of Unit Trust of India. The intention behind this was to give the common man a means to benefit from the growth of the Indian economy by investing in Mutual Fund.

Subsequently, the Securities and Exchange Board of India (Mutual Fund) Regulations, 1996 ('MF regulations') were introduced. Since then, the Indian mutual fund industry has evolved over the years. Currently, 49[1] mutual funds are operating in India.

Since then, the Indian mutual fund industry has evolved over the years. Though, it has grown at a Compounded Annual Growth Rate ('CAGR') of 15 per cent from 2007 to 2013, the growth performance in the recent years have been rather subdued. In comparison to global markets, India's AUM penetration as a per cent of GDP is between 5-6 per cent while it is around 77 per cent for the U.S.A., 40 per cent for Brazil and 31 per cent for South Africa[2].

The reason for this stark contrast is that mutual fund as an investment product has not gained enough popularity vis-à-vis other investment avenues. As per July 2011 report by National Council of Applied Economic Research, there are 227.84 million households in India. Of these, only 10.74 per cent households are investors[3] while 89.26 per cent households are non-investors i.e. only savers[4].

Over the years, the industry regulator, Securities and Exchange Board of India ('SEBI') has brought about a series of amendments in order to protect the investors and make investments in the mutual fund sector lucrative.

Some of the issues currently plaguing the mutual fund industry have been discussed below:

Direct tax issues

A. Amendments brought in by Finance (No. 2) Act, 2014

The newly elected Government presented its maiden Union Budget in July 2014 which was

1 As per details available on SEBI website

2 SEBI – Memorandum on long-term policy for mutual funds in India

3 (households that invested in any of Government Bonds, Bonds issued by undertakings such as IDBI, SBI, GAIL, etc., debentures of private companies, equities of private companies, mutual funds and derivatives)

4 (households that invested only in Post Office and other similar savings, Pension Schemes, Public Insurance Schemes, Bank Deposits, Commodities, Real Estate, Precious Metals, etc.)

a mix bag of positives and negatives. Three major unpleasant changes that have impacted the mutual fund industry (specifically debt segment) are discussed in the ensuing paragraphs:

1. **Period of holding for qualifying as a long-term capital asset**
   Period of holding for units of mutual fund (other than units of equity oriented fund) to qualify as long-term capital assets has been increased. Earlier, these units were treated as long-term capital asset if such units were held for more than 12 months. As against this, the said units would now be treated as long-term capital asset only if such units are held for a period of more than 36 months[5].

2. **Tax rate for long-term capital gains on debt schemes**
   Long-term capital gains arising on transfer of units of mutual fund scheme (other than equity oriented schemes) are now taxed at 20 per cent (after claiming indexation[6]) in the hand of residents. Earlier, the investor had an option to be taxed at 10 per cent without indexation or 20 per cent with indexation. The said option is not available now.

   The Finance Minister in his Budget Speech had mentioned that while long-term capital gains on transfer of mutual funds units (other than equity oriented) are taxed at a concessional rate of 10 per cent, direct investments in banks and other debt instruments attract higher tax rate allowing arbitrage opportunity. Since arbitrage has hardly benefited retail investors as their percentage is very small among such Mutual Fund investors, he sought removal of this opportunity by amending the period of holding and tax rate.

   The Finance Minister may be right in curbing the arbitrage opportunity. However, given the fact that large number of retail investors invest in debt funds and intention of the Finance Minister was to curb the arbitrage opportunity only for corporates, it would have been reasonable if the said amendment was brought only in respect of corporate investors.

   The above amendments have made debt funds less popular and unattractive for investors with short-term horizon (i.e. holding period of less than 3 years)

3. **Grossing up of dividend**
   Dividends distributed by domestic companies and mutual funds are to be grossed up for the purpose of computing dividend/income distribution tax on schemes other than equity oriented schemes. Earlier, the income distribution tax was payable on the net amount of dividend payable whereas now, the net amount payable is to be grossed up for the purpose of paying income distribution tax. In this regard, there are two school of thoughts. According to first one, tax rate (including surcharge and education cess) should be considered for grossing up, whereas as per the second one, the tax rate should be grossed up first then surcharge and education cess should be levied on it. The latter one seems to be a better view. The impact of the grossing up provision based on the latter view is explained by way of an illustration:

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5 Long-term capital gains are generally taxed at a concessional rate as against short-term capital gains which are taxed at normal rates

6 A technique to adjust price inflation

	Old provisions	New provisions w.e.f. 1st October, 2014
Rate of Tax (excluding surcharge and cess)	30 per cent	30 per cent
Dividend declared by Mutual Fund	100.00	100.00
Tax		
Tax amount	30.00	
Tax amount [(Dividend *Rate)/ (100 – Rate of Tax)]		42.86
Surcharge @ 10 per cent on Tax	3.00	4.29
Education Cess @ 3 per cent on Tax & Surcharge	0.99	1.41
Total Tax	33.99	48.56
Net Outflow by the Mutual Fund	133.99	148.56

It can be observed from the above table the impact of grossing up is significant on tax rate.

B. PTC issue

Over the past few years, securitisation business has come in the limelight, courtesy, the decision of the income-tax authorities to tax the securitisation trusts.

Securitisation is a process by which, banks / NBFCs sell assets to bankruptcy remote special purpose vehicle ('SPVs'), generally formed as a trust. The trust thereafter issues 'pass through certificates' ('PTCs') to various investors who could be financial institutions, mutual funds, etc. The PTCs issued by the securitisation trust would generally carry a fixed rate of return.

As the share of all the investors is known, the contention of the trusts is that it being a determinate trust, the income is chargeable to tax in the hands of the trustee in the same and like manner as taxable in the hands of the investors (i.e. beneficiaries). Accordingly, no tax is chargeable on the income distributed by it on the basis that mutual funds (who are the beneficiaries of the trusts) are exempt from tax as per the provisions of section 10(23D) of the Act.

However, the income-tax officers took a different stand and argued that what was set up was not a trust but an Association of Person ('AOP') and denied benefits of section 161(1) of the Act. Alternatively, the income-tax officer also took an argument that even if the assessee is regarded as a trust its activities are in the nature of business activity and accordingly the income of the trust should be chargeable to tax at the maximum marginal rate and consequently the officer raised demand on various trusts.

The trusts in turn went back to the mutual funds asking them to pay the tax demanded by the income-tax authorities in proportion to the PTCs subscribed by them. The income-tax authorities also in some cases initiated recovery proceedings directly against the mutual funds (as they were the beneficiary of the trusts) and in some cases against AMCs too.

The mutual funds had filed writ petitions to the High Court seeking relief from the tax demand on the ground that they are tax exempt entities. The High Court granted an interim stay on the matter until final decision is taken by the Commissioner of Income-tax (Appeals), ['CIT(A)'] and six weeks thereafter.

The CIT(A) had examined the entire scheme and while granting part relief, he held as under:

- No genuine trust is in existence and the status of the Appellant is confirmed as an AOP for the fact that all the interested parties came together for a common purpose;
- The contention of assessee that share of beneficiaries are determinate is incorrect; and
- Deduction for interest paid by the trust and premium amortised is allowed.

At present, the matter is pending before the Tribunal. The Tribunal has granted stay of demands raised.

This issue has undesirably impacted the investments in securitisation trusts by mutual funds and the entire mutual fund industry awaits the verdict of the Tribunal with the hope that Tribunal will acknowledge the entire scheme of arrangements, requirement to establish trust as per the securitisation guidelines provided by the Reserve Bank of India ('RBI') and restrictions imposed on certain investments by mutual funds as provided under the MF regulations. .

If the Tribunal ruling is in favour of the securitisation trust/mutual funds then it will certainly bring a cheer to the industry. However, it may also open doors for further litigation if the income-tax department decides to challenge the ruling of the Tribunal before the High Court. Thus, a favourable Tribunal ruling will be an acid test for the income-tax department to live up to the expectations of the new government which is promising an investor friendly taxation regime and is committed to take efforts to cut tax terrorism.

While the issue remains open in case of past years, the Finance Act, 2013 has put this controversy to rest by introducing special code for taxation of securitisation trusts (w.e.f. 1st June, 2013) which provides that a securitisation trust will have to pay a distribution tax at the time of distribution of income except in case of person who are exempt from tax. As a result, in case where the income is distributed to Mutual Funds, the securitisation trusts will not be required to pay any distribution tax in respect of the income distributed to the Mutual Funds.

C. Disallowance of scheme expenses incurred by AMCs on behalf of mutual fund

Allowance of scheme expenses incurred by AMCs on behalf of mutual funds has been subject matter of litigation over the past many years.

The MF regulations provides for a ceiling on expenses that could be charged to the Mutual Fund. This restriction was imposed with an intention that mutual funds should not be overcharged as the same would lead to a decrease in the Net Asset Value which would in turn impact the returns of the investors. Thus, putting a curb on the expenses to be borne by the mutual fund was one of the many steps implemented by SEBI for protecting the interests of investors.

Given this backdrop, only a part of scheme related expenses are charged to the mutual fund and the remaining expenses are borne by AMCs. In some cases, in order to attract investors, schemes do not bear expenses up to limits specified in MF Regulations. For example, if regulations prescribed a limit of 2.25 per cent, the schemes bear 1.5 per cent and balance 0. 75 per cent are borne by the AMC.

Typically, the income-tax officers disallow the scheme expenses in the hands of AMCs for the reason that such expenses are not incurred for the purpose of business of AMCs and hence disallowed under section 37(1).

This issue has also been put to rest by the Mumbai High Court in case of M/s Templeton Asset Management India Pvt Ltd.[7] wherein the High Court has observed that an AMC, due to business exigencies claims and recovers from the Mutual Funds lesser amount than the amount of expenditure actually incurred during the course of its business, then, unless it is established that there were no business exigencies or the claim was not genuine, the expenditure incurred cannot be disallowed. Further, SEBI regulations are not intended to mandatorily saddle the Mutual Funds with the liability set out in the said regulations. Accordingly, no addition is required to be made to the income of the AMC.

7 340 ITR 279

In addition to the above, there are series of judgments[8] wherein it has been held that scheme expenses are incurred by AMCs on behalf of mutual funds are allowable business expenses.

D. Income distribution tax on allotment of additional units, redemption/repurchase of units

In early 2013, the income-tax department had issued notices to various mutual funds in relation to payment of income distribution tax as per the provisions of section 115R of the Act on allotment of additional units, redemption /repurchase of units by mutual funds to its investors. The tax department was of the opinion that mutual funds distribute income to its investors not only in the form of dividend but also by way of distribution of additional units, redemption/ repurchase of units and section 115R of the Act provides for income distribution tax as against dividend distribution tax. Accordingly, any income distributed by a mutual fund whether in nature of dividend, additional units, redemption of units, etc. should be subject to the provisions of section 115R of the Act.

Thus, apart from distribution of dividend, income-tax department's view was to tax the following under section 115R:

- Distribution "by way of appreciation";
- Allotment of additional units; and
- Dividend reinvestment plan

Apart from complying with the notices of the income-tax officer, the mutual fund industry as a whole made representation before the Central Board of Direct Taxes ('CBDT') to resolve the controversy. In a welcome move, the CBDT put the said controversy to rest by clarifying that redemptions, repurchase of units and also issue of additional (i.e. bonus) units would not be subject to tax under section 115R of the Act. The circular has helped allay concerns of mutual fund as well as the investors.

Indirect tax issues

A. Reimbursements of expenses – Levy of Service Tax

Mutual Fund agents/distributors incur various expenses in the nature of advertisement/ marketing during the course of distribution of units. These expenses are then reimbursed by Mutual Fund/AMC to the Mutual Fund agents/distributors. Also, at times, there are reimbursements or benefits provided to such agents/distributors in terms of travel expenses, telephone expense etc. Mutual Funds/AMC also provide certain target based incentives to the agents/distributors in form of gifts, gold coins, participation in seminars, etc.

Section 67 of the Chapter V of the Finance Act, 1994 ('Service Tax Law') defines consideration as gross amount charged by the service provider for such services provided or to be provided by him.

Here, it is pertinent to note the provisions of Rule 5(1) of the Service Tax (Determination of Value) Rules, 2006 – Valuation Rules, which specifies that all the costs and expenses incurred by a service provider for providing taxable output services would have to be added to the taxable value. Further, Rule 5(2) of the Valuation Rules lays down the conditions to establish that the costs and expenses incurred are in the nature of reimbursements to a pure agent and therefore would not be liable to Service Tax.

Against this backdrop, over a period of time, Service Tax department have raised queries during the EA-2000 Audit and have also issued notices proposing to tax such reimbursements, expenses and incentives in the hands of AMC.

While the decision of Hon'ble Delhi High Court in the case of Intercontinental Consultants and Technocrats Pvt. Ltd.[9] put to rest the issue of taxability of reimbursements where they held that Rule 5(1) of the valuation rules which

8 ACIT vs DSP Merrill Lynch Investment Managers Ltd. (15 SOT 639); First India Asset Management (P) Ltd vs. DCIT [2008] 30 SOT 5

9 Intercontinental Consultants and Technocrats [2012-TIOL-966-HC-Del-ST]

provides for inclusion of expenditure or costs incurred by the service provider in the taxable value, is *ultra vires* sections 66 and 67 of the Finance Act, 1994, Service Tax department still adopts a different stand to levy Service Tax on such reimbursements.

Accordingly, the onus lies in the hands of the AMC to prove that it satisfies all the conditions as mentioned in Rule 5(2) of the Valuation Rules to bring such reimbursements/costs out of the Service Tax net.

On the other hand, the taxability of incentives is an issue which is seeing increasing litigation.

B. Overflow costs between Mutual Fund and AMC

As mentioned above, the MF regulations provides for a ceiling on expenses that could be charged to the Mutual Fund. Accordingly, out of the total expenses incurred for the scheme, only a part of the expenses can be borne by Mutual Fund and the remaining expenses are borne by AMC. In such a scenario, a question may arise with regard to levy or otherwise of Service Tax on such amount paid by AMC to the Fund.

The question arises whether the expenses borne by the AMC should be subject to tax when such amount is paid by AMC to Mutual Fund. The excess amount received by Mutual Fund from AMC may not be subject to Service Tax on the ground that there is no Service as such provided by Mutual Fund to AMC.

C. Eligibility of CENVAT Credit

Another issue that Mutual Funds / AMC faces is the eligibility of input services to claim CENVAT Credit.

Before moving on to the legal provisions, the agreement entered between the Mutual Fund, AMC and Distributor needs to be reviewed to understand the structure adopted for payment of brokerage and other scheme related expenses. This would help to establish the obligation and liability to incur such expenses i.e. who is the service recipient (the Fund or AMC) eligible to claim credit of such input services.

The term 'input service' has been defined in Rule 2(l) of the CENVAT Credit Rules, 2004 ('CCR 2004'). In terms of the said definition, a service provider is eligible to claim CENVAT Credit of all the expenses used for providing an output services except for certain exclusions one of which is input services specifically used for the personal consumption or benefit of employees such as life insurance, outdoor catering, membership of a club, travel etc.

Further, at times, the Service Tax department, has been challenging the claim of input services by the AMC on the ground that the services are received by the Fund and also on the ground that some of the input services are not in relation to the business activity.

While there are plethora of judicial pronouncements to support both ends of the argument, the facts and the nature of every individual case has to be looked into detail to support the claim of eligibility or otherwise of availment of CENVAT Credit on a particular input service;

Acche Din for mutual fund industry

In India, a large amount of savings are invested in unproductive assets like gold. A substantial amount of precious foreign exchange reserves of the country is utilised in importing gold. Channelising the investments from gold to mutual funds would not only reduce the current account deficit but also would help in development of overall economy. A strong and large mutual fund industry is need of the hour as this will reduce the dependency of capital market on FIIs.

One of the key reasons of success of mutual fund as an investment avenue in foreign countries is the incentives (mainly tax related) provided by the Government of the respective countries to its investors[10]. It is time for SEBI and Finance Ministry to pick up the best practices and implement the same in India and remove tax uncertainties in order to make the "Acche Din" a realty for the mutual fund industry!!

10 SEBI – Memorandum on long-term policy for mutual funds in India

Ashok Patil, Mandar Vaidya & Priti Shukla
Advocates

DIRECT TAXES
High Court

1] Section 80HHB – Assessee having more than 50 projects in India and abroad – Special deduction available in respect of each project instead of netting up of profits of overseas projects

CIT vs. Hindustant Construction Co. Ltd. [2014] 368 ITR 733 (Bom.)

The assessee was engaged in the construction business and was having more than 50 projects in India and outside India. The assessee claimed deduction u/s. 80HHB with respect to each overseas project separately. The AO allowed the relief on the basis of netting up of all the overseas projects. The High Court affirmed the order of the Tribunal in holding that in computing deduction u/s. 80HHB could be made in respect of each unit and the same was not prohibited by section 80HHB(1).

2] Sec. 271(1)(c) – Gold seized by excise department – Stand that gold belonged to someone else – No books were maintained – There was no concealment from the Income Tax Authorities – Seizure of gold would amount to loss – No penalty cannot be leviable

Balaji Shivalingam vs. Commissioner of Income Tax (2014) 110 DTR (AP) 265

There was search conducted by the excise department on the shop premises of the assessee where gold amounting to ` 3,30,400/- was found and seized by the excise department. The plea of the assessee all through was that the gold belonged to his brother. The plea was not accepted and the value of the gold was added to the income of the assessee and also penalty of ` 1,50,000 was levied on the same. The High Court held that if the assessee had admitted that the gold was held by him and he was obligated to furnish its value in the return, then the allegation to concealment would have been acceptable, but that was not the case here. Though the impact of the proceedings initiated under the Central Excise Act and the IT Act can constitute the basis to add income, levy of penalty on the allegation of concealment cannot be sustained, as the concealment was not from the Income Tax authorities, and as the assessee was not maintaining any books of account there was no occasion to disclose or conceal the gold from the point of view of the Income Tax. The High

Court further held that if the value of the gold is taken as income, then the seizure of the same should have been treated as loss, and once it is treated as a loss, non-disclosure thereof cannot be the subject matter of 271(1)(c).

3] Section 12AA – CIT cannot sit in the chair of the AO and look into the amount spent on charitable activities at the time of creation of the trust

CIT vs. Vijay Vargiya Vani Charitable Trust (2014) 271 CTR (Raj) 689

The assessee was a Public Charitable Trust. An application was moved for Registration u/s 12AA. CIT rejected the registration for the reason that the activities were carried out for a particular section of community and not to the general public at large. On further appeal in Tribunal, Tribunal allowed the appeal of the assessee and held that the predominant objects of the Trust are required to be seen at the time of grant of registration u/s 12AA and once these objects have been found to be charitable in nature, ancillary/subsidiary objects, need not be seen or looked into at the time of granting of registration. On further appeal in HC, HC upheld the findings of Tribunal and further held that genuineness of the trust can be proved only by its activities at a later point of time after grant of registration in case the trust does not carry on activities charitable in nature. CIT cannot sit in the chair of the AO and look into the amount spent on charitable activities at the time of creation of the trust. When a trust on institution files application for registration, it is not the stage for reviewing application of income. At the time of granting of registration CIT' satisfaction about genuiness of the activities of the Trust is no criteria as the Trust is yet to commence its activities.

4] Section 12AA – Non commencement of charitable activities – No reason for denial of Section 12AA Registration

DIT(Exemptions) vs. Seervi Samaj Tambaram Trust (2014) 271 CTR (Mad.) 684

Assessee Trust was formed for carrying on charitable and religious activities. The assessee filed an application before the DIT(E) who held that the activities of respondents were both charitable and religious and both should not be mixed up and the same was not in conformity with the provisions of Section 11(1)(a) of the IT Act and further also held that though the Trust was in existence from 13-8-2010, no activity was stated. Application was rejected u/s 12AA of the IT Act. On appeal in Tribunal, the Tribunal allowed the registration relying on the decision of the *CIT vs. Arulmighu Shri Kamatch Amman Trust (2012) 206 Taxmann 64 (Mad.)(Mag.) & CIT vs. Kutchi Dasa Oswal Moto Pariwar Mabama Trust (2014) 271 CTR (Guj.) 595.* On Revenue appeal in HC, the HC dismissed the appeal of the Revenue and held that there was no bar in granting registration though the trust had both charitable as well as religious objects, further genuineness of the objects of the Trust having not been questioned by the CIT, registration u/s. 12AA could not be denied for the reason that trust had not commenced its activities.

5] Section 69B – No discrepancy found in the books of account – Books not rejected – Reference to valuation officer cannot be made

– Additions made on the basis of the valuation report cannot be sustained

CIT v. VijayKumar D. Gupta (2014) 50 Taxmann.com 94 (Guj.)

AO made reference to the Valuation Officer to ascertain assessee's investment in house property and based on his report, made addition u/s. 69B. On appeal CIT(A) partly allowed the appeal. On further in Tribunal, Tribunal deleted entire addition. On revenue's appeal in High Court, the court dismissed Revenue's appeal and held that AO had not found any discrepancy in books of account of assessee. Unless books of account were rejected, AO could not make a reference to Valuation Officer. Therefore entire addition being merely based upon the estimation of DVO was baseless hence deserved to be deleted.

6] Section 281 – AO cannot declare a transfer void u/s 281 – The AO has to resort to appropriate proceedings under the provisions of Transfer of Property Act

Dr. Manoj Kabra vs. ITO 50 taxmann.com 42 (All)

The petitioner purchased a property by means of a registered sale deed. At relevant time assessment were pending against the seller, which culminated in certain demand against him. Based on said assessment order, the AO declared sale deed executed by seller in favour of the petitioner as a void document. On Writ petition in High Court, the Hon'be High Court allowed the Writ Petition and held that AO has no jurisdiction to adjudicate matter u/s 281 and declare a sale deed void. Further the court held that in order to declare a transfer void u/s 281, AO is required to take appropriate proceedings under Transfer of Property Act.

7] Section 263 – Two views possible –No revision maintainable

CIT v. LIC Housing Finance Ltd. (2014) 272 CTR (Bom.) 10

The question of law to be argued before the High Court was whether Tribunal was correct in holding that when two views are possible with regard to the applicability of Section 36(1)(viii) r.w.s 41(4A) amended w.e.f. 1-4-1997 do not provide any room for interpretation other than the one adopted by the CIT in his order passed u/s 263 of the Act? The Hon'ble Court dismissed the appeal of the Revenue and held that merely because the AO adopts one of the two views possible and that has resulted in loss of the Revenue it cannot be treated as erroneous order prejudicial to the interest of the revenue, unless the view taken by the AO is unsustainable in law. The court also held that there was no justification in setting aside the order of the AO. The court also upheld the findings of the Tribunal that there was no obligation to maintain the fund under Section 36(1)(viii) r.w.s 41(4A0, when the fund was created and the withdrawal of the fund from the special reserve was before the obligation to maintain the fund came into effect on 1-4-1998.

Jitendra Singh & Sameer Dalal
Advocates

DIRECT TAXES
Tribunal

REPORTED

1. Section 11 of the Income-tax Act, 1961 – Charitable in nature – Indian Chamber of Commerce and Industry – Receipts for performing specific services to its members – Entitled to the exemption in the absence of profit motive. [Sec. 28(iii) & Sec. 2(15)] A.Y. 2008-09 & 2009-10

Indian Chamber of Commerce vs. Income-tax Officer (Exemption) – [2014] 52 taxmann.com 52 (Kolkata – Trib.)

The assessee is an association of various industrialists formed in the year 1925 for development of trade, industries and commerce. It is a non-profit company incorporated under section 25 of the Companies Act, 1956. The assessee association was formed for the purpose of promotion and protection of Indian business and industry and is also registered u/s. 12A of the Act as 'Charitable" Association. The assessee filed its return of income for A.Y. 2008-09 being a charitable institution eligible for exemption u/s. 11 of the Act on 13-10-2008 declaring NIL total income. During assessment proceedings A.O. noted that certain activities of the assessee were clearly in the nature of business activities. According to A.O., assessee had violated the provisions of section 11(4A) of the Act, as the activities were in the nature of trading and business and separate books of account were purportedly not maintained. The assessee explained that the above activities were not in the nature of trade or business and same were all conducted for the empowerment, betterment and for creating awareness amongst industrialists in order to bring about development of trade and industries in India. However, the A.O. while finalising the assessment order denied the exemption claimed by assessee u/s. 11 of the Act. On appeal the First Appellate Authority upheld the action of the A.O. Being aggrieved by the order passed by learned CIT(A), the assessee preferred further appeal before the Hon'ble Appellate Tribunal, Kolkata. The Appellate Tribunal allowed the claim of exemption under section 11 of the Act by observing that the receipts derived by a chamber of commerce and industry for performing specific services to its members, though treated as business income under Section 28(iii) would still be entitled to the exemption under Section 11 read with Section 2(15) of the Act, provided there is no profit motive.

2. Section 12A of the Income-tax Act, 1961 – Charitable Trust – The trust is established for the purposes of cow-breeding and protection of cows and oxen – Distribution of milk free of cost to children, hospitals and schools – Profit from sale of remaining milk to general public at very nominal rate – Will not amount to carrying on any business – Assessee entitled to registration under section 12AA of the Act [Section 2(15) & Section 12AA(3)] A.Y. 2009-10

Shree Nashik Panchvati Panjarpole vs. DCIT (Exemption) – [2014] 148 ITD 343 (Mumbai – Tribunal)

The assessee-trust was established for cow-breeding and protection of cows and oxen. It was granted registration under section 12AA by department. During relevant year, the DIT(E) found that income of assessee from sale of milk was far in excess of ` 10 lakh. The DIT(E) thus, opined that assessee was doing regular activities which were in the nature of business by way of sale of milk, and was directly hit by the proviso to section 2(15). Accordingly, the DIT(E) having invoked provisions of section 12AA(3), cancelled the registration granted to assessee-trust. The assessee being aggrieved by the above order preferred an appeal before Hon'ble Mumbai Appellate Tribunal. The Hon'ble Appellate Tribunal allowed the appeal of the assessee by observing that where assessee-trust was established for purpose of cow-breeding and protection of cows and oxen, incidental income earned by it from sale of milk could not be regarded as carrying on activity of trade or commerce within meaning of proviso to section 2(15).

3. Section 115JB r.w.s. 234B and 234C, of the Income-tax Act, 1961 –No advance tax was payable on MAT computed under section 115JB for the years under consideration – Hence, no interest under sections 234B and 234C could be levied A.Ys. 2008-09 & 2009-10

Charbhuja Industries (P.) Ltd. vs. Addl. CIT [2014] 51 taxmann.com 411 (Mumbai – Trib.)

The assessee filed its return of income declaring income of ` 82,96,100/- under the normal provisions of the Act and ` 93,76,366/- under section 115JB. The A.O. while finalising the assessment computed book profits for the purpose of minimum alternate tax under section 115JB and accordingly levied the interest under sections 234B and 234C. The assessee, being aggrieved by the assessment order challenged the levy of interest under sections 234B and 234C before the First Appellate Authority. Before the learned CIT(A), the assessee contended that for the year under consideration in view of decision of Hon'ble Supreme Court in the case of *CIT v. Kwality Biscuits Ltd. [2006] 284 ITR 434,* no interest under sections 234B and 234C is leviable as the income-tax is determined under section 115JB of the Act. However, the learned. CIT(A) upheld the action of the A.O. relying on the decision of Hon'ble Supreme Court in the case of *Jt. CIT v. Rolta India Ltd. [2011] 330 ITR 470.* The assessee being aggrieved preferred an appeal before the Hon'ble Mumbai Appellate Tribunal. The Appellate Tribunal allowed the appeal of the assessee by observing that prior to the decision of the Supreme Court in the case of Rolta India Ltd. (supra) settled proposition of the law on the point was that no advance tax was payable on minimum alternate tax computed under section 115JB and, accordingly, interest under sections 234B and 234C could not be levied for non-deposit of advance tax on minimum alternate tax for the year under consideration.

[Contd. on page 77]

CA Sunil K. Jain

DIRECT TAXES
Statutes, Circulars & Notifications

NOTIFICATIONS

Income-tax (Eleventh Amendment) Rules, 2014 – Amendment in Rules 2C, 2CA, 11AA, Form 10A, Form 56 and Form 56D

The Central Board of Direct Taxes made the rules to amend the Income-tax Rules, 1962, which may be called the Income-tax (11th Amendment) Rules, 2014 and shall come into force from the date of their publication in the Official Gazette.

According to this, amendments have been made in rules 2C, 2CA, 11AA, relating to Forms 10A Re; Application for registration of charitable or religious trust or institution under clause (aa) of sub-section (1) of section 12A of the Income-tax Act; Form 56 Re: Application for grant of exemption or continuance thereof under sections 10(23C)(iv) and (v) for the year; and in Form 56D Re: Application for grant of exemption or continuance thereof under sections 10(23C)(vi) and (via) for the year.

(Notification No. 61/2014, dated 10-11-2014)

Bank Term Deposit (Amendment) Scheme, 2014 – Amendment in Para 3

The Central Government made the amendments to the Bank Term Deposit Scheme, 2006, called the Bank Term Deposit (Amendment) Scheme, 2014 to come into force on the date of its publication in the Official Gazette. According to this in the Bank Term Deposit Scheme, 2006, in para 3, in clause (1), for the words "one lakh rupees", the words "one hundred and fifty thousand rupees" have been substituted.

(Notification No. 63/2014 [F.No.142/09/2014-TPL]/ SO 2906, dated 13-11-2014)

Tax liability of a specified resident applicant determined by Authority for Advance Rulings under section 245N(b)(iia) of the Income-tax Act, 1961

In terms of sub-clause (iia) of clause (b) of section 245N of the Income-tax Act; the Central Government specified a resident, in relation to his tax liability arising out of one or more transactions valuing rupees one hundred crore or more in total which has been undertaken or proposed to be undertaken, being such class of persons, as applicant for the purposes of Chapter XIX-B of the said Act. The notification shall come into force on the date of its publication in the Official Gazette.

(Notification No. 73/2014 dt. 28th November, 2014)

CIRCULARS

Section 139 of the Income-tax Act, 1961 – Return of Income – Measures for revenue augmentation – Calling for returns of income in case of non-filers for A.Y. 2014

CBDT noted that 5,09,898 taxpayers who have submitted an e-Retum of A.Y. 2011-12, or 2012-13 or 2013-14 (up to 20th October, 2014) with returned income of more than ` 10 lakhs or paid self assessment tax of more than/equal to ` 1 lakh (as per ITR) have not filed their ITR for the A.Y. 2014-15. The list of cases CCIT wise is available on i-taxnet. The path to view these cases is:

Resources – Downloads – ITD instructions – List of non-filers for A.Y. 2014-15

The Board has directed all the CCsIT to personally monitor these cases.

(Letter [F. No. DIT(S)-II/NON-FILERS/ 2014-15/4011, dated 29-10-2014)

Finance Act, 2007 – Explanatory Notes on provisions relating to Direct Taxes – Clarification on para 61.2 of Circular No. 3 of 2008, dated 12-3-2008 relating to revised settlement scheme

Chapter XIX-A of the Income-tax Act, 1961 contains provisions relating to settlement of cases by the Income-tax Settlement Commission (ITSC). The provisions contained in the said chapter were amended by Finance Act, 2007 and a Revised Settlement Scheme was put in place. Explanatory Circular No. 3/2008 dated 12-3-2008 issued by CBDT *vide* para 61 (comprising sub paras 61.1 to 61.17) deals with Revised Settlement Scheme.

It has been inadvertently stated in para 61.2 of Circular No.3 of 2008 that the assessment shall be deemed to have been completed only on the date of service of assessment order to the applicant. This statement is not in consonance with the provisions contained in Explanation to clause (b) of section 245A of the Income-tax Act which, *inter alia,* provides that a proceeding for assessment of any assessment year shall be deemed to have concluded on the date on which the assessment is made.

In view of the above, para 61.2 of Circular No. 3 of 2008 is replaced with the following with effect from the 1st day of June, 2007:—

> "61.2 Under the existing provisions, an assessee may make an application to the Commission at any stage of the proceedings in his case pending before any Income-tax Authorities. After 31st May, 2007, an assessee can make an application to the Commission only during the pendency of the proceedings before the Assessing Officer. It is further clarified that (a) since intimation under section 143(1) is not an assessment order, there will be no bar in filing an application for settlement subsequent to receipt of an intimation under section 143(1). It is not material whether time-limit for issue of notice under section 143(2) has expired or not; (b) the assessment shall be deemed to have been completed on the date on which the assessment order is passed."

(Circular No. 16/2014 dated 17-11-2014)

Due date for Filing Return in Jammu & Kashmir extended to 31-3-2015

Considering the devastation due to floods in the State of Jammu & Kashmir, the Central Board of Direct Taxes, and in continuation to the earlier order under section 119 of the Act dated 16-9-2014, further extended the 'due date' of furnishing return of income from 30th November, 2014 to 31st March, 2015, in cases of Income-tax assessees in the State of Jammu & Kashmir which are covered under clause (a) or clause (aa) of Explanation 2 to sub-section (1) of section 139 of the Act. The `due date' for obtaining and furnishing reports of audit

for the assessees in the State of Jammu and Kashmir under various provisions of the Act pertaining to such returns of income is also extended to 31st March, 2015.

(*F.No. 225/268/2014/ITA.II dated 28th of November, 2014)*

INSTRUCTIONS

Section 143, read with section 142 of the Income-tax Act, 1961 – Assessment – Scope of enquiry in cases selected for scrutiny – Further steps towards a non-adversarial tax regime

The need for furthering a non-adversarial tax regime has been emphasised time and again. A non-adversarial tax regime cannot be achieved without concerted endeavour at each level, especially at levels where the public interaction is high. The CBDT has issued instructions from time to time on some of these issues; still there is a need for consolidation of earlier instructions and issuance of further directions in this regard. Accordingly, CBDT directed that the officials of the Income-tax Department must adhere to the following guidelines for achieving such objective:

i. Letter dated 21-8-2014 of Chairman, CBDT on cleanliness and punctuality should be implemented in letter and spirit as these are the basic requirements of an efficient and taxpayer centric organisation.

ii. Any appointment given to the public must be honoured and such appointments should not be cancelled or postponed without any unavoidable reason, especially when the assessee/ representative is willing to attend.

iii. Despite less than one per cent cases being selected for scrutiny assessment, this area of work continues to remain in focus where the tax administration is questioned as adversarial. The selection of cases under Computer Assisted Scrutiny Selection has resolved the issue of subjectivity in selection of cases for scrutiny. However, the process of scrutiny involving long and non-specific questionnaires, the nature of additions made and the high-pitched assessments without proper basis continue to attract adverse attention. Instruction No. 6/2009 entrusted a responsibility on each Range Head to ensure improvement in quality of assessments by issuing directions under section 144A of the Act. There is a need to follow the said Instruction in letter and spirit and accordingly, the Range Heads are required to ensure that frivolous additions or high-pitched assessments without proper basis are not made. The Principal Commissioners of Income-tax/ Commissioners of Income-tax are required to supervise the work of their subordinates to ensure due discharge of these functions.

iv. Instruction No. 15 of 2008 dated 4-11-2008 provides for review of scrutiny assessment orders by the supervising officers on a quarterly basis. Instruction No. 16 of 2008 dated 4-11-2008 lays down the procedure for Inspection of Work of Assessing Officers, Tax Recovery Officers, Range Offices and Commissioners of Income-tax (Appeals). These instructions are issued with the overall aim of capacity building and improving quality of work. Supervisory authorities are required to ensure that these instructions are duly followed.

v. Instruction No. 7 of 2014 dated 26-9-2014 clarifies that ordinarily in scrutiny cases selected on the basis of AIR/CIB/26AS information, the scrutiny shall be limited to that information. Wider scrutiny would be possible only with the sanction of Principal Commissioner of Income-tax/ Commissioner of Income-tax in specified cases and under the monitoring

of the Range Head. (Such cases form 25-30% of the total scrutiny basket, thus limiting the cases of full scrutiny).

vi. Withholding of refunds due to mismatch of TDS data has been sought to be remedied through Instruction No. 5 of 2013 dated 8-7-2013 which provides for grant of credit on the basis of evidence submitted by the assessee. This Instruction must be followed scrupulously.

vii. Instruction No. 1914 of 1993 dealing with recovery of demand, stay of demand and grant of instalments has stood the test of time and is equally relevant today. Same is reiterated for implementation in deserving cases. Measures for recovery of tax should be subject to the said Instruction.

viii. In cases of remand, the Commissioners of Income-tax (Appeals) should specify the aspect which needs to be verified. The practice of forwarding the entire documents/submission of the assessee for comments of the Assessing Officers should cease. Assessing Officers will be required to submit a remand report only in cases where the remand is on a specific matter.

ix. Threshold limits have been set for appeals to ITAT, High Courts and Supreme Court at ` 4 lakhs, ` 10 lakhs and ` 25 lakhs, respectively. This, however, does not imply that appeals above these amounts have to be necessarily filed. Where the tax effect is above these amounts, the officer concerned is enjoined with the duty to ensure that the same is filed only if it is feasible to so do on merits of the case.

x. A review of the proposals for filing SLPs reveals that in most of the cases, the decision to file a reference before the High Court itself was not in order. No substantial question of law existed or the question of law was not correctly drafted. Hence, in stations having more than one Chief Commissioner of Income-tax (CCIT) the decision to file a reference before the High Court will be taken by two CCsIT including the CCIT in whose jurisdiction the matter lies. The Principal CCIT/CCIT (CCA) concerned may issue directions for pairing of CCsIT for this purpose. In case of disagreement between the two CCsIT, the matter will be referred to the Principal CCIT/CCIT (CCA). For references in the jurisdiction of the Principal CCIT/CCIT (CCA), in case of disagreement, the matter will be referred to the CCIT-II.

xi. Any regime where taxpayers' grievances are not attended to in time may be considered adversarial. Time limits have been set out for their disposal under Citizens' Charter, CPGRAMS, etc. However, the pendency reflects poorly on the monitoring effort. All the supervisory authorities are directed to ensure that the grievances are disposed of within the specified time period.

xii. The issue of summons without adequate caution and due application of mind has caused concern to the Board. Supervisory authorities have to ensure that the summons is issued only in deserving cases. Summons should also clarify if the person has been called as a witness or in his own case, and the matter for which he has been called.

Officers and staff at all levels have been advised to follow the above instructions scrupulously. Non adherence to these instructions will be viewed very seriously and disciplinary action initiated.

(Office Memorandum [F. No. 279/MISC/52/2014-(ITJ)], dated 7-11-2014)

CA Tarunkumar Singhal & Sunil Moti Lala, *Advocate*

INTERNATIONAL TAXATION
Case Law Update

A] HIGH COURT JUDGMENTS

I. Payments received in the nature of fees for technical services in respect of agreements entered before 1-4-1976 are exempt from tax.

CIT vs. Montedison of Italy (49 taxmann.com 8) (Bombay High Court) – Assessment Year: 1979-80

Facts

1. The subsidiary company ('S Co.') of assessee had entered into agreements with certain public sector undertakings and J.K. Synthetics Ltd. for the supply of technical know-how and for rendering technical services. The S Co. merged with assessee company by virtue of which all the rights and liabilities of S Co were taken over by the assessee-company.

2. During the year under consideration, the assessee received payments from certain public sector undertakings and J.K. Synthetics Ltd. for the supply of technical know-how and for rendering technical services by S Co.

3. The Assessing Officer ('AO') held that all the payments received by the assessee fell within the definition of the term "Royalty" given in Explanation 2 of section 9(1)(vi) of the Income-tax Act, 1961 ('the Act').

4. On appeal, the CIT(A) held that the payments received by the assessee-company during the year were in the nature of technical service fees covered under section 9(1)(vii) of the Act and ought to be excluded from taxation in view of the proviso thereto, which took away the applicability of the said section in respect of the agreements entered into prior to 1st April, 1976 which were approved by the Government.

5. The Hon'ble Income Tax Appellate Tribunal ('ITAT'), on revenue's appeal, ruled in favour of assessee agreeing with the findings of CIT(A).

6. Aggrieved, the revenue preferred an appeal before Hon'ble High Court.

Judgment

1. The Hon'ble High Court held that payments made to the assessee-company would fall within sub-clause (vii)(b) of section 9(1) of the Act. However, the proviso stipulates that nothing in sub-clause (vii) to section 9(1) shall apply in relation to any income by way of fees for technical services payable in pursuance of an agreement made before the 1st day of April, 1976, and approved by the Central Government.

2. It observed that the CIT(A) as well as the ITAT have analysed and interpreted the various agreements entered into between the assessee-company and other service recipients in great detail and thereafter came to the conclusion that the payments made thereunder in the financial

year in question were by way of fees for technical services.

3. The Hon'ble High Court further observed that it was an undisputed position that all the agreements were entered prior to 1-4-1976. Thus, the said payments were exempt from tax by virtue of the proviso to section 9(1)(vii).

II. When goods are purchased from associated enterprises and resold without any further processing, then Resale Price Method can be adopted notwithstanding the fact that significant selling and distribution expenses were incurred

CIT vs. L'Oreal India P. Ltd (ITA No. 1046 of 2012) (Bombay High Court) – Assessment Year: 2003-04

Facts

1. The assessee is into the business of manufacture and distribution of cosmetics and beauty products.

2. During the year under consideration, the Transfer Pricing Officer ('TPO') made an adjustment in the distribution segment by applying transactional net margin method ('TNMM') and thereby rejected resale price method ('RPM') adopted by assessee on the ground that the assessee's pricing policy was not at arm's length since it was consistently incurring losses. He further held that the comparable's gross margins could not be relied upon because of product differences.

3. On appeal, the CIT(A) deleted the addition made by TPO.

4. On further appeal, the Hon'ble ITAT ruled in favour of the assessee by placing reliance on the OECD guidelines which state that in case of distribution or marketing activities, when the goods are purchased from associated enterprises and there are sales effected to unrelated parties without any further processing, then RPM method can be adopted. It further observed that the TPO himself has accepted the RPM method in the previous and subsequent years with respect to distribution activity of the assessee.

5. Aggrieved, the revenue preferred an appeal before Hon'ble High Court

6. The Revenue contended that the assessee had to incur several expenses including promotional and advertising and hence there was substantial value addition to the goods sold due to which RPM could not be applied to determine arm's length price.

Judgment

1. The Hon'ble High Court observed that TPO had accepted the RPM method in previous and subsequent years in respect of the distribution activity of the assessee.

2. It further observed that the Hon'ble Tribunal, in its order, had noted that RPM is a standard method and that the OECD guidelines also state that RPM can be adopted in case of distribution and marketing activities when the goods are purchased from associated enterprises and there are sales effected to unrelated parties without any further processing.

3. The Hon'ble High Court held that since the TPO had accepted the RPM method in previous and subsequent years in respect of the distribution activity of the assessee and there being no distinguishing features noted by the Hon'ble Tribunal in its order, the Hon'ble Tribunal was correct in holding that RPM was the most appropriate method for the international transactions in respect of import of finished goods. Therefore, no substantial question of law arose from such findings and accordingly, it dismissed the appeal of the revenue.

III. Performance of employees of LO was determined by number of direct orders received by them and employees were also entitled to sales incentives

for these orders – Such incentive plans established that LO was not engaged merely in preparatory or auxiliary activities but extended to marketing activities as well – Thus LO was to be treated as PE of foreign company

Brown and Sharpe Inc v. CIT (ITA No. 219 of 2012) (Allahabad High Court) – Assessment Year: 2003-04

Facts

1. The assessee, a company incorporated in US, established a Liaison Office ('LO') in India after receiving approval from Reserve Bank of India which were subject to various conditions including prohibition on any business activity.

2. During the assessment proceedings, the AO held that Exclusion contended under Article 5(3)(e) of India-US Double Tax Avoidance Agreement ('DTAA') was not attracted since the activities of LO were not limited to preparatory or auxiliary activities in India and they had extended to marketing and promotional activities as well in view of the following:

a. the activities of the LO extended to searching for the prospective buyers and for promoting sales of the assessee in India.

b. the employees of the assessee were entitled to sales incentives to the extent of 25% of their annual remunerations. Further the performance of the employees was judged by the number of direct orders received by them.

c. the assessee had filed return of income claiming loss under the head 'Profits and gains in business or profession' and had claimed depreciation under Section 32(1) of the Act.

Thus the income attributable to the LO in India would be taxable in India.

3. The Commissioner (Appeals) and the Tribunal upheld the order of the AO.

4. Aggrieved by the same, the assessee preferred an appeal before Hon'ble High Court.

Judgment

1. The Hon'ble High Court observed that the activities of the liaison office included: (i) explaining the products to buyers in India; (ii) furnishing intimation in accordance with the requirements of the buyers; and, (iii) a discussion of commercial issues pertaining to the contract through the technical representative, after which an order was placed by the buyer directly.

2. The Hon'ble High Court held that what was relevant was the nature of the incentive plan which clearly indicated that the purpose of the liaison office in India was not merely to advertise the products of the assessee or to act as a link of communication between the assessee and a prospective buyer but involved activities which traversed the actual marketing of the products of the assessee in India because it was on the basis of the orders generated that an incentive was envisaged for the employees.

3. The stand of the assessee that the incentive which was provided for in the letters of the appointment was only "standard language of the appointment letter of the company", which had inadvertently not been deleted from the contract of appointment by the liaison office, was far-fetched.

4. It observed that the Hon'ble Tribunal while affirming the order of the CIT(A) had relied upon relevant documentary material in arriving at the conclusion that the activities of the liaison office established that it was promoting sales of the assessee in India. Accordingly, it held that there was no perversity in the approach of the Hon'ble Tribunal nor had it misapplied itself either in fact or in law.

5. The Hon'ble High Court held that with respect to the alternate submission of the assessee that, the AO had not considered whether any part of the profits were attributable to the permanent establishment accordingly restored the matter

to the Assessing Officer for fresh determination of the taxable income having due regard to the provisions of Article 7 of the DTAA.

IV. Consideration received for hiring out dredgers on bareboat basis is not royalty as per the amended provision of Article 12 of India – Netherlands DTAA – Entire control over the equipment being with the Indian Company, it cannot be held to be permanent establishment as per Article 5(2) of the DTAA.

CIT vs. Van Oord CZ Equipment BV (ITA No 1202 of 2007) (Madras High Court) – Assessment Year: 2003-04

Facts:

1. The assessee, a company incorporated in Netherlands, had let out dredging equipments to one of its sister concerns, a company incorporated in India for the purpose of dredging as per the contract awarded by Gujarat Adhani Port Limited.

2. During the year under consideration, the assessee filed its return of income and claimed refund of taxes deducted by payee company stating that they were not liable for tax under the provision of India-Netherlands Double Tax Avoidance Agreement ('the DTAA'). The AO held that w.e.f. 1-4-2002 any consideration for the use or right to use any industrial, commercial or scientific equipment are included in the term "Royalty", in view of insertion of clause (iva) in Explanation 2 to sec. 9(i)(vi) of the Act and accordingly, levied income tax at the rate of 10%.

3. On appeal, the CIT(A) considering the modified provisions of Article 12 of the DTAA deleted the addition.

4. On further appeal, the Hon'ble Tribunal upheld the CIT(A)'s order and also held that there was no permanent establishment in India.

5. Aggrieved, the Revenue preferred an appeal before Hon'ble High Court.

Judgment

1. The Hon'ble High Court observed that as per the modified provision of Article 12 of the DTAA w.e.f 1-4-1998 deleted the words "the payment for the use of equipment or any consideration for the use of , for the right to use industrial, commercial or scientific equipment" which was originally found in clause (1) of Article 12 of the DTAA.

2. The Hon'ble High Court observed that clause (iva) in Explanation 2 to sec. 9(1)(vi) of Income-tax Act defines "Royalties" w.e.f. 1-4-2002. However, the said clause (iva) in Explanation 2 to of Section 9(1)(vi) was not applicable as the payments for the use of equipment was no longer taxable in the Contracting State viz., India under the DTAA as per the modified provision of Article 12 of the DTAA w.e.f. 1-4-1998.

3. It distinguished the decision of *Poompuhar Shipping Corporation Ltd. and Another vs. ITO [2014] 360 ITR 257 (Mad)* as the treaties applicable in that case contained the use of equipment clause in Article 4. Further, in that case it was hiring of ship on time-charter basis, whereas in assessee's case it was dredging equipment leased out on bareboat basis, namely, without Master and Crew

4. The Hon'ble High Court also rejected the plea of the Department that as per Article 5(2), an installation or structure used for the exploration of natural resources is a permanent establishment, provided that the activities continue for more than 183 days. It held that the dredging equipment was leased out on bareboat basis and therefore it could not be treated as a permanent establishment as the entire control over the equipment was with the Indian company and not with the assessee.

VI. The Hon'ble High Court in the case of M/s Intoto Software India Pvt. Limited (engaged in the business of providing software development service to its Associated Enterprise) upheld the

order of the Hon'ble Tribunal which excluded companies engaged in both product development as well as software development service companies as comparable. It further held that Product Company were functionally different from a software development service companies and therefore the AO ought not to consider companies engaged in both services in absence of segmental data.

CIT vs. Intoto Software India Pvt. Ltd. [ITA No. 233 of 2014 Order dated 27th March, 2014] [Andhra Pradesh High Court]

B) TRIBUNAL DECISIONS

I) India-Switzerland DTAA – FTS – Installation and commissioning of the equipment is an assembly activity, not taxable as FTS in India. Training to Indian company's employees by a foreign company for operation of the equipment is taxable as FTS.

ITO vs M/s. Bennett, Coleman & Co. Ltd. 2014-TII-160-ITAT-Mum-Intl. Assessment Year: 2007-08

Facts

1. The assessee is an Indian company engaged in the business of printing and publishing of newspapers. The assessee needed a sophisticated plant and machinery (mail room equipment) that could collate the various pages of the newspaper, which assisted in printing, picking and stacking them and pack the newspapers for timely delivery.

2. To acquire such a plant and machinery, the assessee called for global bids for supply, delivery and installation of the plant and machinery and training of its staff. The bid was closed in favour of FERAG AG, a company registered in Switzerland.

3. The assessee entered into two contracts with FERAG AG, of which one was for the supply of the various components/units of the mail room equipment, and second was for installation and commissioning of the components/units of the mail room equipment in the premises of the assessee and training of the staff of the company for operation of this equipment to be supplied.

4. In relation to the work done as mentioned in the second contract, the assessee made payment to FERAG, without deduction of tax at source.

5. The Assessing Officer (the AO) held that the payments made by the assessee, were liable to tax deduction at source (TDS) as 'Fees for Technical Services' (FTS) in the hands of FERAG AG. Accordingly, the AO directed the assessee to pay the TDS with the interest thereon.

6. The Commissioner of Income Tax (Appeals) [CIT(A)] held that 75 per cent of the remittance was made by the assessee was towards installation and commissioning and therefore was not FTS as per Explanation 2 to Section 9(1)(vii) of the Act and therefore, not chargeable to tax in the hands of FERAG AG. However, the balance 25 per cent of the remittance was towards training of the assessee's staff, was chargeable to tax as FTS.

Decision

The Tribunal held as under:

Re: The activity of installation and commissioning of the equipment is 'assembly' hence not taxable

1. The mailroom equipment comprised of various units and was hence a complex equipment. The bid document stipulated that the units/components of the mailroom equipment would have to be installed and commissioned by trained and qualified personnel of the supplier, who shall, then provide training to the assessee's employees, on the operation and maintenance of mailroom equipment. The price quoted included installation, commissioning and training.

2. The price for supply was separately indicated in the contract for supply and that

for the services in the contract for services. The obligations under the contract for services were distinct.

3. The contract for supply stipulated that the warranty can be claimed by the assessee only if the mailroom equipment were installed and put into operation by Vendor Certified Personnel. In other words, the person who installs the equipment should be certified by the vendor. This condition was not the same which required qualified personnel of the vendor to install the equipment which was indicated in the bid document and not in the contract signed by the assessee.

4. Accordingly, the services rendered by FERAG AG, by way of installation, commissioning of the mailroom equipment and the training of the assessee's employees were not inextricably and essentially linked to the sale of the mailroom equipment.

5. The services mentioned in the agreement for services indicated that the scope involved, was bringing and positioning various components, properly aligning them, connecting the individual units, etc. with a view to ensuring that all the components are working in unison, at maximum capacity and that the power consumed is as prescribed.

6. FERAG AG, had, in fact, supplied a pickup station, a gripper conveyor, stacker and automatic bundle addressing system, etc. All these units and components had to be fitted together in a manner that they were properly positioned, aligned and, connected to ensure optimum functioning, in the shortest duration. This activity can be called as 'assembly'.

7. The definition of the word 'assembly' does not appear in the Act and hence the word has to be interpreted as understood in common parlance. Consequently, the consideration paid to FERAG AG, related to installation and commissioning of the units/components of the mailroom equipment, will not fall within the purview of FTS as defined in Explanation 2 to Section 9(1)(vii) of the Act and therefore, not taxable.

8. The consideration paid towards these services was only taxable in Switzerland in the hands of FERAG AG, by virtue of the provisions of Article 14 of the tax treaty.

Re: The activity of training assessee's employees is not 'assembly' hence taxable

1. The services rendered by FERAG AG, towards training the employees of the assessee cannot fall within the ambit of the expression 'assembly'.

2. Article 14 of the tax treaty refers to 'residents of a contracting state' and hence it is not restricted to individuals as was the case in the India-Denmark tax treaty that came up for consideration before the Tribunal in the case of *Christiani & Nielsen Copenhagan vs. ITO [1991] 39 ITD 355 (Bom.)*

3. Article 12(4) of the tax treaty defines FTS as including the services rendered by FERAG AG, towards installation and commissioning and training. Article 12(5) of the tax treaty provides that services covered under Article 14 of the tax treaty will not qualify for FTS.

4. Article 14 of the tax treaty, while defining the term 'Professional Services', includes independent activities of engineers which does not cover training given to the employees of the assessee. Though a training activity that may be connected to an engineering concern, it would not constitute an engineering activity so as to fall within 'professional services' under Article 14 of the tax treaty.

5. The CIT(A)'s estimation of 25 per cent of the consideration, attributable towards training the employees of the assessee, was on a higher side and also against the facts and therefore, the break-up of the cost as provided by the assessee was accepted.

6. The training period would not have been substantial and that too not essentially shop floor

training, as to how to operate the mail room equipment, which would have been training on the machine and therefore, Article 12 of the tax treaty shall apply on class room training

II) Transfer Pricing – Sogo Shosh vis-à-vis Trading Co. – TNMM Application of Berry ratio – 'Sogo Shosha' different from normal trading, no allocation for location saving and assembled workforce required; and Berry ratio an appropriate PLI where no funds are blocked due to inventory

Mitsubishi Corporation India Pvt. Ltd. vs. DCIT 2014-TII-215-ITAT-DEL-TP – Assessment Year: 2007-08

Facts

1. The assessee is a wholly owned subsidiary of Mitsubhishi Corporation Japan (MC Japan) which is one of the leading Sogo Shosho establishments in Japan. Sogo Shosho is a Japanese expression which means general trading company engaged in both import and export of a diverse range of products.

2. In the instant case, the assessee was engaged in two segments namely, trading segment i.e. import of goods from an Associated Enterprise (AE) for resale and service fees/commission income segment pertaining to sales and marketing support services to the AE.

3. The assessee selected the Transaction Net Margin Method (TNMM) as the most appropriate method with Berry ratio (gross profit/operating expenses) as the PLI. The assessee mentioned in its Functional, Risk and Assets (FAR) analysis that it is essentially in the business of providing sales support and co-ordination activities in relation to international transaction, and therefore it will be akin to that of a service provider rather than that of a trader.

4. During the course of TP assessment proceedings, the Transfer Pricing Officer (TPO) rejected the PLI adopted by the assessee stating that in case of Berry ratio, entire international transactions relating to sales and services of commodities will remain out of PLI. Also, while considering operating expenses as the cost base, the cost of sales will get excluded from the denominator of the PLI used. The TPO was further of the view that the Income-tax Act, 1961 (the Act) and the Income-tax Rules, 1962 (the Rules) does not permit the use of operating expense in the cost base as these expenses do not include cost of sales.

5. The TPO also contended that the service/commission income segment should be treated as equivalent to the trading segment because the same pertains to trading activities.

6. Further, the contention of the TPO was that AEs have transferred the manufacturing and procurement activities from high cost economies to low cost economies (India) resulting in considerable location saving to the AEs. Also, the TPO was of the view that the assessee has developed several unique intangibles in the form of supply chain intangibles and human assets intangibles which has benefited and enhanced the profitability of the AEs.

7. Based on the above, the TPO proposed adjustment by selecting comparable companies with an arithmetic mean of 2.49 per cent (taking OP/TC as the PLI) for the combined segments i.e. trading and service. Aggrieved by the adjustments made by the TPO, the assessee appealed before the Dispute Resolution Panel (DRP), wherein the DRP confirmed the TPO's order.

Issues before Tribunal

Various issues raised by the assessee before the Tribunal are as follows:

i) Whether functions performed by the assessee are akin to that of service or commission agent or it is covered under trading activities?

ii) Whether Berry ratio can be considered as an appropriate PLI in case of TNMM being selected as the most appropriate method?

iii) Whether additional allocation on account location savings and assembled workforce is required?

iv) Whether income from service fee/commission segment should also be considered as trading income?

Decision

The Tribunal held in favour of the assessee as follows:

1. The assessee contended that even if the functions performed are covered to a limited extent under trading activities as against akin to an agent's function, the benchmarking analysis should be conducted considering suitable comparable companies. The uniqueness of the business model of the assessee cannot be ignored.

2. With respect to the selection of the PLI, the assessee contended that in case of back to back trading with no inventory risk involved, Berry ratio should be considered as the most appropriate PLI. Further, as per Rule 10B(1)(e)(i) of the Rules, there is no specific prohibition on the use of Berry ratio.

3. The assessee was of the view that the intangibles, in order to be taken into account for profitability, should be unique intangibles, not present in the business of the comparables and owned by the assessee and not in the AEs.

4. Therefore, based on the above facts and circumstances, the assessee was urged to uphold the use of Berry ratio as appropriate PLI to the peculiar case for 'Sogo Shosho' companies, which even though treated as trader, do not carry any inventory risk.

5. The Tribunal noted that the High Court has clarified that the assessee can be compared only to entities which are similarly placed as the assessee, considering the functional and risk profile of the assessee.

6. The Tribunal pointed out the importance of inventory level which is a crucial factor in determining the kind of activity the assessee has carried out. In this regard, the Tribunal referred to the CBDT notification defining a wholesale trader with reference to, *inter alia*, its monthly inventory level being less than 10 per cent and prescribing a lower tolerance range at one-third the level of the normal tolerance range. Thus, the Tribunal pointed out that there is a direct relationship between the normal inventory levels and the normal profitability.

7. The Tribunal was of the view that in the cases where no economic risk for inventory is assumed and no function is performed in respect of the inventory, except to facilitate trading of the same, it is appropriate to exclude inventory cost from the cost base. The Tribunal relied on the ruling in the case of *GAP International Sourcing India Pvt Ltd. vs. ACIT [2012] 149 TTJ 437 (*Del.) wherein it was held that the Berry ratio is used for distributorship functions and its application could also be related to the service providers. Further, emphasis was placed on the zero risk associated with significantly low or zero inventory level as compared to other comparables earning additional profit on account of additional inventory risk.

8. The Tribunal clarified that the basis of computation, as set out in Rule 10B(1)(e)(i) of the Rules is not exhaustive whereas it is only illustrative and it ends with the expression 'or having regard to any other relevant base' and accordingly does not prohibit the use of Berry ratio as a PLI. In light of the above, the Tribunal adjudicated that the Berry ratio could be considered as an appropriate PLI for the purpose of benchmarking international transactions.

9. The Tribunal was of the view that if a assessee is able to buy a product or service at a lower price vis-à-vis price in another jurisdiction, including the domicile jurisdiction, such purchases *per se* do not give rise to a location saving for the purpose of ALP determination. Further, the

Tribunal relied on guidance on the transfer pricing aspects of intangibles issued by OECD as a part of its deliverables of the Action Plan on Base Erosion Profit Shifting (BEPS) and concluded that in the case of the assessee, it was not established by the revenue authorities that there exist location saving with the help of performing four steps incorporated in the said guidance.

10. With respect to assembled workforce, relying on the judgment in the case of *Li & Fung India Private Limited vs. CIT [2014] 361 ITR 85 (Del)*, the Tribunal held that an assembled workforce can be taken into account only when it has significant replacement cost. The assessee is engaged in back to back trading activities which does not involve any trained workforce which can be considered as unique intangibles. Based on the above observations, the Tribunal upheld the application of TNMM with the use of Berry ratio as an appropriate PLI and remanded the matter back to the Assessing Officer (AO) for fresh assessment.

11. With respect to service fee/commission segment, the Tribunal upheld that it is not open for revenue authorities to reconstruct the financial statements of the assessee and accordingly directed the AO to determine ALP on the basis of the commission/service fee.

III) India-U.K and India – Netherland DTAA – FTS – Application of concept of 'Make Available' – Pre-clinical research studies conducted by foreign companies make available skill, knowledge, expertise, etc. to the Indian company, therefore, such services are taxable as FTS under the tax treaty

Dr. Reddy's Research Foundation Hyderabad vs. DCIT – 2014-TII-159-ITAT-HYD-INTL – Assessment Year: 2003-04

Facts

1. The assessee is a leading pharmaceutical research company carrying out research and development (R&D) activities in drug discovery. Such R&D activities are centered on new molecule discovery involving related biological process and chemical research.

2. New molecular discovery research is focused on the therapeutic areas of metabolic disorders (insulin resistance and associated disorders in particular), cancer inflammation, bacterial infections etc. Thus, the assessee is mainly involved in drug discovery research.

3. Since the cost incurred on basic research is very high, and the time for exclusive marketing is less, the time factor is very crucial in drug discovery. Earlier a drug is introduced in the market, the better it is for the innovator company as it increases the 'time for exclusive marketing rights'. To increase this 'time' and also to reduce the cost of research, appropriate parts of research were allocated by the patent holding innovator company to other research organisations.

4. The assessee entered into an agreement with an UK company, Simbec Research Ltd. and a Netherlands Company, NDDO Oncology BV for conducting pre-clinical research studies. The assessee made the payments to M/s. Simbec Research Ltd. and NDDO Oncology BV (research organisations)

5. The Assessing Officer (AO) was of the opinion that the payments made by the assessee to the foreign parties could be considered as FTS. The AO considered that such payments were chargeable to tax in India as per the provisions of Section 5(2)(b) read with Section 9(1)(vii) of the Income-tax Act, 1961 (the Act). The AO also considered the provisions of the tax treaties and held that such payments were taxable as FTS.

6. Since, the assessee had made the payments without deduction of tax, because of its agreement with the foreign party, wherein, it had agreed to make the payment net of taxes, the assessee was liable for the consequences of violation of provisions of Section 195A of the Act.

7. The Commissioner of Income Tax (Appeal) [CIT(A)] held that from a perusal of the agreements, it was clear that during the course of performance of the study, the assessee had access to the technical information, technology, documentation, knowhow and processes involved in the whole procedure of study. In view of this, it cannot be said that the technology was not made available by the foreign company to the assessee. As per agreement, such technology, technical information, knowledge and processes were indeed made available but kept confidential.

8. All intellectual property including rights to patents which would be generated, would belong to the assessee only. The entire process by which this field trial research was conducted was defined and controlled with active participation of the assessee. Since the technology was implicitly made available, the assessee was enabled to apply the same. Hence the payments to research organisations certainly falls within the purview of the definition of FTS as defined in Article 13 of the India-UK tax treaty and Article 12 of the India-Netherlands tax treat. These payments cannot be considered as business income. Therefore, there is no application of Article 7(1) of India-UK tax treaty. The claim of the assessee that payments made by them are not FTS but rather business income of the foreign party was not accepted.

9. FTS is an open area for taxation. These services can be taxed in both the countries as is seen from the opening special clauses of the respective article in both the tax treaties, which provides for their taxation in both the tax treaties.

10. The CIT(A) observed that the assessee had relied on the decision of Hyderabad Tribunal in the case of *DCIT vs. Dr. Reddy's Laboratories Ltd. [2013] 144 ITD 302 (Hyd.)* where the issue of FTS was considered under India-USA and Canada tax treaty. The assessee relied on Article 12(2)(a)(ii) of these tax treaties to argue in this case. It is therefore established that the assessee was relying on legal provision, which was not applicable to the facts of this case. When the knowledge generated in the course on rendering of technical services is transferred to the sponsor of the research and becomes his sole property including the rights over the patents, which are likely to be generated in the course of technical services, then, there is no doubt that such technical services is chargeable to tax under the Act.

11. The CIT(A) concluded that the AO was right in coming to the conclusion that the payment by the assessee of fees to the foreign parties was FTS which was subject to tax in India. The claim of the assessee that these payments were business income earned by the foreign parties was of no relevance.

Decision

The Tribunal held in favour of the revenue as follows:

1. The CIT(A) considered the case of Dr. Reddy Laboratories relied on by the assessee, and distinguished the same on facts to state that these are not agreements with contract research organisations but with independent research entities. The agreement also indicate that the assessee had rights over the patents, secret knowledge etc., attained during the course of conducting research.

2. The assessee had admitted that the payments were taxable as FTS. Whereas, in the case of Dr. Reddy Laboratories the payments were not accepted as FTS, even under the Act.

3. The CIT(A) rightly pointed out that India-USA and India-Canada tax treaties were entirely different from India-UK and India-Netherlands tax treaties.

4. The Tribunal agreed with the CIT(A)'s order that the payments made were taxable as FTS. Since, the assessee had not deducted tax on the said payments, AO was correct in raising the demands under Sections 201 and 201(1A) of the Act.

IV) India-Canada DTAA – Payments to foreign company for services availed through Indian third party are not in the nature of reimbursement. Such payments are taxable as Fees for Included Services under the Canada tax treaty

AMD Research & Development Center India Private Limited vs. DCIT – 2014-TII-148-ITAT-HYD-INTL – Assessment Years: 2007-08 to 2010-11

Facts

1. The taxpayer is a subsidiary company of ATI Technologies, Canada (parent company). It is basically set up as a Research and Development (R&D) and Design Centre for providing captive services to its parent company.

2. The services rendered by the taxpayer mainly include development of software and hardware solutions in support of handheld and digital TV products, graphics and CPU (Central Processing Unit) and testing and validation of developed software and hardware and assistance in designs, development and support for the software and hardware solutions.

3. During the Assessment Years 2007-08, 2008-09, 2009-10 and 2010-11 under consideration, the taxpayer made payments to parent company on account of the software and engineering expenses. These payments were initially paid by the parent company for engineering services provided by Soctronics India Private Limited (Indian third party) to the taxpayer and subsequently reimbursed by the taxpayer to the parent company.

4. The Assessing Officer (AO) held that payments to parent company represented fresh cash/income and therefore, the payments were taxable in the hands of the parent company under the head 'Income from other sources' under the Income-tax Act, 1961 (the Act) as well as Article 21(3) of the tax treaty. The AO held that since tax has not been deducted at source, the taxpayer was liable to be treated as 'assessee in default' under Section 201(1) of the Act and interest was liable to be paid under Section 201(1A) of the Act.

5. The Commissioner of Income Tax (Appeals) [CIT(A)]held that 50 per cent of the amount remitted by the taxpayer to its parent company on account of software expenses was in the nature of royalty taxable in India under Section 9(1)(vi) of the Act as well as Article 12 of the tax treaty. As regards the balance amount of 50 per cent, the CIT(A) held that it was the excess payment made by the taxpayer to its parent company and hence it was taxable as business profits under Article 12(8) of the tax treaty.

Decision

The Tribunal held as under:

1. There was no agreement entered into either between the taxpayer and Indian third party or between the parent company and the taxpayer. On a perusal of Master Service Agreement (MSA) entered into between the parent company and its group companies it indicates that the taxpayer was engaged by the parent company to render chip designing and software development services.

2. The Tribunal observed that since the taxpayer did not have the complete skill set to render such services, the parent company was to provide the requisite portion of services to the taxpayer through other concerns.

3. In furtherance of the MSA, the Master Transfer Pricing Agreement (MTPA) was also entered into between the taxpayer and the parent company which clearly provided that services contracted by one party from a third party were also meant for the benefit of other members of ATI group including the taxpayer.

4. As per these agreements, the parent company was entrusting specific jobs to its subsidiaries. The services or skill set required for the execution of the said job was not available with the subsidiaries and it was procured from the third parties and made available to the subsidiary company.

5. It was observed that the exact nature of the arrangement or transaction was also examined by the Commissioner of Service Tax (CST). On a perusal of the findings recorded by CST in its order, it indicates that the benefit of services rendered by Indian third party and procured by parent company was availed by the taxpayer, and the amount was paid by the taxpayer to parent company for such services. Moreover, the findings recorded by the CST were not specifically disputed either by the lower authorities.

6. It was observed that from Assessment Year (AY) 2010-11 onwards, Indian third party was no more eligible for the benefit of deduction available under Section 10A of the Act. Accordingly, they agreed to enter into a direct agreement with the taxpayer. In view of this subsequent development, it indicates that the services rendered by Indian third party and procured by the parent company was meant for the benefit of the taxpayer also and the amount was paid to parent company for such services. Accordingly, it was not a case of any payment of extra profit/cash by the taxpayer to parent company as alleged by the lower authorities.

7. On a perusal of Contractor Service Agreement (CSA), it was observed that the services were rendered by Indian third party to parent company. Indian third party was retained by the parent company as contractor to provide certain services. In rendering the services to parent company, Indian third party may develop scientific, technical and/or business innovations.

8. Even as per the MTPA executed among the ATI group companies it indicates that the service contracted from third parties procured by parent company were made available for the benefit of other group companies, including the taxpayer.

9. Based on the facts of the case, it cannot be said that the taxpayer was the only beneficiary of the services rendered by Indian third party and it was a case of pure reimbursement of actual expenses without there being any profit element involved therein.

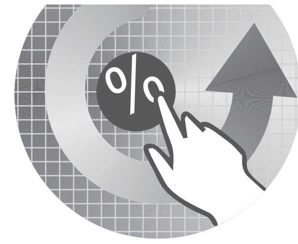
10. In our opinion, the parent company was also substantially benefited from the services rendered by Indian third party by retaining the proprietary rights and what was provided by them to the taxpayer was only a part of the benefit of such services for consideration which was inclusive of profit.

11. It was thus not a case of gratuitous payment made by the taxpayer company to parent company nor the case of reimbursement of actual expense on cost basis simpliciter without any element of profit as claimed by the taxpayer.

12. In their respective orders, the lower authorities have observed that if one were to go by the conclusion of the CST, the amount paid by the taxpayer to the parent company for services procured from Indian third party will be in the nature of FIS taxable in the hands of parent company as per the domestic law as well as the tax treaty.

13. The taxpayer has also agreed that if the case of the taxpayer for reimbursement of actual cost to parent company, without any profit element is not found acceptable by the Tribunal, the amount was liable to be treated as FIS, taxable in India in the hands of parent company as per the Act and the tax treaty.

14. Accordingly, the taxpayer was liable to deduct tax from the amount as per the provisions of Section 195 of the Act. However, since the taxpayer failed to deduct tax, it has to be treated as an 'assessee in default' under Section 201(1) of the Act to the extent of tax payable by parent company in India along with interest payable thereon under Section 201(1A) of the Act.



CA Janak Vaghani

INDIRECT TAXES
VAT Update

1) Trade Circulars

Exemption From filing of Returns under the CST Act – Partial withdrawal

Trade Circular No. 20T of 2014, dated 25-11-2014

The Commissioner of Sales Tax, Maharashtra State has issued above circular withdrawing partially the exemption from filing CST Returns.

In earlier Trade Circular No. 52T of 2007 dated 31-7-2007, it was clarified that where there are no inter-State sales in any return period then no return is required to be filed under the Central Sales Tax Act, 1956 (CST Act) provided that the Maharashtra Value Added Tax Act, 2002 (MVAT Act) return for the same period shows 'NIL' turnover of inter-State sales.

The exemption granted in respect of filing of the returns under the CST Act was posing difficulties in generating the list of returns defaulters under the CST Act in the automation system i.e. Mahavikas.

In view of the above, the issue is re-examined and fresh guidelines are being issued by modifying the earlier circulars on the subject.

The revised instructions are as follows:

(a) A dealer, who is claiming deduction, u/s. 8(1) of the MVAT Act or deduction u/s. 6A (branch transfers etc.) of the CST Act, in the MVAT return shall be required to file a return, under the CST Act.

In other words, a dealer who is effecting the following types of transactions during a period shall be required to file CST return:

(i) Inter-State sales u/s. 3 of the CST Act,

(ii) Goods transferred u/s. 6A(1) of CST Act,

(iii) Sales outside the State u/s. 4 of CST Act,

(iv) Export sales u/ss 5(1) and 5(3) of the CST Act,

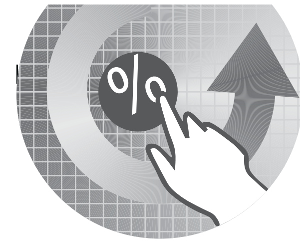
(v) Sales in the course of import u/s. 5(2) of the CST Act,

(b) This circular shall be applicable for the returns starting from the period 1st October, 2014.

2. Website Update

Application for issue of declarations under the CST Act for the period from 1-4-2005 to 31-3-2008

It is clarified on the website of the department that dealer can apply manually to the Joint Commissioner of Sales Tax (Reg.) Mumbai on or before 31-12-2014 for issue of declarations like C forms, F forms, H forms etc. It is further clarified that 31-12-2014 is the last date for making application.



CA Rajkamal Shah & CA Naresh Sheth

INDIRECT TAXES
Service Tax – Statute Update

Clarification regarding availment of CENVAT Credit after six months from the date of issue of any document specified in R. 9(1) of CCR, 2004 (effective from 1-9-2014)

As a measure of much relief to the manufacturer and service provider taking CENVAT credit, the CBEC has issued clarification in relation to amendment made in Rules 4(1) and 4(7) of CCR to the effect that the manufacturer or output provider shall not take credit after six months of the date of issue of any document specified in R. 9(1).

It has been clarified that the limitation of six months shall apply only when the credit is taken for the first time on an eligible document and it would not apply for taking re-credit of the amount reversed after the prescribed conditions in the relevant rules are met. These rules are,

1. Third proviso to R. 4(7) – If CENVAT credit is availed but payment of value of input service and service tax thereon not made within three months from the date of invoice etc., then the CENVAT credit availed is required to be paid back by the manufacturer or service provider. However, when such payment of value of input service and service tax is paid, the amount so paid can be re-credited.
2. R. 3(5B) – If the value of input or capital goods for which the CENVAT credit availed is written off or provision for written off is made in the books of account before that being put to use, the manufacturer or service provider is required to pay the amount equal to credit so taken. However, when the inputs or capital goods are subsequently used, the amounts so paid can be re-credited.
3. R. 4(5)(a) – In case input sent to job worker is not received back within 180 days, the manufacturer or sales provider is required to pay the amount equal to amount taken on such input in first instance. However, when the inputs are subsequently received back from job worker the amounts so paid can be re-credited.

It has been further clarified that the purpose of the Notification No.21/2014 – CE (NT) dated 11-7-2014 is to ensure that after issue of document under Rule 9(1), credit is taken for the first time within six months from issue of the document. Once this condition is met the limitation has no further application. Thus, in each of the above situations, the limitation of

six months would apply only when the credit is taken for the first time on an eligible document. It would not apply for taking re-credit of the amount reversed as per the prescribed condition in those rules.

(Circular No. 990/14/2014-CX-8 dtd. 19-11-2014)

INSTRUCTIONS

F.No.296/165/2014-CX.9
Government of India
Ministry of Finance
Department of Revenue
Central Board of Excise & Customs

Dated 30th September, 2014

To

All Chief Commissioners/Directors General

Subject: Action – Plan to evolve non-adversarial indirect tax administration – reg.

Sir,

The Citizens' Charter of CBEC is a declaration of our mission, values and standards to achieve excellence in the formulation and implementation of Customs, Central Excise and Service Tax policies and enforcement of cross border controls for the benefit of trade, industry and other stakeholders. One of the key objectives of the Department is to foster non-adversarial tax administration and initiatives have been taken to simplify procedures to reduce interface between the tax officials and the tax payers.

2. Further, certain initiatives are being undertaken to make the tax administration non-adversarial and taxpayer-friendly. These are as follows:–

(i) **Punctuality:** Officers are advised to maintain the appointed time as indicated in the communications regarding personal hearing/, trade meetings and any other interaction with the taxpayers. It may also be ensured that adequate gap in the timings between two meetings be maintained so that there is no undue delay in the subsequent meeting.

(ii) **Prompt acknowledgement of all letters/ complaints/references:** It may be ensured that all references/communications received from the trade are acknowledged promptly. To this end, a centralised computerized system for receipt/dispatch of dak may be put in place so that status can also be monitored centrally.

(iii} **Priority processing of representations/ communications received from taxpayers:** It is the mission of CBEC to administer indirect taxes collection by creating a climate for voluntary compliance and by providing suitable guidance to tax payers.. To this end, it is imperative that all communications received from the trade seeking clarifications are attended to expeditiously.

(iv) **Regular interaction with the trade**: As per the Board's instructions, meetings of the Regional Advisory Committee/Public Grievance Committee/Permanent Trade Facilitation Committee/Open House etc., chaired by the Chief Commissioner/ Commissioner are to be held by the concerned Zones/Commissionerates on a regular basis. In this regard the Board desires that field officers persuade assessees to ensure participation at a higher level from Trade and Industry so that these meetings result in tangible outcomes.

3. Attention is also invited to the standards of service delivery prescribed under Sevottam. Sevottam compliant formations may ensure strict adherence to the timeframes indicated therein. The other field formations which are in the process of certification are advised to implement

the standards immediately without awaiting BIS certification.

4. The Board is also in the process of

(i) Simplifying the Registration process to obviate the need for physical visit of the taxpayers to the offices.

(ii) Facilitating online credit of refunds and rebates to the taxpayers.

(iii) Easing of Compliance verification norms.

5. These initiatives are designed to bring about a more collaborative and solution-oriented indirect tax administration, in tandem with the international best practices.

Yours faithfully.

(Surendra Singh)
Under Secretary to the Govt. of India
Tel.: 2309 2413

Copy to Webmaster, Central Board of Excise and Customs with the request to upload the above instructions on the Website.

[Contd. from page 57]

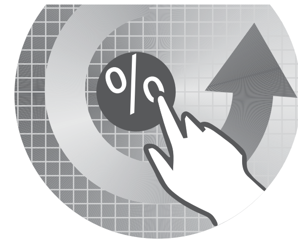
UNREPORTED

4. Section 80IB of the Income-tax Act, 1961 – Excise duty refund is "derived" from the Industrial undertaking – Eligible for deduction under section 80IB. A.Ys. 2008-09 & 2009-10

DCIT vs. M/s Coromandel International Ltd. – [I.T.A. No.: 1147 & 1157 / Hyd. / 2014; Order dated 21-11-2014; Hyderabad Bench]

The A.O. during the course of assessment proceeding observed that the assessee has included excise refunds for the purpose of computation of deduction under section 80IB of the Act. The A.O., therefore, relying on the decision of Hon'ble Apex Court in the case of *Liberty India v. CIT [2009] 317 ITR 218 (SC)* disallowed the claim of the assessee and excluded the excise duty refund from the business profits for the purpose of computing the deduction under section 80IB of the Act. On appeal, the First Appellate Authority allowed the claim of the assessee. The department being aggrieved by the order passed by the learned CIT(A) preferred further appeal before the Hon'ble Appellate Tribunal, Hyderabad. The Hon'ble Appellate Tribunal upheld the order of the learned CIT(A) by observing that in the case of Liberty India, the Hon’ble Supreme Court was considering the profits derived from sale/transfer of DEPB/ Duty Draw Back Benefits. DEPB/Duty Draw Back Benefits is given under a scheme framed under the Customs Act and it is transferable. In other words, it is a marketable commodity. Excise duty refund by assessee in the present case is neither a marketable commodity nor transferable. It is only a refund of expenditure already incurred by assessee, hence the decision of the Hon’ble Supreme Court in case of Liberty India (supra) will not apply.

Comments: Similar view has been taken by the Hon'ble Delhi Appellate Tribunal in the case of *M/s. J.K. Aluminium Co. vs. Income-tax Officer in ITA No.3303/Del./2010 order dated 29-4-2011.*



CA Bharat Shemlani

INDIRECT TAXES

Service Tax – Case Law Update

1. Services

Rent-a-Cab Scheme Operator Service

1.1 CST vs. Vijay Travels 2014 (35) STR 513 (Guj.)

The High Court in this case held that, the Legislature has not made any distinction between hiring of vehicle, which the appellant claimed to do so as to be excluded from the tax net, and renting of vehicle for the purpose of levy of service tax. The scheme has been formulated for regulating the business of renting of motor cabs or motorcycles to persons desirous of driving by themselves or through drivers, either for their own use or for matters connected therewith, nature of service provided while hiring and renting is the same such that services are taxable. Thus the assessee cannot escape tax liability on ground that, hiring is different from renting as intention of Government is to tax service provider of service which involves both hiring and renting of cab for a longer duration.

Business Auxiliary Service

1.2 CCE, Kanpur vs. Kunal Fabricators & Engineering Works 2014 (36) STR 549 (Tri.-Del.)

The Tribunal in this case held that, fabrication, erection and installation of steel storage tanks, dozers and settlers, steel structures etc. is not covered under any clause in section 65(19) of FA, 1994 hence, not liable to service tax under BAS.

1.3 CST, Delhi vs. Shriya Saran 2014 (36) STR 641 (Tri.-Del.)

The assessee was having contract with client for celebrity endorsement. The department sought to tax them under BAS. The Tribunal held that, assessee is promoting a brand and not merely marketing or promoting some particular goods or services and services of brand promotion has been made taxable w.e.f. 1-7-2010.

1.4 CCE, Chandigarh vs. Kathuria Financial Services 2014 (36) STR 662 (Tri.-Del.)

The assessee in this case has been engaged as Direct Sale Agent to evaluate prospective customers for ICICI Bank. The Tribunal held that, there is a contract between assessee and ICICI Bank and not between assessee and customers and services provided by the assessee are in the nature of promotion and marketing and the said services cannot fall under category of 'provision of service on behalf of client' as prescribed under category (c) of Notification No. 14/2004-ST and benefit thereof is not available to assessee.

1.5 Microsoft Corporation (I) (P) Ltd. vs. CST, New Delhi 2014 (36) STR 766 (Tri.-Del.)

The appellant Indian subsidiary of foreign company carried out market development

operations for foreign principal. The Tribunal observed that it was BAS provided by a sub-agent in India to a service recipient located outside. The marketing operations in India were not at behest of any Indian customer. The services were being provided to foreign recipient company to be used in their country, and they may or may not result in any sales of product in Indian soil. The customers who paid for impugned services of sale promotion was foreign company and not person who bought its products in India, though he may also be a beneficiary of such service. It is held that, though impugned service was for sale of products in India, there was export of service, not liable to be taxed in terms of ESR, 2005.

It is also held that, though there is equivalence in certain aspects for taxing the export of goods and services, there is fundamental difference between them. The latter is tangible while former is non-tangible in most cases though its effect or outcome may be tangible. It is difficult to conceive of taking service and crossing the border.

Management Consultancy Service

1.6 CCE, Allahabad vs. Bharat Yantra Nigam Ltd. 2014 (36) STR 554 (Tri.-Del.)

The Tribunal in the Present case held that, services viz. monitoring and review of performance of subsidiaries, providing technology upgradation, research and development etc. is clearly covered under the definition of Management Consultancy Service. The assessee being public sector undertaking, extended period of limitation cannot be invoked.

Business Support Service

1.7 Gecas Services India P. Ltd. vs. CST, New Delhi 2014 (36) STR 556 (Tri-Del.)

The Tribunal in this case held that, evaluation of prospective customers, collection of information, advising holding company, meant for use by holding company in Ireland is liable to service tax under BSS. Further the recipient of service is in Ireland and consideration is received in CFE, the said service qualifies as export of service. It is further held that, debit entries made during period prior to 10-5-2008 in GECAS Ireland account (associated enterprises) cannot be treated as payment made to GECAS Ireland as actual payments have been made in the year 2009, therefore demand of interest is not sustainable.

Banking & Other Financial Service

1.8 Flex Industries Ltd. vs. CCE, Indore 2014 (36) STR 659 (Tri.-Del.)

The Tribunal in this case held that, renting of plant & machinery by appellant under lease/licence agreement is not taxable under BFS but under Renting of Immovable Property Service w.e.f. 1-6-2007.

Works Contract Service

1.9 Essar Projects Ltd. vs. CCE&ST, Rajkot 2014 (36) STR 681 (Tri.-Ahmd.)

The department in this case contended that, CBEC Circular No. 98/1/2008-ST dated 4-1-2008 bars assessee from claiming benefit of Works Contract composition scheme for work contract service rendered after 1-6-2007 if tax at full standard rate become payable on part of contract value prior to 1-6-2007. The Tribunal held that, there is no prohibition in CBEC Circular for vivisection of composite contract under two classifications and service rendered under long-term contract signed prior to 1-6-2007 classifiable under Commercial or Industrial Construction Service and Works Contract Service. The Circular only prohibits vivisection of single composite service and not of a contract. A construction contract entered prior to 1-6-2007 which envisages performing five different tasks/services of which one task/service is completed prior to 1-6-2007 and the remaining four tasks performed after 1-6-2007 then for such four tasks performed after 1-6-2007 composition scheme can be availed. The assessee is entitled to avail composition

rate for value of work contract service provided after 1-6-2007 and classification of service prior to impugned date not to affect entitlement to composition scheme for service rendered subsequent to impugned date.

Commercial Coaching or Training Service

1.10 Hindustan Institute of Aeronautics 2014 (36) STR 703 (Tri.-Del.)

The training programme to impart and promote advancement and diffusion of knowledge in the field of aerospace, aviation science, aircraft engineering, technology and evaluation of aeronautical professional is not liable to service tax in the light of decision in *Indian Institute of Aircraft Engineering 2013 (30) STR 689 (Del.)*

Online information and database access or retrieval Service

1.11 British Airways vs. CCE (Adjn) Delhi 2014 (36) STR 598 (Tri.-Del.)

The department in this case demanded service tax under RCM on receipt of service from foreign CRS/GDS companies. The assessee contended that, no service was received as transaction occurred between Head Office in UK and CRS/GDS companies located abroad and payment therefore was also made outside India. The Tribunal observed that, appellant was a branch office, and not a temporary establishment for some limited purpose and by virtue of section 66A(2) of FA, 1994 it has to be treated as a separate person from Head Office, such that transaction only existed between Head Office and foreign companies. Thus it is held that, appellant cannot be treated as recipient of service provided by CRS/GDS companies and no Service Tax can be charged from them.

Supply of tangible goods for use Service

1.12 Reliance Industries Ltd. vs. CCE&ST LTU Mumbai 2014 (36) STR 820 (Tri.-Mumbai.)

In this case, the appellants entered into agreements with owners of Offshore Supply Vessels (OSVs) for supply of OSVs for deployment by appellant in eastern and western coasts of India in their offshore oil and exploitation sites. The Tribunal held that, since right of possession and effective control of such machinery, equipment and appliances not parted with such activity comes under the scope of supply of tangible goods for use service. It is further held that, vessels in question not being taken to installation and structures, not to be considered as vessels within the meaning appearing in Notification No. 1/2002-ST dated 1-3-2002. It is also held that, from 1-3-2002 to 7-7-2009, FA, 1994 was extended only to designated areas in Continental Shelf and Exclusive Economic Zone of India and since vessels were plying from Kakinada Port to installations/structures through sea which is not in India and thus non-designated area.

Franchise Service

1.13 Directi Internet Solutions P. Ltd. vs. CST, Mumbai 2014 (36) STR 849 (Tri.-Mumbai.)

The appellant in this case accredited with International Corporation for Assigned Names and Numbers (ICANN), after identifying and setting minimum standards for registration, allowed to use symbol indicating accreditation. However, mission, core values and agreement between ICANN and assessee not indicating any service/process for which ICANN was known and was used by the assessee. The Tribunal held that, ICANN only set minimum standards for performance of registration function and permitted use of its symbol that did not imply that registrars were providing any service or process identified with ICANN. In absence of any above-mentioned service or process being used by assessee, it could not be said that assessee was providing franchise service of associate franchisor of ICANN. Accreditation and representing ICANN were two different things, and assessee was only accredited by ICANN. It is further held that, agreement between assessee and reseller was on principal to principal basis and resellers could be

considered as franchisee or associate franchisor of ICANN.

Real Estate Agent Service

1.14 Sarjan Realties Ltd. vs. CCE, Pune 2014 (36) STR 877 (Tri.-Mumbai)

The appellant in this case engaged in purchasing and selling of land suitable for wind farm projects. The department alleged that acquisition of land on behalf of manufacturer of wind turbine generators and therefore liable to service tax under Real Estate Agent Service. The Tribunal observed that, appellant acquired and sold land in own name and also borne cost of acquisition and other related costs which are later recovered from customer. The Tribunal held that, notwithstanding agreement with SEL, legal transaction indicating assessee purchaser/seller of land not to be washed away and word "commission" in agreement facilitating 11% on total cost of land not to negate legality of transaction and hence consideration received is not liable to service tax.

Advertising Agency Service:

1.15 Spring Advertising Pvt. Ltd. vs. CCCEX&ST, Aurangabad 2014 (36) STR 883 (Tri-Mumbai.)

The Tribunal in this case held that, the appellant only collected advertisement and forwarded to newspapers for publication and not carried out any activity connected with making, preparation, display etc. is not liable to service tax under Advertising Agency Service.

Stock Broker Service:

1.16 Religare Securities Ltd. vs. CST, Delhi 2014 (36) STR 937 (Tri-Del.)

The Tribunal in this case held that, delayed payment charges (DPC) collected by the appellant is not liable to service tax as it was not on account of any stock broking service, but it was collected only in case of overdue payments, as penal interest for compensation of assessee for payments already made by it to the Exchange on behalf of the client. It is further held that, no service tax is payable on services provided by sub-brokers in Jammu & Kashmir to clients situated in J&K even though accounts of such services were being maintained in Delhi NCR offices, which is for the sake of facility and maintaining control on its finance.

Commercial or Industrial Construction Service

1.17 Graphite India Ltd. vs. CCE, Nashik 2014 (36) STR 948 (Tri.-Mumbai)

The appellant in this case supplied GRP pipes manufactured by it and carried out lowering, laying, joining and testing such pipes at the site of customer. They contended that since pipelines laid for a Government of Gujarat Undertaking i.e. GIDC for providing water supply they are not liable to service tax. The Tribunal held that, GIDC has been set up to establish and organise areas/centres for commercial purposes or industries within the State of Gujarat and therefore laying of pipeline is taxable under CIC service.

2. Interest/Penalties/Others

2.1 Gurmehar Construction vs. CCE, Raipur 2014 (36) STR 545 (Tri.-Del.)

The Tribunal in this case held that, free supply of diesel by service recipient is not includible in gross consideration received by service provider for rendition of taxable service and therefore demand relating to free supplies of diesel is not sustainable. It is further held that, interest is not chargeable when wrongly taken CENVAT credit has been reversed before utilisation.

2.2 Khosla Profile Pvt. Ltd. vs. CCE, Thane-I 2014 (36) STR 592 (Tri.-Mumbai.)

The Tribunal in this case allowed refund under Notification No. 41/2007-ST on export of goods by holding that in the invoice of CHA there is description of goods exported and refund cannot be denied on sole ground that agreement between foreign buyer and appellant is not produced.

2.3 Gujarat Borosil Ltd. vs. CCE&ST, Surat 2014 (36) STR 808 (Tri.-Ahmd.)

The appellant in this case contended that, services provided to them by foreign service provider outside India and consumed/received by them outside India will not attract service tax as import of service. The Tribunal held that, for services specified in rule 3 of Import of Service Rules the place of consumption/receipt of service is immaterial, once the recipient of such service is located in India.

2.4 DHL Logistics Pvt. Ltd. vs. CST, Mumbai-I 2014 (36) STR 874 (Tri.-Mumbai)

In this case adjudicating authority confirmed demand under cargo handling service whereas appellant were not put to notice under such category but under category transport of goods by air service. The Tribunal held that, demand is beyond the scope of show cause notice hence, not sustainable.

2.5 CST, New Delhi vs. Lea Associates South Asia P. Ltd. 2014 (36) STR 909 (Tri.-Del.)

The Tribunal in this case held that, rate of tax prevailing at the time of rendition of taxable service is applicable and not the rate of tax in force at the time of receipt of payments for such services.

2.6 CCE, Raipur vs. Anand Colour Lab 2014 (36) STR 915 (Tri.-Del.)

The Tribunal in this case held that, section 85(4) authorises Commissioner (Appeals) to hear and determine an appeal and pass such order as "he may think fit", therefore he has powers to remand matter to primary authority.

3. CENVAT Credit

3.1 CST, Bengaluru vs. Team Lease Services Pvt. Ltd. 2014 (36) STR 543 (Kar.)

The High Court in this case held that, CENVAT credit of service tax paid on Group Accident and Group Medical policies for employees is admissible under rule 2(l)(i) of CCR, 2004.

3.2 Beico Industries Pvt. Ltd. vs. CCE&ST Vapi 2014 (36) STR 551 (Tri.-Ahmd.)

The Tribunal in this case held that, denial of credit for want of registration with Central Excise Department is not sustainable as entire exercise being done for setting up of factory for manufacturing of excisable goods that can be done so only when assessee erects, installs and commission capital goods with help of various agencies.

3.3 Jotindra Steel & Tubes Ltd. vs. CCE, Delhi-IV 2014 (36) STR 672 (Tri.-Del.)

The Tribunal in this case held as under:

- Allowed CENVAT credit of service tax paid on shipping service, documentation charges, terminal handling charges in respect of exported goods.
- Assessee has two options whereby they can either take credit instead of refund when service relates to export. The Notification which permits refund does not debar availment of credit in case refund is not claimed. The assessee cannot be pressurized to claim refund only.

3.4 Binani Cement Ltd. vs. CCE&ST, Jaipur-II 2014 (36) STR 676 (Tri.-Del.)

The Tribunal in this case allowed CENVAT credit of service tax paid on insurance for workers as the same has integral connection with manufacture.

3.5 Gujarat Forging Ltd. vs. CCE, Rajkot 2014 (36) STR 677 (Tri.-Ahmd.)

The appellant in this case as per terms of warranty was under obligation to provide repair and maintenance service to the customers. They have claimed CENVAT credit of service tax paid on repair & maintenance service during warranty period. The Tribunal held that, appellant is entitled to claim such credit which is after sale service charges and value of goods included such warranty charges.

3.6 Punjab Alkalies & Chemicals Ltd. vs. CCE&ST Chandigarh-II 2014 (36) STR 688 (Tri.-Del.)

The Tribunal in this case allowed CENVAT credit of service tax paid on photostat services as said services are necessary for business.

3.7 Mercedez Benz India P. Ltd. vs. CCE, Pune-I 2014 (36) STR 704 (Tri.-Mum.)

The Tribunal in this case held that, trading is not a service prior to 1-4-2011 hence cannot be treated as exempt service and credit thereon is entirely not allowed. For period prior to 1-4-2011 credit should be apportioned with reference to turnover of manufactured cars and turnover of traded cars.

3.8 JSW Steel Ltd. vs. CCE, Thane-I 2014 (36) STR 801 (Tri.-Mum.)

The Tribunal in this case allowed CENVAT credit of service tax paid on clearing charges paid to CHA, commission on export sale, material handling charges, terminal handling charges, bank commission charges, aviation charges and courier charges as the same are used in the course of export of goods where place of removal is port.

3.9 Moser Baer India Ltd. vs. CCE, Noida 2014 (36) STR 815 (Tri.-Del.)

The department in this case denied credit on the ground that, documents for availing credit issued in the name of head office and not the factory. The Tribunal held that, credit is available *qua* manufacturer and not *qua* factory and the basic requisite condition for distribution of credit is that head office receives invoices towards purchase of input service and pays service tax. Being a registered ISD, they are entitled to distribute credit to its manufacturing plant. Since the credit availed by the appellant reflected in statutory records no suppression of facts or mis-statement with *mala fide* intention attributable to invoke longer period of limitation.

3.10 Rajasthan Diesel Sales & Service vs. CCE, Jaipur II 2014 (36) STR 832 (Tri.-Del.)

The department in this case denied CENVAT credit of service tax paid on repair & maintenance service received by branch office but paid by head office on the ground that invoices for services were in the name of branch office. The Tribunal held that, receipt of service and eligibility to CENVAT credit is not disputed and objection of revenue rectified by producing certificate from service provider that address may be read as head office therefore no valid reasons for denial of credit.

3.11 Apollo Tyres Ltd. vs. CCEC&ST, Calicut 2014 (36) STR 835 (Tri.-Bang.)

The appellant in this case claimed CENVAT credit of GTA service utilised for clearance of tubes and flaps in replacement market being part of trading activity. The Tribunal held that, proportionate credit attributable to trading arrived at in accordance with Standard Accounting Principle is required to be reversed. It is further held that, if GTA service credit taken is reflected in returns and process of trading activity is also intimated to department there is no suppression or misdeclaration with intent to evade duty.

3.12 PNB Metlife India Insurance Co. Ltd. vs. CCEST&C, Bengaluru 2014 (36) STR 891 (Tri.-Bang.)

The Tribunal in this case allowed CENVAT credit of service tax paid on reinsurance service procured by the appellant from overseas company as reinsurance is a statutory obligation and is coterminous with the insurance policy. The percentage of insurance to be reinsured is directly connected to the premium collected from the persons who are insured with insurer and it is basically transfer of a portion of the risk and therefore it can be said that reinsurer is providing the service to insurance company when he accepts to reinsure a portion of insurance undertaken by the insurer.

Janak C. Pandya, *Company Secretary*

CORPORATE LAWS
Company Law Update

[2014] 187 Comp Cas7 (Bom) – [In the Bombay High Court] – SKS Ispat and Power Ltd., In re

In the Scheme of Arrangement, the share exchange ratio is a commercial decision of well-informed equity share holders and it is not for court to sit this value judgment

Brief facts

SKS Ispat and Power Limited ("SKS") has filed a petition for obtaining court sanction to the Scheme of Arrangement ("Scheme"). As per the scheme, SKS propose to demerge its cement division and transfer to a separate company. The resultant company is named as SKS Cement Ltd. The demerged company is a wholly-owned-subsidiary ("WoS") of SKS.

As per the scheme, the net value of assets of the cement division is arrived at ` 96.27 lakh. In lieu, SKS Cement is to issue equity shares to SKS. The SKS Cement will be a WoS of SKS. The valuation of share swap ratio was decided based on the Chartered Accountant report.

The scheme was approved by the board of directors of the both the companies. The scheme was also approved by the equity share holders of both the companies.

The scheme was objected by two creditors namely M/s. L & T Finance Ltd. ("L&T") and Tata Capital Financial Services Ltd. ("Tata Cap"). Later on, L&T has withdrawn the objection but insisted for recording their objection. Tata Cao continues to object the scheme on the ground of valuation report and valuation method adopted therein.

The court observed certain flow into valuation method. It also observed that valuation report is one year old. The court has directed another chartered accountant ("CA") who is on panel of official liquidator to provide fresh valuation report. CA has requested for various new information. After reviewing all additional information, it has concluded that cement division is still in formative stage and thus only viable valuation method is actual expenditure incurred, i.e., net assets value. It also observed that same method was also adopted in the old valuation report. In the view of Tata Cap, the P/E ratio is more realistic and reflects the true value.

Tata Cap also objected to the second valuation report. It has contended that for cement business, various licences and mining licence should have been considered for the purpose of valuation.

Judgments and reasoning

Court has rejected the objection raised by Tata Cap. Court has analysed various valuation methods including DCF valuation and P/E valuation method as submitted by the Tata Cap. Court has observed that in case of Greenfield

project, DCF valuation has no utility. On P/E methods, it has observed that when plant is not operating and there is no history of past profits, it is impossible to estimate future profits for this method. Court also observed that except Tata Cap, all other secured and unsecured creditors and the equity share holder have approved the scheme. In this regard, court has accepted the submission of the petitioner to refer the judgment of the Supreme Court in *Miheer H. Mafatlal v. Mafatlal Industries Ltd. [1996] 87 Comp Cas 792 (SC).* In the said judgments, it was observed that …. Financial institutions and statutory corporations… are naturally informed about the business requirements and economic needs and the requirements of corporate finance in the light of their personal interest…. They would not wholly approve the scheme if it was contrary to the interest of share holders as a class"…

In the said judgment, court has observed that share exchange ratio is a commercial decision of well-informed equity share holders and it is not for court to sit this value judgment.

Court has also accepted the reliance placed by the petitioner in the single court judgment in *PMP Auto Industries Ltd., In re [1994] 80 Comp Cas 289 (Bom)* where it is mentioned that … it is settled law that there need not be a unity of the objects or purposes of the two companies in questions….."

[2014] 187 Comp Cas 143 (SC) – [In the Supreme Court of India]

Stock Exchange Bombay vs. V.S. Kandalgaonkar and Others.

That lien possessed by the stock exchanges on the assets of the defaulting members makes it secured creditors. Thus, being a secured creditor would have priority creditors over government dues.

Brief facts

The Stock Exchange Bombay ("BSE") declares one of its members as defaulters. The Income Tax ("IT") department has sent a notice to BSE, and claimed that the membership card being liable to auction, the money must be paid first to settle income tax claim.

BSE has declined the IT claim with following submission.

1. Under Rules 5 & 6 of stock exchange, membership right is a personal right and personal privilege and is inalienable.

2. Under rule 9, upon death or default of a member his right of nomination shall cease and vested with the exchange.

IT has issued prohibitory order restraining BSE to pay the dues to any other persons.

BSE has filed writ petition claiming the relief as follows.

a. To issue writ of certiorari or a writ in nature of certiorari or direction under Article 226 of the constitution calling for records for recovery proceedings initiated by IT and quashed the same.

b. To issue writ of mandamus or appropriate writ and direction under Article 226 directing IT to withdraw recovery proceedings.

c. Allow BSE to exercise the right of nomination in respect of membership of defaulting member. Also to apply consideration received thereof in accordance with the rules, bye-laws and regulations of the exchange.

The above contention of BSE was rejected and writ was dismissed.

BSE has filed a special leave petition for staying on judgment of law. However, operation of judgment was not stayed to the extent of making payment to IT and release of certain securities in favour of IT.

The court has looked at the followings.

a. Provisions of section 226 of the Income-tax Act which provides for garnishee notice.

b. Sections 8 and 9 of the Securities Contracts (Regulation) Act, 1956 ("SCR") related to rules and regulations and bye-laws to be made by stock exchanges.

c. Provisions related to (1) Membership a personal privilege; (2) Right of nomination; (3) Right of nomination of deceased or defaulter member; (4) Forfeited or lapsed right of membership; (5) Dues of exchange and clearing house; (6) Liabilities related to contracts and other relevant provisions; (8) Provisions related to defaulter's assets, application of defaulters' assets and other amounts.

The court has formulated the questions to be decided out of previous judgments as follows.

a. Whether IT is right in attaching the sale proceeds of nomination rights of defaulting member. If not, can there is an attachment under rule 26(1) of Schedule II to IT Act for balance amount lying with BSE under rule 16(1)(iii). AND

b. Whether deposit made by defaulting member under various heads with BSE are attachable under section 226 (3) (i)(x) read with rule 26(1) (c) of Schedule II to IT Act.

BSE has submitted as follows.

1. As per judgment in *Stock Exchange Ahmedabad vs. Asst. CIT [2001] 3 SCC 559,* the sale proceeds of membership card, as membership card is a personal privilege the same cannot be attached by IT. Once, a member is declared as defaulter, his all rights including right of nomination cease and vest with stock exchange

2. In *Isha Valimohamad vs. Haji Gulam Mohamad and Haji Dada Trust [1975] 1 SCR 720,* Supreme Court has made a distinction between "privilege" and "accrued right". Thus, no accrued right to property was ever vested in defaulting member.

Court has also referred to the judgment in *Bombay Stock Exchange vs. Jaya I. Shah [2004] 1 SCC 160* on claim made by a non-member against a member under arbitration award under 1940 act.

Court has also referred to the settled law as to Government debts have precedents only over unsecured creditors as held in *Dena Bank vs. BhikhabhaiPrabhudas Parekh and Co. [2005] 5 SCC 694.*

Court has also refer to other judgments as to distinguish on statutory lien against other creditors.

Judgments and reasoning

The Court has allowed the BSE petition. The court has set aside the order passed by the Division Bench. The court based on various judgments as mentioned above has observed that lien possessed by the stock exchanges makes it secured creditors. Thus, being a secured creditor would have priority creditors over government dues. Court also noted that based on Dena Bank's case (supra) government dues only have a priority over unsecured creditors.

CA Mayur Nayak, CA Natwar Thakrar &
CA Pankaj Bhuta

OTHER LAWS
FEMA Update

In this article, we have discussed recent amendments to FEMA through Circulars issued by RBI:

1. Export of Goods / Software / Services – Period of Realisation and Repatriation of Export Proceeds – For exporters including Units in SEZs, Status Holder Exporters, EOUs, Units in EHTPs, STPs and BTPs

Vide A.P. (DIR Series) Circular No. 52 dated November 20, 2012, RBI had extended the enhanced period for realisation and repatriation to India, of the amount representing the full value of exports, from six months to twelve months from the date of export. This relaxation was available up to March 31, 2013. Thereafter, *vide* A.P. (DIR Series) Circular No. 105 dated May 20, 2013, this period was brought down from twelve months to nine months from the date of export, valid till September 30, 2013. Further, in terms of A.P. (DIR Series) Circular No. 35 dated April 1, 2002, A.P. (DIR Series) Circular No. 25 dated November 1, 2004 and A.P. (DIR Series) Circular No. 108 dated June 11, 2013, the Units located in SEZs, Status Holder Exporters, EOUs, Units in EHTPs, STPs & BTPs were required to realise and repatriate full value of goods/software/services, to India within a period of twelve months from the date of export.

RBI has decided that henceforth the period of realisation and repatriation of export proceeds shall be nine months from the date of export for all exporters including Units in SEZs, Status Holder Exporters, EOUs, Units in EHTPs, STPs & BTPs until further notice.

However, the provisions in regard to period of realisation and repatriation to India of the full exports made to warehouses established outside India remain unchanged, i.e., 15 months from the date of shipment of goods.

(A.P. (DIR Series) Circular No. 37 dated 20th November, 2014)

[Comments: Vide the above Circular RBI has given a much needed clarity regarding the period of realisation and Repatriation of Export Proceeds for all other exporters (as post 30th Sept., 2013 there was no clarity for realisation of exports proceeds for exporters other than Units in SEZs, Status Holder Exporters, EOUs, Units in EHTPs, STPs and BTPs.)]

2. Acquisition/Transfer of Immovable property – Payment of taxes

RBI has clarified that transactions involving acquisition of immovable property under these

regulations shall be subject to the applicable tax laws in India.

Accordingly, the RBI has since amended the Notification 21/2000-RB dated May 3, 2000, by adding Regulation 9 through Notification No. FEMA.321/2014-RB dated September 26, 2014 w.e.f. 17th October, 2014.

(A.P. (DIR Series) Circular No. 38 dated 20th November, 2014 / Notification No. FEMA.321/2014-RB dated September 26, 2014)

(Comments: This Circular reaffirms the requirement of deduction of tax at source under tax laws.)

3. External Commercial Borrowings (ECB) Policy – Parking of ECB proceeds

In terms of A.P. (DIR Series) Circular No. 52 dated November 23, 2011 relating to parking of proceeds of External Commercial Borrowings (ECB), eligible ECB borrowers are required to bring ECB proceeds, meant for Rupee expenditure in India for permitted end uses, such as, local sourcing of capital goods, on-lending to Self-Help Groups or for micro credit, payment for spectrum allocation, etc., immediately for credit to their Rupee accounts with AD Category–I banks in India.

With a view to providing greater flexibility to the ECB borrowers in structuring draw down of ECB proceeds and utilisation of the same for permitted end uses, the RBI has permitted AD Category – I banks to allow eligible ECB borrowers to park ECB proceeds (both under the automatic and approval routes) in term deposits with AD Category–I banks in India for a maximum period of six months pending utilisation for permitted end uses. The facility will be with the following conditions:

i. The applicable guidelines on eligible borrower, recognised lender, average maturity period, all-in-cost, permitted end uses, etc. should be complied with.

ii. No charge in any form should be created on such term deposits i.e. to say that the term deposits should be kept unencumbered during their currency.

iii. Such term deposits should be exclusively in the name of the borrower.

iv. Such term deposits can be liquidated as and when required.

The amended ECB policy will come into force with immediate effect and is subject to review. All other aspects of ECB policy would remain unchanged.

(A.P. (DIR Series) Circular No. 39 dated 21st November, 2014)

(Comments: This is a welcome amendment on the part of the RBI as ECB Borrowers will now be able to earn interest on term deposits till the time they are able to utilize the ECB proceeds for the permitted end uses.)

4. Release of Foreign Exchange for Haj/Umrah pilgrimage

The A.P. (DIR Series) Circular No. 19 dated October 30, 2000; A.P. (DIR Series) Circular No.11 [A.P. (F.L. Series) Circular No.1] dated November 13, 2001 and A.P.(DIR Series) Circular No. 50 [A.P.(FL Series) Circular No. 7] dated May 4, 2010, relate to release of foreign exchange in the form of foreign currency notes and coins which remain as hitherto.

The RBI has now permitted Authorised Dealers and Full Fledged Money Changers to release the full amount of BTQ entitlement in cash (i.e. USD 10,000/-) or up to the cash limit specified by the Haj Committee of India, to the Haj/ Umrah pilgrims also.

(A.P. (DIR Series) Circular No. 40 dated 21st November, 2014)

5. Routing of funds raised abroad to India

The RBI reviewed the extant regulatory framework under the Foreign Exchange Management Act (FEMA), 1999 related to the External Commercial Borrowings (ECB), issuance of guarantees, and overseas direct investment from India.

Accordingly, the RBI noticed that some Indian companies are accessing overseas market for debt funds through overseas holding / associate / subsidiary / group companies. It has also been reported that such borrowings are raised at rates exceeding the ceiling applicable in terms of extant FEMA regulations and that the funds so raised are routed to the Indian companies which accounts for sole/major operations of the group. Different modalities/structures are resorted to for channelling such funds for Indian operations including investment in rupee bonds floated by the Indian company.

On a review of the matter in light of the existing regulatory framework, the clarifications are as under:

i. Indian companies or their AD Category – I banks are not allowed to issue any direct or indirect guarantee or create any contingent liability or offer any security in any form for such borrowings by their overseas holding / associate / subsidiary / group companies except for the purposes explicitly permitted in the relevant Regulations.

ii. Further, funds raised abroad by overseas holding / associate / subsidiary / group companies of Indian companies with support of the Indian companies or their AD Category – I banks as mentioned at (i) above cannot be used in India unless it conforms to the general or specific permission granted under the relevant Regulations.

iii. Indian companies or their AD Category – I banks using or establishing structures which contravene the above shall render themselves liable for penal action as prescribed under FEMA, 1999.

(A.P. (DIR Series) Circular No. 41 dated 25th November, 2014)

(Comments: Since forex funds are cheaper than the rupee funds, various corporates have been tapping up the forex debt market to repay rupee loans or to meet other capex needs in recent years. This circular will prevent companies from raising offshore bonds with the intent of routing the funds back to India via the issue of rupee-denominated bonds in the onshore market.)

6. Import of Gold (under 20:80 Scheme) by Nominated Banks / Agencies / Entities

The RBI has reviewed the circulars starting with A.P. (DIR Series) Circular No. 25 dated August 14, 2013 and the subsequent clarifications issued from time to time, resting with the A.P. (DIR Series) Circular No. 133 dated May 21, 2014, relating to the Import of Gold by Nominated Banks / Agencies / Entities under the 20:80 Scheme.

The Government of India has now withdrawn the 20:80 Scheme and restrictions placed on import of gold. Therefore, all instructions issued about the scheme from time to time starting with A.P. (DIR Series) Circular No. 25 dated August 14, 2013 stand withdrawn with immediate effect.

[A.P. (DIR Series) Circular No. 42 dated 28th November, 2014]

(Comments: This is a very thoughtful and practical decision taken by the Government of India. In the backdrop of easing CAD position and improved forex reserves, Government has decided to scrap the 20:80 Scheme. The 20:80 Scheme had opened the floodgates to import of gold dominated by six nominated agencies which raised alarm bells in the Government. The scrapping of the scheme is expected to cut smuggling and raise legal shipments into the world's second-biggest consumer of the metal after China.)

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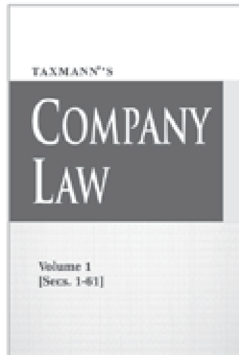

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BEST OF THE REST

1. Grant of probate – Execution of Will – Failure by propounder of Will to explain suspicious circumstances regarding genuineness of Will – Execution of Will, not proved – Propounder not entitled to grant of probate. Succession Act, 1925, Ss. 63(c), 222, 276

The plaintiff originally filed a Petition to grant probate of the Will stated to have been executed by his mother Smt. Rajam Sarangachari. The plaintiff contended that Smt. Rajam Sarangachari executed her last with and testament on 28th February, 1991 in the presence of two witnesses. The plaintiff was appointed as the executor of the Will. The Will contained certain stipulations with regard to the disposal of movable and immovable properties left by the testatrix. Defendants 1 and 2 are the children born to the pre-deceased daughter of the testatrix. The testatrix died on 24th January 2001. The plaintiff long thereafter filed Petition with a prayer to grant probate of the Will.

The first defendant filed a written statement disputing the execution of the Will. According to the first defendant, the testatrix was not in a sound and disposing state of mind while executing the Will. The Petition for grant of probate was filed long after the period of limitation. According to the first defendant, the plaintiff fabricated the Will to grab the property from the legal representatives of Smt. Rajam Sarangachari, who died intestate on 24th January 2001.

The High Court held that the Will has to be proved like any other documents. In the case of Will, the testator is not alive and as such the burden is on the propounder of the Will to prove due execution. S. 63 (c) of the Indian Succession Act lays down the requirement of a valid Will. The statute provides that the Will shall be attested by two or more witnesses each of whom has seen the testator signing or affixing his mark to the Will. There is a further requirement that the witnesses have to sign the Will in the presence of the testator. The Will must therefore be proved in the manner indicated under S. 63 of the Indian Succession Act and S. 68 of the Evidence Act.

The Hon'ble Court noted that in the instant case, alleged receipt issued by sisters of propounder and father of defendants acknowledging receipt of amount from propounder due to them though indicates the execution of Will, was not clear as to whether it was the very same Will, which was referred to in the said documents. Even though the plaintiff relied on said documents to the effect that payments were made immediately after the death of testatrix in year 2001 and in accordance with the condition of Will, he had come up with a case that he had seen the Will

for the first time only in year 2006. The evidence of propounder goes contrary to the recitals in documents. This is more on account of the fact that the notary failed to indicate as to whether he had entered the execution of document in his register, kept under the Notaries Act and Rule. The propounder had not summoned the notary register maintained by the notary. He has just said that the notary was no more. The Will was typed keeping the place earmarked for "date" blank. It was later filled up with pen. There was no evidence before Court as to who filled up the date and with whose handwriting it was made. The propounder was expected to clear all these doubts. However, he had miserably failed in all aspects to prove the doubt with regard to due execution of Will. Therefore the Propounder was not entitled to grant of probate.

J. S. Vasudevan v. R. Murari & Anr. AIR 2014 Madras 199.

2. Compensation – Future prospects – Award towards – Future prospects relevant factor to be considered for determining annual income for calculating and awarding amount of compensation – Social Welfare Legislation Motor Vehicles Act, 1988, Ss. 163A, 168

The claimants/respondent Nos. 1 to 3, who are wife and sons of the deceased Bhanu Thapa, filed an application for compensation of ` 9,78,000/- (Rupees nine lakh seventy eight thousand) before the Tribunal on 2-1-2012 in respect of death of late Bhanu Thapa, who died in an accident, arising out of use of motor vehicle.

The learned Tribunal passed an award of ` 8,01,500/- in favour of claimants/respondent Nos. 1 to 3 under different heads and directed the opposite party No. 1 / appellant to pay the said compensation with interest @ 10% per annum from the date of filing of the claim petition, till the date of its realisation.

The High Court held that the Tribunal was correct in recording the finding that the deceased was 41 years of age at the time of accident and rightly applied the multiplier of 15. The claimants in their claim application has mentioned the age of deceased as 41 years. This is a first document. Apart from age, date of birth of the deceased has also been mentioned in it. The claimant No. 1 in her statement also stated that the age of deceased was 41 years. No evidence has been adduced on behalf of any of the opposite parties in rebuttal thereto. Driving licence was issued in the year 2005. It was an old document in comparison to election identity card, which is of the year of 2007. The opposite parties have not placed on record any document to substantiate the age of deceased mentioned in the election identity card. Even if there are two contradictory documents in respect of age of deceased, then it being a social and welfare legislation, the document which favours the claimants has to be accepted.

The High Court further held that about the compensation awarded by the Tribunal under the heads of "Future prospects" and "non-pecuniary" are concerned, it is clear from various judgments of Apex Court that in such a matter the compensation under the head "Future prospects" can be awarded. However, in view of judgment in Sarla Verma's case AIR 2009 SC 3104 which relied upon by a subsequent judgment of the three-Judge Bench in case of ***Rajesh & Ors. vs. Rajbir Singh & Ors. (2013) 9 SCC 54***, the only addition should have been @ 30% of the total income as deceased was 41 years of age i.e. in the age group of 40 to 50 years. Therefore, the award of the Tribunal to that extent was modified as a sum of ` 1,17,000/- i.e. 30% of ` 3,90,000/- as compensation in place of ` 2,50,000/- under the head "Future prospects".

The compensation awarded on account of "funeral expenses" and `loss of consortium' has not been claimed in the claim petition nor it has been awarded by the Tribunal, but as held by Hon'ble Apex Court that the Tribunal/Court should award just, equitable, fair and reasonable

compensation, if necessary, ignoring the claim made in the application for compensation.

The Branch Manager, Bajaj Allianz General Insurance Co. Ltd., Siliguri, West Bengal v. Smt. Rita Thapa & Ors. AIR 2014 Sikkim 22

3. Hindu Law – Joint family property – Partition suit – Failure by plaintiff to prove that properties acquired in name of his father defendant were joint family properties – Legal necessity or benefit of joint family

There is no dispute that the appellant and the respondents belong to one family. The appellant as plaintiff has filed the suit for partition claiming that the plaint schedule landed properties are the ancestral property and rest of the properties have been acquired out of the joint family nucleus. But, respondent No. 1., who is the father of the appellant and of respondent Nos.3 and 4, has managed to create some documents of acquisition in respect of some of the plaint schedule properties in his name. It is alleged that R.1 though was a State Govt. servant he was having a surplus personal income for acquisition of immovable properties. All the plaint schedule properties are under the joint possession and enjoyment of the family even though some properties have been acquired in the names of the appellant, the respondent No. 1 and late Purusottam Senapati (father of respondent No. 1).

The Trial Court had asked the parties to maintain status quo in respect of the suit plot. The appellant submitted that his limited prayer to restrain the respondents from creating any third party interest in suit for partition should have been allowed by the trial court in order ot avoid multiplicity of litigation.

The High Court held that though in the plaint there was averment that the joint family had a nucleus, there was nothing to show that it was such as out of it the properties acquired in the name of defendant father of plaintiff could be purchased. Since, father of the plaintiff, was having his own income and some of the suit properties had been acquired in his name, the plaintiff ought to come with a definite pleading as to what was the total income of the joint family property and what was the surplus after defraying the needs of the family. There is no presumption that a Hindu family, because it is joint, possesses nucleus and property acquired in the name of any of the members of the joint family has been acquired out of the income of the nucleus. Hindu law does not prohibit a member of a joint family from acquiring any property for his own benefit. Therefore, any property acquired in the name of an individual member is not presumed to be the property of the joint family or that it has been acquired for the joint family. Heavy onus lies on the plaintiff seeking partition of any property acquired in the name of a member of the joint family to prove that the property was joint. That being the position of law, the plaintiff could not be said to have made out a strong ***prima facie*** case that the properties acquired in the name of his father were joint family properties. However, instant being a partition suit, it stands in a separate footing. The father was the head of the joint family consisting of the plaintiff and the defendants, his wife and his sons. Father and mother had grown old. It was submitted that both were suffering from serious ailments and for their treatment they need money. It was also submitted that though the plaintiff was in business, other two sons of the defendant were unemployed and to support them financially to start their own business huge amount of money was necessary. That apart, being the head of the joint family, defendant was entitled to dispose of joint family property for legal necessity or for the benefit of the joint family. On the other hand, this being a partition suit, if alienations were made during pendency of the suit it might adversely affect the rights of the plaintiff if he ultimately establishes his stand. It was also claimed by plaintiff that in one of the suits house he was often staying to look after his small business. In circumstance, directions were issued

to parties not to alienate any part of property without leave of Court.

Rabindra Mohan Senapati v. Budhiram Senapati and Others AIR 2014 Odisha 152

4. Precedent – Binding nature – Decision rendered by Division Bench in appeal arising out of common order – Is binding on another Division Bench – If later Division Bench disagree with view of earlier Bench, it has to refer matter to Full Bench – It cannot decide appeal on merits by taking contrary view

The State of Assam (Education Department) in the years 1988 and 1991, issued two advertisements inviting applications from eligible candidates for the posts of "Assistant Teacher". Language Teacher and some other posts in the intermediate cadre in different provinialised higher secondary schools in several districts of Assam. Candidates in thousands, if not more, applied for these posts.

In the selection process undertaken by committee, several persons were appointed whereas many were not selected. Those appointed then joined the respective posts at different districts. However, after sometime, the State terminated the services of some appointees on the ground that since their appointment was made against the rules and hence it could not be continued. These terminated persons became aggrieved by their termination. Similarly, those who were not selected also felt aggrieved due to their non selection. This led to disputes between these persons on the one hand and the State on the other hand resulting in filing of several writ petitions by such persons against the State for ventilating their grievances.

Since these writ petitions involved common issues, they were clubbed for their analogous disposal These writ petitions were heard by the writ court (single judge) and by common order dated 9-4-2009, the learned Single judge dismissed all the writ petitions by upholding the stand taken by the State. The writ petitioners felt aggrieved, filed several individual writ appeals against the dismissal of their writ petitions.

It may be pertinent to mention that though several writ appeals were filed by different writ petitioners against the common order of the writ court, they were not clubbed together as one bunch for their analogous disposal. Due to this, some appeals were heard independently by different division benches. This led to conflicting decisions on the same issue by co-ordinate benches of the High Court. This led to making of the reference to the Full Bench in aforesaid pending appeal.

The Full Bench of Guwahati High Court held that where two writ appeals arose out of common order passed by the writ court, both these appeals including others arising out of same order should have been heard together on merits in accordance with law. Secondly, since all the writ petitions were decided by common order which suffered their dismissal, the appeals arising out of such order too should have resulted in passing of a common order either way unless any individual appellant was able to point out any distinguishing feature of his case from the bunch for its separate hearing. Thirdly, once a decision was rendered by one Division Bench in one appeal arising out of common order, a fortiorari, such decision was binding on another Division Bench (whether consisting of the same Judges or other) to avoid passing of 2 conflicting orders in one case. Fourthly, if for any reason, the later Division Bench did not agree to the view taken by the earlier Division Bench, then it had no option but to refer the matter to a larger Bench (Full Bench) to resolve the conflict after setting out the reasons for their disagreement and the area of difference. Fifthly, the later Division Bench had no jurisdiction to decide the appeal on merits by taking contrary view except to follow the reasoning and the conclusion arrived at by the earlier Division Bench and if they formed an opinion to take a contrary view then it was

obligatory on the Division Bench to make a reference to larger Bench to resolve the conflict. Sixthly, the jurisdiction to take a contrary view or / and to declare the decision "per incuriam" was with the Full Bench on a reference made by the later Division Bench and lastly, since no one brought the earlier decision to the notice of later Division Bench, a situation had arisen where a judgment came to be passed, which is in conflict with the earlier Division Bench judgment. Therefore, it has to be held as per incuriam.

Jagdish Deka v. The State of Assam and others AIR 2014 Guwahati 143 Full Bench

5. Interim Relief – Jurisdiction of Court – Both Indore as well as Chennai Court had jurisdiction to try subject-matter of dispute and grant interim relief – Parties by agreement can exclude jurisdiction of Indore Court – Arbitration and Conciliation Act, 1996, Ss. 9, 2(1)(e)

The appeal has been filed by the appellant challenging the order of the trial court by which appellant's application under Section 9 of the Arbitration and Conciliation Act, 1996 has been rejected on the ground that the trial court Indore has no jurisdiction and Chennai court has the jurisdiction. The appellant submitted that as per section 2(1)(e) and section 20 of the Act, the parties were free to choose the venue of the arbitration but that will not affect the jurisdiction of the Court. He has also placed reliance upon the judgment of the Supreme Court in the matter of ***Rajasthan State Electricity Board v. Universal Petrol Chemicals Limited, (2009) 3 SCC 107*** and ***M/s. Patel Roadways Limited Bombay v. M/s. Prasad Trading Company with M/s. Patel Roadways Ltd., Bombay v. M/s. Tropical Agro Systems Pvt. Ltd. and Anr. AIR 1992 SC 1514.*** The respondent stated that arbitration award has already been passed therefore, application under section 9 is not maintainable and that the trial court has rightly placed reliance upon the judgment in the matter of ***Balaji Coke Industry (2009 AIR SCW 5751).*** He further stated that parties by agreement had agreed for the jurisdiction of Chennai Court and thus took preliminary objection about maintainability of section 9 application submitting that the award has already been passed by the Arbitrator, but such an objection cannot be sustained since section 9 of the Act expressly provides that the provisions of section 9 can be invoked at any time after the making of the arbitral award, but before it is enforced in accordance with section 36. In the present case though the award has been passed but it has not been enforced till now, therefore, the application under section 9 of the Act will be maintainable.

The High Court held that it is settled position in law that where two or more competent courts have jurisdiction to entertain a suit, the parties to the contract by agreement exclude the jurisdiction of one such court to try the dispute, but the parties to the contract by agreement cannot confer jurisdiction to a court which has no territorial jurisdiction to entertain such a dispute. In present case both Indore as well as Chennai court has the jurisdiction, therefore, the only issue is if the parties by agreement had excluded the jurisdiction of Indore Court. As per arbitration clause, the arbitration proceedings were to take place at Chennai. Undisputedly the arbitration proceedings have been concluded by the arbitrator at Chennai and the arbitration award has been passed at Chennai.

Since the Arbitration clause in the present case is similar to the arbitration considered by the Supreme Court in case of Bharat Coke, the issue involved in the present case is squarely covered by the judgment in favour of the respondent, and the trial Court has committed no error in rejecting the application under section 9 of the Act filed by the appellant placing reliance upon the said judgment and in holding that only Chennai Court has the jurisdiction.

Sundaram Finance Limited v. Mahinder Singh and another AIR 2014 Madhya Pradesh 134

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CA Rajaram Ajgaonkar

ECONOMY AND FINANCE

THE CRUDE SHOCK

The month of November turned out to be positive for most of the oil importing countries in the world, including India, as prices of crude oil drastically dropped down across the world due to a higher supply than demand. The crude oil prices were ruling firm for quite a number of years but they started dropping due to oversupply since July 2014. It was initially perceived to be a correction but the prices started reducing so quickly that it was a stiff fall. Over a period of last six months, the oil prices have tanked more than 35%. As OPEC countries have decided not to reduce the production, the pressure on the oil prices continues. There is a talk that oil may drop below 65 US $ per barrel. Oil being a commodity of finite supply and as it cannot be recreated at a reasonable cost; there was a feeling over the last number of years that the oil prices will continue to go only northwards. Due to continuous production, over the years, many of the oil fields have depleted reserves therein and discovery of new oil fields was quite slow, which created insecurity in the minds of many countries deficit in oil. The past trend of the oil prices was a further dampening factor and there was a view that the oil prices will continue to rise till such time an alternative source is found.

The real game changer was the development of infrastructure for extracting shale gas from the beginning of the current century. Since then, shale gas production is increasing rapidly. This gas was in a way an alternative to crude oil, especially as a fuel and it has started replacing oil as a source of energy and for heating purposes in North America and Europe. Over the last few years, huge reserves of shale gas were discovered in the US as well as Canada and it was realised that this source of energy has an enormous potential due to its prospects of high supplies. As the oil prices were ruling high, lots of efforts were made in the last decades to develop these gas fields, gas extraction techniques; and the gas storage and transportation infrastructure. As a result, the US which is the biggest oil importer in the world, reduced its imports, causing a downward pressure on the crude oil prices. Though it was logical for the OPEC countries to reduce the supply of oil to the world, they have decided not to do so as probably they want to develop a new equation in the energy industry. Shale gas can replace crude oil for a number of its uses. The cost of producing shale gas as well as crude oil differs from each field based on the depth of the location of the reserves, the

geological structure of the fields and many other similar complicated factors. Therefore, the cost of producing oil per barrel or gas per Million British Thermal Units (MBTU) can be substantially different from field to field.

One of the cheapest oil producers in the world is Saudi Arabia and the cost of production of oil in the Middle East is lower than most of the other regions. As the price of oil keeps on rising, more and more oil fields can be operated economically when the price goes above their production cost. As the demand rises and the oil prices rise, more supply emerges to satisfy the demand from the marginal oil fields and that takes the oil price to equilibrium at a given point of time. Similar is the story for gas production. As the oil prices have started coming down in the global markets, the gas prices have also started easing due to the direct correlation between the two commodities. As the prices fall, more and more oil fields as well as gas fields will start becoming uneconomical as the prices will tumble below their production cost. The falling prices will reduce the supply of this major source of energy and prices will reach equilibrium at a given time based on the demand then. The OPEC countries probably want the production of oil to be uneconomical for many oil producing countries and similarly for many shale gas producers. These countries believe that if the oil and gas production in the US, which has higher cost than the production cost of many of the OPEC countries, become non economical; the demand will revive as the US will have to import oil to sustain its consumption of energy. Once the demand revives, the fall in the prices will get arrested and the prices will start rising again. Whatever may be the commercial as well as the political logic, the whole world is lauding the low prices of petroleum products as well as gas. It is resulting in saving of household expenses as well as transportation cost, which will increase the consumable surplus in the hands of many consumers in across the world. It will increase overall demand in the world, which can help to improve the sluggish global economies, especially of the oil importing countries. This energy war is getting more and more interesting and time alone will tell who will emerge successful. However, whilst the war is on; the consumers across the world are happy and greatly benefited.

Month after month, the US economy is getting into a better shape and the sentiments are getting stronger. The concern of increase of interest rates exists but it cannot be forgotten that the interest rates cannot be kept artificially low for a sustained period as it hurts the savers and the capital formation in a country. Interest rates are likely to rise by the middle of 2015 in the US but it is expected that the economy will be strong enough then to be able to sustain the growth momentum. For the US economy, the next few years look good. The stock markets in the country have reacted positively and they are ruling at an all time high. Many stocks are also ruling at their highest levels and the potential for further appreciation does exist. The investors can invest in the US economy by purchasing the US stocks based on their risk appetite and surplus funds. Europe continues to remain sluggish without any great hope. However, lowering energy prices will also have a positive impact on the countries in the region. The region consumes a substantial amount of energy for heating and for transportation. The savings therein can give a push to consumption and help the economies to perform a bit better.

The Chinese economy remains a major concern for the world. Over the last few

years and especially during the recent global recession this economy was driving the overall growth in the world. The economy is expected to grow at 7% for the year 2015, which may be a bit lower than that achieved in 2014. This slowdown can result in dampening the global trade and growth in many regions. The Japanese woes are not ending. The poor expectations from the economy have resulted in the announcement of general elections and a new mandate will emerge. Still, the revival in the economy seems to be unlikely in the immediate future. The collapsing oil prices have already started creating a strain on the Russian economy. The sanctions against the country and falling oil prices may push Russia into a recession in the near future. The declining oil price is also going to affect the Brazilian economy negatively. Slowing down of these economies will certainly create some negative traction on the global growth.

The US growth engine is firing well and it will benefit many economies in Europe and Asia, which will be positive for the world. Though there are no clear negative factors emerging, some people have started believing that the rally has covered a major distance; and the growth here onwards may not be as quick as it was last year. Though the overall sentiment remains positive, the future progress may be slower than expected.

India seems to be a lucky economy as of now as the falling oil prices are going to give her substantial benefits. Over the past few decades, high oil prices had forced the Government to give subsidies, which had resulted in massive fiscal deficits, year after year. It has drained the precious foreign exchange over a long period and has also contributed in the weakening of the Indian economy. The drop in oil prices has a potential of strengthening the economy. It will empower the policy makers to take bolder decisions. The reduction in petroleum prices will also result in a decrease in inflation in the country, which has contributed to the higher rate of interest in the economy. These developments can result in acceleration of the economic growth and it will aid the new Government to perform by undertaking reforms and bolder decisions. Even cyclically, the Indian economy is on an upswing as the worse is over. The next two to three years should be fairly positive and the growth rate can reach near 7%. This will attract investments from domestic as well as international investors and further improve the economic activities in the country. The time seems to be right for investing in India and in fact it has become one of the best destinations for investors. India needs to take care of the hurdles in doing business in the country which has become a major road block for the foreign investors. The current Government has promised to bring changes in that direction and if they can do so India will start booming.

The stock markets in India have been booming for the last few months. The index surged by about 2.5% during November. The Indian stock market has been one of the top performing markets in 2014. It is much stable and its potential appears bright over near to medium term. Foreign Institutional Investors have been continuously pumping money in the Indian markets and in the recent months, even the domestic investors including retail investors have shown an inclination towards equity, which was absent for last number of years. Though the stock markets are already at high levels as the growth story is emerging, their potential is fairly good. Equity will remain the top asset class for the Indian investors. The growth story is not only restricted to India, even the US stock markets are booming on the back of sustained positive news. The

investors will do well to remain invested in equity and increase their allocation in equity in the global as well as Indian markets.

The bond yields have started coming down and so have the rates of interest on Fixed Deposits. The Reserve Bank of India (RBI) has not reduced the benchmark rate of interest in its recent policy announcement but adequate hints have been given that the reduction of interest rate is around the corner. Inflation is steadily coming down and there is continuous pressure on the RBI to reduce the benchmark rate of interest so as to make the availability of credit cheaper. It is very likely that the interest rates will start dropping in the calendar year 2015 and over the year they may drop up to 1%, albeit the reduction will be in doses of a quarter of a per cent each time. The falling interest rate will create capital gains for bond holders, as the bond prices will rise on the back of falling interest rates. The investors have potential of earning returns of 10-12% in the calendar year 2015. Smart investors should take advantage of this opportunity as after 2015 the interest rates as well as the bond yields may drop substantially. Those investors who have long-term horizon for their deposits can lock-in their funds for higher rate of interest on a long-term basis.

Property markets have started showing some momentum and over the next few months this momentum is likely to increase gradually. A sudden rise in property prices does not seem to be possible as there is substantial supply waiting for the right customers. Falling inflation will also reduce the inflation in cost of construction which will be a positive for the property market. Lower inflation will germinate a perfect ground for lower interest rate, which will reduce the cost of borrowings and correspondingly the EMIs on the property loans. This can improve the demand for properties, which is sluggish for the last number of years. Soon, it is expected that property investments will start turning attractive.

It is advisable to stay away from precious metals on short as well as on a long-term basis. Though the prices of precious metals like silver and gold have come down substantially over the last few months, there is a possibility that these commodities will be cheaper in the near future. Platinum has also become cheaper over last few months and the metal does not look attractive. Precious stones and diamond may not appreciate much in near future in tandem with the precious metals. Investors may stay away from this asset class for the time being.

The Rupee is slightly weakened against the US dollar but it has appreciated against many other currencies as the US dollar has appreciated well against those currencies. Though the rupee may not appreciate much against US dollar, it may appreciate against GBP and Euro, especially if the inflation gets controlled. The strength of the Indian economy and expected high GDP growth may also contribute to the strength of the Indian rupee. The overall prospects of the Indian rupee look steady.

The investment climate in India and especially for stock market investment is positive. Investors will benefit by contributing to the Indian growth story.

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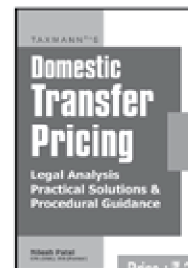

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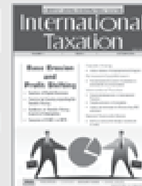

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The Chamber News

Important events and happenings that took place between 8th November, 2014 to 8th December, 2014 are being reported as under.

I. Admission of New Members

1) The following new members were admitted in the Managing Council Meeting held on 21st November, 2014.

LIFE MEMBERSHIP

1	Mr. Patil Ulhas Bhaskarrao	CA	Nashik

ORDINARY MEMBERSHIP

1	Mr. Baxi Harshal Piyush (Half Year Oct. 14 - Mar. 15)	CA	Mumbai
2	Mr. Nagda Ankit Anil (Half Year Oct. 14 - Mar. 15)	CA	Mumbai
3	Miss Shah Pooja Manojkumar (Half Year Oct. 14 - Mar. 15)	CA	Ahmedabad
4	Mrs. Sheth Pooja Harshit (Half Year Oct. 14 - Mar. 15)	CA	Ahmedabad
5	Mr. Oza Madhav Satyanarayan (Half Year Oct. 14 - Mar. 15)	ITP	Ichalkaranji
6	Mr. Bansal Anuj V. (Half Year Oct. 14 - Mar. 15)	Advocate	New Delhi
7	Mr. Joshi Ravindra Pandharinath (Half Year Oct. 14 - Mar. 15)	ITP	Mumbai
8	Mr. Pereira Vincent Emygdio (Half Year Oct. 14 - Mar. 15)	ITP	Mumbai
9	Ms. Acharya Prapti Anil (Half Year Oct. 14 - Mar. 15)	CA	Mumbai

II. Past Programmes

Sr. No.	Programme Name / Committee/Venue	Date / Subjects	Chairman / Speakers
1.	**Allied Laws Committee**		
	Allied Laws Study Circle Meeting Venue : Kilachand Hall, 2nd Floor, IMC.	18th November, 2014 Provisions relating to The Indian Partnership Act, 1932 – An overview (Part – II)	Mr. Pravin Veera, Solicitor

Sr. No.	Programme Name / Committee/Venue	Date / Subjects	Chairman / Speakers
2.	**Direct Taxes Committee**		
A.	**Full Day Seminar on Assessment, Reassessment and Settlement Commission** Venue : M. C. Ghia Hall	**8th November, 2014** i. Current Common issues faced during assessment and reassessment proceedings. ii. Do's and Don'ts during the assessments proceedings and reassessment proceedings with practical examples iii) Law of Evidence and importance of evidence in assessment and reassessment proceedings iv) Settlement Commission – Scope, Advantages, Limitations and Procedures	CA Reepal Tralshawala CA Atul Bheda Mr. K. Gopal, Advocate CA Chetan Karia
B.	**Intensive Study Group on Direct Tax Meeting** Venue: CTC Conference Room	13th November, 2014 Recent Important Decisions under Direct Taxes	Mr. Rahul Sarda, Advocate
3.	**Indirect Taxes Committee**		
	Indirect Tax Study Circle Meeting Venue: Conference Hall, 2nd Floor, All India Local Self Government, Sthanikraj Bhavan, C. D. Barfiwala Marg, Juhu Lane, Andheri	**2nd December, 2014** Recent Updates & Issues in MVAT Audit	Chairman : CA Deepak Thakkar Group Leader : CA Deepali Mehta
4.	**International Taxation Committee**		
	FEMA Study Circle Meeting Venue : CTC Conference Room	**12th November, 2014** Basic Framework of FEMA Law	CA Manoj Shah
5.	**Membership & EOP Committee**		
	Self Awareness Series Venue : CTC Conference Room	**11th November, 2014** Art of Managing – Self and Around	Mrs. Rita Shah, Management Consultant
6.	**Study Circle & Study Group Committee**		
	Study Circle Meeting Venue : Babubhai Chinai Committee Room, 2nd Floor, IMC	**4th December, 2014** Subject: Penalties u/ss. 271 (1)(c), 271AAA & 271AAB of Income-tax Act, 1962.	Chairman : Mr. Vipul Joshi, Advocate Group Leader : Mr. Mihir Naniwadekar, Advocate

Sr. No.	Programme Name / Committee/Venue	Date / Subjects	Chairman / Speakers
7.	**Students Committee**		
	Student Study Circle Meeting Venue : Maheshwari Bhawan, Chira Bazar, Marine Lines, Mumbai.	**4th December, 2014** Subject : MVAT Audit	CA Prashant Vora

III. Future Programmes

Sr. No.	Programme Name/Committee/Venue	Day & Date
1.	Allied Laws Committee	
A.	**1st RRC on the Companies Act, 2013 with the flavour of LLP Act, 2008** (Jointly with Corporate Members Committee) Subjects : 1) Paper of Presentation – Role and Responsibilities of Directors, Independent Directors, Key Management Personnel, Managerial Remuneration 2) Paper for Discussion – Case Studies-1 on Accounts, Audits, Internal Audit, Fraud reporting, NFRA, Responsibilities of Auditors, lending and investments, Related Party Transactions 3) Paper for Presentation – Private / Unlisted Companies – Benefits Lost and retained – Way forward through LLP 4) Paper for Discussion – Case Studies–2 on Raising of Finance – Share Capital, Debentures, Deposits etc. 5) Brains' Trust – Important issues on Companies Act, 2013 Venue : Ras Resort Silvassa	**Friday, 12th December, 2014 to Sunday, 14th December, 2014**
B.	**Allied Laws Study Circle Meeting** Subject : Opportunities for Professionals in "Alternate Dispute Resolution" (ADR) (Arbitration, Conciliation, Mediation and Negotiation)" Venue : Maheshwari Bhavan Hall, 1st Floor, Chira Bazar Road, Princess Street, Opp. Parsi Agiary, Mumbai – 400 002	**13th January, 2015**

Sr. No.	Programme Name/Committee/Venue	Day & Date
2.	**Direct Taxes Committee**	
A.	**Intensive Study Group on Direct Tax (Only for ISG Members)** Subject : Recent Important Decisions under Direct Tax Venue : CTC Conference Room	**23rd December, 2014**
B.	**Study Course on Interpretation of Taxing Statutes** Subjects : 1. General Introduction to Interpretation 2. Principles and Rules of Interpretation – Heydon's Rule, Mischief Rule, Purposive Construction, Literal Construction, Strict Construction etc.; Interpretation of Penal Statutes 3. Subsidiary rules i.e. Mandatory and directory provisions, harmonious and beneficial construction 4. Aids to construction, Internal and external aids 5. Rules governing construction of Double Taxation Agreement, or International Agreement, Treaties etc. 6. Principles of Natural Justice 7. General Clause Act – Interpretation 8. Doctrine of *res judicata* and Estoppel as applicable to tax law : Doctrine of Binding Precedent / *Stare Decis.* 9. Constitution of India vis-à-vis Income-tax Act Venue : Babubhai Chinai Committee Room, 2nd Floor, Indian Merchants' Chamber, Churchgate, Mumbai – 400 020	**30th & 31st January, 2015** **6th & 7th February, 2015**
3.	**Indirect Taxes Committee**	
	3rd Residential Refresher Course on Service Tax Subjects : Paper – I – Case Studies on Indirect Tax Issues in Real Estate Industry Paper – II – Case Studies in Place of Provision and Point of Taxation Rules under Service Tax Paper – III – Case Studies under Service Tax (other than on the above two topics) Presentation – I – Settlement Commission, Compounding of Offences and Advance Ruling under Service Tax Venue : Fountainhead Leadership Centre, Bamansure, Post Kihim, Alibag, Maharashtra – 402 201.	**23rd January, 2015 to** **25th January, 2015**

Sr. No.	Programme Name/Committee/Venue	Day & Date
4.	**International Taxation Committee**	
A.	**Workshop on Taxation of Foreign Remittances** Subjects : 1) Law and procedure applicable to Taxation of Foreign Remittance, applicable Rules Circulars and Provisions of the Treaty, Law, Procedure of TDS provisions for Non Residents 2) Overview of the DTAA -Application scope, (Article 1,2,3 and 4)and Mechanism of Use of Treaty, Interplay between ITA and Treaty, Priority of Articles, Tax credit mechanism etc 3) Business profits 4) Taxation of Other payments-.Artist and Sports men, Other Income, Directors Fees and Students Remuneration 5) Income of Non Residents from Shipping and Aircraft Operation 6) Taxation of Interest and Dividend 7) FTS and Royalty 8) Taxation of Capital Gains including indirect transfers 9) Expatriates Taxation-Inbound and Outbound deputation-Payment to Non Residents for Services in India as well as Outside India 10) Brains Trust Venue: West End Hotel, New Marine Lines, Mumbai.	**19th December, 2014** **20th December, 2014**
B.	**6th International Tax Conference with Focus on Practical Evolving Issues** Subjects : 1) Keynote address 2) Revised in Digital economy in the light of BEPS report and Implications in Indian situation 3) Emerging issues for Inbound and Outbound Structuring of Investments from tax perspective 4) Emerging issues in Royalties and FTS considering BEPS Venue: Palladium Hotel, Near High Street Phoenix Mall, Lower Parel, Mumbai	**14th February, 2015**

Sr. No.	Programme Name/Committee/Venue	Day & Date
C.	**5th Intensive Study Course on Transfer Pricing (Including Domestic Transfer Pricing) – 24 Session–6 Days** Subjects : 1. Basic of Transfer Pricing 2. Benchmarking 3. Industry Specific Sessions 4. Key Controversy Areas – Recent TP Audit experience 5. Practice Areas 6. Other areas having TP implications 7. Domestic Transfer Pricing 8. The Road Ahead 9. Attribution issues, experiences, recent rulings and Revenue's perspective 10. Closing Session Venue : Hotel West End, New Marine Lines, Opp. Bombay Hospital, Mumbai	**14th and 20th March, 2015** **10th and 11th April, 2015** **24th and 25th April, 2015**
D.	**FEMA Study Circle Meeting** Subject : Foreign Investments in India – Part-I Venue : CTC Conference Room	**10th December, 2014**
E.	Publication : **Transfer Pricing** An Industry & Technical Perspective	Special price for Members only ` 1,250/-
5.	**Information Technology Committee**	
	Open Doors to Open Source Subjects : 1. • Myths and truths of software licensing • Need to a typical CA office vs. possibility • Practical Possibilities for open source options • Hitches in change management 2. • Agonies of licensing • Need and stage assessment for licensing • Practical Issues on licensing • Case studies on adaptation 3. • Advantages BSS Office • Possibilities of running Tax utilities with Open office • Simplicity of implementation of Open Office	**15th January, 2015**

Sr. No.	Programme Name/Committee/Venue	Day & Date
6.	**Residential Refresher Course & Public Relations Committee**	
	38th Residential Refresher Course Venue : At Toshali Sands Resort, Puri, Odisha Subjects : Paper I – Deeming Provisions under the Income-tax Act. Paper II – Issues in Corporate Taxation including LLP Paper III – Case Studies on Direct Tax Paper for Presentation : Domestic Transfer Pricing Brains' Trust – Direct Taxes	**Thursday, 19th February, 2015 to Sunday, 22nd February, 2015**
7.	**Students Committee**	
A.	**1st Indoor Sports Tournament** (Jointly with Membership & EOP and RRC & Public Relation Committees) Sports Events : 1) Badminton (Singles, Doubles) 2) Table Tennis (Singles, Doubles) 3) Carrom (Singles, Doubles) 4) Chess Venue: Andheri Sports Complex, Veera Desai Road, Andheri West, Mumbai – 58	**1st February, 2015**
B.	**Student Study Circle Meetings** Subjects : 1) Compliance under Companies Act, 2013 2) E-Filing of TDS Return 3) Finance Bill Venue : Maheshwari Bhawan, Chira Bazar, Marine Lines, Mumbai	**8th January, 2015** **5th February, 2015** **5th March, 2015**
8.	**Study Circle & Study Group Committee**	
A.	**Study Group Meeting** (Only for SG Members) Subject : Recent Judgments under Direct Taxes Venue : Babubhai Chinai Committee Room, IMC	**11th December, 2014**
B.	Study Circle Meeting (Only for Study Circle Members) Subject : Issues in Wealth Tax Venue : Babubhai Chinai Committee Room, IMC	**29th January, 2015**
9.	**AMITA MEMORIAL LECTURE MEETING** Subject : To be finalised Venue : Jaihind College Auditorium, A Road, Next to Churchgate Station, Mumbai – 400 020	**13th February, 2015**

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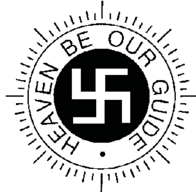

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INDIRECT TAXES COMMITTEE

Indirect Tax Study Circle Meeting held on 2nd December, 2014 on the subject "Recent Updates & Issues in MVAT Audit" at Andheri

CA Deepak Thakkar chairing the session.

CA Deepali Mehta addressing the members.

DIRECT TAXES COMMITTEE

Intensive Study Group on Direct Taxes Meeting held on 13th November, 2014 on the subject "Recent Important Decisions under Direct Tax" at CTC Conference Room

Mr. Rahul Sarda, Advocate addressing the members.

STUDENTS COMMITTEE

Students Study Circle Meeting held on 4th December, 2014 on the subject "MVAT Audit" at Maheshwari Bhawan, Marine Lines, Mumbai

CA Prashant Vora addressing the members.

MEMBERSHIP & EOP COMMITTEE

Self Awareness Series Meeting held on 11th November, 2014 on the subject "Art of Managing – Self and Around" at CTC Conference Room

Mrs. Rita Shah, Managing Consultant addressing the members.

ALLIED LAWS COMMITTEE

Allied Laws Study Circle Meeting held on 18th November, 2014 on the subject "Provisions relating to The Indian Partnership Act, 1932 – An Overview (Part-II)" at Kilachand Hall, IMC

Mr. Pravin Veera, Solicitor addressing the members.

STUDY CIRCLE & STUDY GROUP COMMITTEE

Study Circle Meeting held on 4th December, 2014 on the subject "Penalties u/s. 271(1)(c), 271AAA & 271AAB of Income Tax Act, 1962" at Babubhai Chinai Committee Room, IMC.

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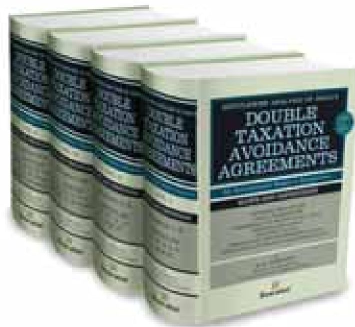

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- Recently issued Exposure Drafts (ED) of IFRS/Ind-ASs and recent disclosure requirements
- Latest updates to IFRS/Indian Accounting Standards (Ind ASs)
- Tips – How to convert I-GAAP financial statements into IFRS/Ind-ASs financial statements
- Practical examples/case studies in each chapter – how to use IFRS/Ind-ASs
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