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THE CHAMBER OF TAX CONSULTANTS

THE CHAMBER'S JOURNAL

Your Monthly Companion on Tax & Allied Subjects

Vol. XIII | No. 3 | December 2024

Capital Gains: Tax Controversies & Considerations

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Glimpses of the Seminar on TAXCON - 2024 [Jointly with WIRC of ICAI, AIFTP (WZ), BCAS, MCTC & GSTPAM] held on 15th & 16th November, 2024 at ICAI Tower, BKC, Mumbai

Lighting of the Lamp

President of all Associations alongwith the Chief Guest Dr. Subramanian Swamy during the Inaugural function

Dr. Subramanian Swamy addressing the audience

CA Vijay Bhatt President The Chamber of Tax Consultants giving the Vote of Thanks

(L-R) CA Mehul Sheth, CA Manish Goel, Mr. Jagdish Shetty (Secretary, Virat Hindu Parishad), Mr. Kishor Vanjara, CA Mandar Telang

(L-R) CA Vijay Bhatt presenting memento to the speaker CA Avinash Rawani, alongwith CA Mehul Sheth, CA Viraj Mehta

Panel Discussion (L-R) CA Gaurav Save, CA Mandar Telang, CA A.R. Krishnan (Moderator), CA Sushil Solanki (Panel Member), CA Darshak Shah (Panel Member), CA Mehul Sheth

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From the Editor's Desk

My Brothers and Sisters,

> *'If I advocate cautious optimism, it is not because I do not have faith in the future but because I do not want to encourage blind faith.'* - ***Aung San Suu Kyi***

The recent meeting of the Reserve Bank of India's monetary Policy Committee where the growth numbers of the Indian economy were presented, show us that growth did slow down in the second quarter of 2024. As we come to a close of a year which has been topsy turvy for the world at large, while we are hopeful and expectant that India, a country which has tremendous growth potential, and a country which has a strong leader, should continue its efforts towards being counted as one of the sought after investment destinations, we are also aware that the global situation continues to be fragile with tensions amongst certain quarters in the world, continuing. It is therefore important that India, a stable economy, continues its steady march towards becoming one of the most sought after investment destinations.

The year 2024 is on the verge of ending and soon, it will be time to celebrate Christmas and the dawn of a New Year, 2025, where one hopes, the human race will come together to address some major concerns like climate change, the commitment to use technology only for the benefit of mankind, etc. Cautious optimism therefore should be the mood, as we transition into the new year.

The Government's efforts to simplify the Income-tax Act, are on in full swing, with suggestions being invited from the stakeholders and several senior officers from the Income-tax Department camping in New Delhi to come up with a version of the Act, which is simple, unambiguous, and easy to read and understand. This is a monumental task. The Chamber also has been invited to submit its suggestions and has done so. One waits, with bated breath, to see the result of this herculean exercise and hopes that the draft of the simplified law will be put up for public comments before it is placed before Parliament. It will be interesting to see how, dispute resolution will be addressed in the simplified Act. One of the key concerns today, remains the ever-increasing number of pending income-tax appeals at the first appellate level. Hopefully, a simple, yet effective dispute resolution mechanism will be put in place

which will alleviate this concern, which has been a source of worry for taxpayers, particularly in the recent past.

Taxation of Capital Gains has been one of the areas which has contributed to the increasing number of appeals. Some of the issues have been unresolved for quite a number of years. Some others have sprung up due to the amendment to the capital gains provisions in the last five to seven odd years. The Journal Committee has identified some of these controversial issues and has got some very fine authors to analyse these issues in this month's issue titled 'Capital Gains – Tax Controversies and Considerations'. Special thanks are due to Vivek Newatia (Calcultta) and Viraj Mehta (Mumbai) for helping the Committee to come out with this issue. This issue also has a 'Hot Spot' article on the landscape of GCCs i.e. Global Capacity Centres, in India by CA Ajay Rotti. India has always been a preferred destination for hosting back offices. How these have evolved into GCCs and what the future holds for GCCs makes interesting reading. I hope the readers will find this issue interesting.

I sign off for the year by wishing all of you best wishes for the upcoming festive season and a Happy New Year. See you in 2025!

ANISH M. THACKER
Editor

From the President

Dear Members,

As we approach the end of 2024, the world witnessed many ups and downs all around, which include a prolonged war between Russia and Ukraine, leading to uncertainty in global markets. On the other hand, India emerged strong in economic ratings, securing a spot among the top 5 countries, making up for a proud moment for every Indian.

As tax professionals, many of you are likely to be busy helping clients file their pending Income Tax Returns before December 31, 2024 and also availing the benefits of the Vivad se Vishwas Scheme of 2024.

The Government of India has introduced the PAN 2.0 Project, a digital transformation of the present PAN system. This eco-friendly, paperless, and seamless process will feature new QR Code features with enhanced security. The Government has allocated ₹ 1,435 crores for this project, which will provide new digital PAN to all existing PAN holders free of cost. There will be a single portal for all PAN/TAN services. India's march towards Digital Era will be taking a new leap with PAN 2.0 project.

For the Chamber, the month of November was an interactive month with the Income Tax Department. As mentioned in my last communiqué, on 11th November the Team Chamber presented Pre-Budget Suggestions to the CBDT in New Delhi. This was followed by an interactive meeting with Shri H.B.S. Gill, Member (Tax Payer Services & Revenue), CBDT and Shri Raj Tandon, Principal Chief Commissioner of Income-tax, Mumbai on 18th November, 2024 for giving suggestions relating to various aspects of Income Tax provisions. Thereafter, the Chamber was invited to give suggestions on Project Integrated e-filing and CPC (IEC3.0) to the Jt. Commissioner (International Taxation), Range 1(3), New Delhi. We are indeed grateful to the Income Tax Department for involving us in the process of resolving Income Tax-related issues.

On Chamber's educational front during December, 2024, the members are welcome to take benefit of short duration courses like "Series on Capital Gains", "Course on M & A" (jointly with Pravin Gandhi College of Law, Mumbai), and various study circle meetings on interesting topics such as VsV Scheme, 2024, Recent Judgements under Company Law & SEBI Regulations, Benami Law, GST Amnesty Scheme etc. We are thankful to Hon'ble

Shri. Justice Akil Kureshi, (Retd. Chief Justice of Rajasthan & Tripura High Court), who has spared his valuable time for students with his participation in "Udaan" Episode, organized by the Students' Committee.

Our Pune Study Circle has organized Study group meeting on Transfer Pricing Assessments. Our Delhi Chapter had organized two important lecture meetings recently viz. Assessment/Re-assessment and another on Black Money & Benami Law. I congratulate all our Study Circle organizers for their efforts in spreading knowledge.

The Student Committee has organized "Indirect Tax Moot Court Competition jointly with the ILS Law College, Pune in Jan/Feb, 2025. The details will be announced soon. I appeal to our members to encourage their Students to participate in this unique event.

The International Tax Committee is geared up to greet the delegates of the 3rd FEMA Residential Refresher Course to be held at Novotel, Ahmedabad, Gujarat from 20th December, 2024 to 22nd December, 2024. I am glad to learn that many young participants have enrolled for this RRC. The enrolment for this short duration RRC closed almost one month before the start of the RRC. I thank all delegates for their whole hearted support with enthusiasm.

This month's Journal features a Special Story on "Capital Gains: Tax Controversies & Considerations". I thank the Editorial Board, the Journal Committee and CA Ameya Kunte, Chairman for selecting this topic. I thank all the authors for their efforts for our members. I also urge readers to spread a word about CTC Journal among the professional colleagues and help the CTC in spreading the knowledge.

With the New Year of 2025 just a few days away, the countdown has begun at Chamber to celebrate its Centenary Year. Team Chamber has already started planning for the Big Event. The details will be announced in due course of time. I encourage you all to be active part of the Centenary Year Events during the term 2025-26. It will be a perfect tribute to the Chamber, if each member encourages at least one non-member to become member of the Chamber before the start of the Centenary Year.

In Advance, wishing you all a very Happy New Year !!!

Jai Hind !

VIJAY BHATT
President

Conversion of Company into LLP and Vice Versa

Aseem Chawla
Advocate

Nivedita Jha
Advocate

Overview

The conversion of a company into an LLP and vice versa presents businesses with significant opportunities for tax optimization and operational flexibility. However, the process is highly dependent on compliance with specific legal provisions. Non-compliance with these conditions could result in tax liabilities, making it essential for businesses to carefully evaluate the legal and tax ramifications before proceeding with a conversion.

The introduction of LLPs as an alternative business structure has provided a favourable environment for businesses in India. However, the legal complexities surrounding conversions require careful attention to ensure that the process remains tax efficient. Companies and LLPs must work with legal and financial advisors to navigate the regulatory landscape effectively.

Introduction

In India, the concept of Limited Liability Partnerships ("LLPs") has gained considerable traction as a plausible alternate business structure, particularly among Small and Medium-sized Enterprises ("SMEs") and service-oriented businesses. The LLP model offers a hybrid of Corporate & Partnership structures, bringing together the benefits of both formulation(s). It combines the limited liability phenomenon which is insignia of a "company" form of an organisation and at the same time providing operational flexibility and tax advantages inherent in a partnership. This dual advantage has led many companies to consider the option of converting into an LLP. The LLP offers a blend of the benefits of both corporate and partnership forms of business, providing limited liability and a flexible organizational structure. As a hybrid business model, LLPs are considered a favourable option due to their relatively simpler regulatory framework compared to Traditional Corporate Entities, viz., Private Limited Companies.

The shift from a private limited company to an LLP is driven by several factors, including tax efficiency, operational flexibility, and the prospect of reduced regulatory burdens. The conversion allows companies to retain the limited liability benefits of a corporate structure while benefiting from the ease of management and tax policies applicable to partnerships. The taxation structure for LLPs is more straightforward. Once the LLP pays tax on its profits, the distribution to partners is tax-free.

The ability to withdraw capital without tax implications is another compelling reason. Companies face strict regulations when it comes to buy-backs, while in an LLP, capital can be withdrawn at any time without triggering additional tax burdens.

Legal Ecosystem - Governing the Conversion of Companies into LLPs

The transfer of assets and liabilities during the conversion process is generally not considered a taxable 'transfer' under the Income Tax Act, 1961 ("IT Act"), provided specified conditions are met. These include ensuring that the assets and liabilities are transferred in their entirety to the LLP, and that shareholders become partners in the LLP in proportion to their shareholding in the company.

Per the Limited Liability Partnership Act, 2008 ("LLP Act"), a company can be converted into an LLP by following the procedure outlined as provided under Section 55 of the LLP Act. This requires the company to apply to the Registrar of Companies (RoC) with a detailed plan for conversion.

Section 47(xiiib) of the IT Act provides a tax-neutral framework for the conversion of a company into an LLP, meaning that no capital gains tax is triggered if certain conditions are met. These include limits on turnover (INR 60 lakh) and total value of assets (INR 5 crore). If the conversion does not meet these conditions, it is deemed a "non-tax-neutral conversion," raising questions about the tax implications.

The conversion of a private limited company or an unlisted public company into a LLP has significant tax implications under the IT Act. The key provisions that govern such conversions are Sections 47, 47A, 48, and 49 of the IT Act.

Section 47(xiiib) of the IT Act provides an important exemption for capital gains arising from the conversion of a private limited company or unlisted public company into an LLP.

The provisions of Section 47(xiiib) lays down certain conditions upon fulfilment of which exemption from taxability can be claimed in cases of conversions. These conditions primarily relate to the continuity of the business, transfer of assets, and liabilities, as well as the manner of conversion, ensuring that the transaction is genuine and not merely a tax avoidance strategy.

The provision states that the conversion itself will not trigger capital gains tax, provided certain conditions are satisfied. The relevant extract of the provision of Section 47(xiii) is usefully extracted hereinbelow:

> ***Section 47: Transactions not regarded as transfer.***
>
> ***47.*** *Nothing contained in Section 45 shall apply to the following transfers:—*
>
> *(xiii) any transfer of a capital asset or intangible asset by a firm to a company as a result of succession of the firm by a company in the business carried on by the firm, or any transfer of a capital asset to a company in the course of demutualisation or corporatisation of a recognised stock exchange in India as a result of which an association of persons or body of individuals is succeeded by such company:*

Provided *that—*

(a) all the assets and liabilities of the firm or of the association of persons or body of individuals] relating to the business immediately before the succession become the assets and liabilities of the company;

(b) all the partners of the firm immediately before the succession become the shareholders of the company in the same proportion in which their capital accounts stood in the books of the firm on the date of the succession;

(c) the partners of the firm do not receive any consideration or benefit, directly or indirectly, in any form or manner, other than by way of allotment of shares in the company; and

(d) the aggregate of the shareholding in the company of the partners of the firm is not less than fifty per cent of the total voting power in the company and their shareholding continues to be as such for a period of five years from the date of the succession;

The aforesaid condition (a) to (c), as laid down under the provisions of Section 47(xiiib), focus on the continuation of the firm's business, the transfer of assets, and the conversion's impact on the assets of the firm. Condition (d) of the said aforesaid provision is equally relevant in the present context as, particularly the second part of it, which requires that the shareholding in the newly formed company (after the conversion) should be retained by the partners for at least five years. If the shares are transferred before the expiry of this five-year period, it will violate the conditions set forth under this provision.

When all these conditions are met, the conversion itself will not result in a capital gains tax liability, and the transaction will be exempt under Section 45 of the Income Tax Act, 1961, which otherwise governs the taxation of capital gains. Therefore, if the conditions are not satisfied, the exemption under Section 47(xiiib) Income Tax Act, 1961 will not apply, and the capital gains will be chargeable to tax.

Also, the provisions of Section 47(xiii) of the Income Tax Act, 1961, read with Section 47A(3), does not intend to create a fiction of capital gains tax when no actual capital gains have occurred.

Non-Tax Neutral Conversion in the Hands of Shareholders

Non-Tax Neutral conversions also raise questions about the tax liability for shareholders. When a company converts into an LLP, its shareholders' equity is exchanged for an LLP interest. This exchange is treated as a transfer, which triggers capital gains tax on the shareholders. Also, it has been held by Hon'ble Authority of Advance Rulings, New

Delhi in ***Umicore Finance Luxembourg, In re***[1] that Section 47(xiii) of the IT Act specifically excludes certain categories of transfers from the purview of capital gains taxation, but it is subject to the fulfilment of the conditions laid down in clauses (a) to (d). All these conditions shall be satisfied. However, the requirement in the second part of clause (d), i.e., shareholding of fifty per cent or more should continue to be as such for a period of 5 years from the date of succession has not been fulfilled in the instant case by reason of the transfer of shares by the Indian company to the applicant before the expiry of 5 years.

Also, with the introduction of Clause (xiii) in Section 47 of the IT Act, the legislature has also enacted a proviso thereto laying down the conditions subject to which the substantive provision in Clause (xiii) should be applied. The extract of the said proviso is usefully extracted hereinbelow:

> ***Section 47: Transactions not regarded as transfer.***
>
> ***47.*** *Nothing contained in Section 45 shall apply to the following transfers:—*
>
> ***Provided** that—*
>
> *(a) all the assets and liabilities of the company immediately before the conversion become the assets and liabilities of the limited liability partnership;*
>
> *(b) all the shareholders of the company immediately before the conversion become the partners of the limited liability partnership and their capital contribution and profit sharing ratio in the limited liability partnership are in the same proportion as their shareholding in the company on the date of conversion;*
>
> *(c) the shareholders of the company do not receive any consideration or benefit, directly or indirectly, in any form or manner, other than by way of share in profit and capital contribution in the limited liability partnership;*
>
> *(d) the aggregate of the profit sharing ratio of the shareholders of the company in the limited liability partnership shall not be less than fifty per cent at any time during the period of five years from the date of conversion;*
>
> *(e) the total sales, turnover or gross receipts in the business of the company in any of the three previous years preceding the previous year in which the conversion takes place does not exceed sixty lakh rupees;*
>
> *(ea) the total value of the assets as appearing in the books of account of the company in any of the three previous years preceding the previous year in which the conversion takes place does not exceed five crore rupees; and*

1. [2010] 189 Taxman 250 (AAR – New Delhi)

(f) *no amount is paid, either directly or indirectly, to any partner out of balance of accumulated profit standing in the accounts of the company on the date of conversion for a period of three years from the date of conversion.*

The consequence of violation of these aforesaid conditions has also been specifically laid down in sub-section (3) of Section 47A of the Income tax Act, 1961. Section 47A(3) of the IT Act mainly enunciates that the amount of profit or gain arising from the transfer of such capital asset not charged under Section 45 shall be deemed to be the profit and gain chargeable to tax of the successor company for the previous year in which the non-compliance of the conditions in the proviso of Clause (xiii) had taken place. It must be noted that the deeming provisions in sub-section (3) of section 47A is not absolute. What is deemed to be the profit and gain of the successor-company is the amount of profit or gain arising from the transfer of such capital asset not charged earlier. If no profit or gain arose earlier when the conversion of the firm into a company took place or if there was no transfer at all of the capital assets of the firm at that point of time, the deeming provision under Section 47A(3) cannot be invoked to levy the capital gains tax.

However, if any of the conditions prescribed under Section 47(xiiib) are not met, the conversion is no longer considered tax-neutral, and capital gains tax may be levied on the transfer of assets from the company to the LLP. Also, the LLP will not be allowed to carry forward the losses or unabsorbed depreciation of the company if the conditions are violated.

Even if the conversion is a 'transfer' under Section 2(47) of the IT Act, the liability to pay capital gains does not arise because Section 45(1) has to be read with reference to Section 48 of the IT Act. The LLP can only be assessed if it receives full value of consideration in exchange of assets transferred. In this regard, Hon'ble High Court of Bombay in ***CIT vs. Texspin Engg. & Mfg. Works***[2] held that the allotment of shares in the company in proportion to the capital of the partners in the erstwhile firm has no correlation to the vesting of properties in the limited company under Part IX of the Companies Act, 1956. The legislative intent, not to tax such conversion, is indicated by the insertion section 47(xiii) by the Finance (No. 2) Act, 1998 with effect from April 01, 1999.

Further, Section 47A(4) of the IT Act deals with the withdrawal of exemptions previously granted under Section 47(xiiib) of the Act. Specifically, if the conditions laid out in Section 47(xiiib) of the Act are violated or not met post-conversion, Section 47A(4) of the Act mandates that if there was any exemption previously availed by the Assessee the same shall be reversed.

The conversion of a private limited company or unlisted public company into an LLP presents both opportunities and challenges in terms of capital gains taxation. The conditions under Section 47(xiiib) provide a potential

2. [2003] 263 ITR 345 (Bombay HC) SLP was filed by department is Dismissed/Rejected

exemption from capital gains tax, but only if the specified criteria are met. On this aspect, Hon'ble Income Tax Appellate Tribunal, Bombay Bench in ***Assistant Commissioner of Income-tax, 19(1), Mumbai vs. Celerity Power LLP***[3] held that failure to comply with these conditions may lead to the withdrawal of exemptions under Section 47A(4), and capital gains tax would be levied on the conversion transaction. Furthermore, the successor LLP is liable for any tax obligations, and the book value of the assets will be considered for the computation of capital gains.

Section 170 of the IT Act provides for the continuation of tax liabilities in case of a succession, including the transfer of business or assets. In the context of a conversion from a private limited company to an LLP, the LLP as the successor entity, inherits the tax liabilities of the original company, including any capital gains tax liabilities on transferred assets. This means that any capital gains arising from the transfer of capital assets will be subject to taxation in the hands of the LLP.

However, the capital gains tax will not be assessed under the regular rules applicable to a transfer. Instead, the LLP's liability will be calculated in accordance with the provisions governing capital gains in the context of the company's conversion into an LLP.

Computation of Capital Gains for the purposes of assessment

Under Section 48 of the IT Act, the "full value of the consideration" for capital gains is typically determined by the sale or transfer price of the asset. However, in cases of the conversion of a private limited company into an LLP, the "full value of the consideration" is determined differently.

Where the entire undertaking of the company is vested in the LLP as part of the conversion, the book value of the assets as reflected in the company's financial records at the time of conversion is considered the "full value of the consideration" for purposes of computing capital gains. This means that capital gains, if applicable, will be calculated based on the difference between the book value and the fair market value (if there is any difference between the two).

Section 49(1)(iii) provides that when capital assets are transferred through succession, inheritance, or devolution, the cost of acquisition of the asset for the new owner (in this case, the LLP) will be deemed to be the cost at which the previous owner (the private limited company) had acquired the asset.

This provision is particularly relevant for calculating capital gains on the transfer of assets from the private limited company to the LLP, as it ensures that the LLP's cost of acquisition of these assets is treated as the same as the company's cost, effectively freezing the tax position at the time of conversion.

In the context of tax assessments, filing an audit report is an essential procedural step. While the filing of the audit report is typically required at the time of the assessment under the Income Tax Act, 1961, the courts have recognized that it is procedural and directory in nature. As such, the audit report can be

3. [2018] 100 taxmann.com 129 (Mumbai - Trib.)

validly filed at a later stage, including at the appellate stage, provided the necessary conditions and time frames are respected. This flexibility ensures that the Assessee is not unfairly penalized for minor procedural lapses.

As the tax landscape continues to evolve, businesses must ensure they meet all regulatory conditions to avoid unwanted tax liabilities and maximize the benefits of such conversions. Proper documentation, including the timely filing of audit reports, remains an essential part of compliance during such transitions.

Extant Legal position on taxability at the instance of Conversion of a Partnership Firm into a Private Limited Company and vice-versa

Section 47(xiiib) of Income Tax Act, 1961 provides a tax advantage for a company converting into an LLP. The Hon'ble High Court of Delhi in a seminal decision in ***Sky Light Hospitality LLP vs. Assistant Commissioner of Income Tax, Circle 28(1), New Delhi***[4] held that in such cases, the conversion is not treated as a transfer, meaning no capital gains tax is levied on the assets of the company. The rationale behind this provision is to facilitate the smooth transition of businesses to LLPs without imposing tax burdens that could hinder such conversions. However, the provisions of Section 47(xiiib) come with stringent conditions. One such condition is outlined in the Proviso (c), which states that shareholders must not receive any consideration (directly or indirectly) other than shares in the LLP, either in the form of profit or capital contribution. The intent behind this clause is to ensure that the conversion remains a "restructuring" and does not involve any immediate taxable gains for the shareholders.

In a seminal decision by Hon'ble ITAT, Kolkata Bench in ***Aravali Polymers LLP vs. Joint Commissioner of Income-tax, Range- 34, Kolkata***[5] where the Assessee claimed the benefit of Section 47(xiiib) for the conversion of a private limited company into an LLP and the Assessing Officer denied this claim on the grounds of non-compliance with the conditions laid down under the section. In the said case, the Assessee had extended interest-free loans to its partners after the conversion. These loans were funded by the reserves and surplus of the erstwhile company, which included accumulated profits. Since these loans were paid out of the company's accumulated profits, the transaction was deemed to be in violation of Proviso (f). This violation was crucial because it meant that the conversion could no longer benefit from the tax exemptions provided under Section 47(xiiib). As a result, the claim for non-taxation of capital gains was denied, and the case was referred to the AO for further proceedings. The Hon'ble ITAT held that provisions of Section 47A(4) were to be triggered when there is a violation of the conditions under Section 47(xiiib). Section 47A(4) states that if the conversion of the company into an LLP does not meet the conditions outlined in Section 47(xiiib), the capital gains tax liability will be imposed on the successor LLP as if the transfer had occurred.

4. [2018] 90 taxmann.com 413 (Delhi HC) SLP was filed by department is Dismissed/Rejected in [2018] 92 taxmann.com 93 (SC)
5. [2014] 47 taxmann.com 335 (Kolkata - Trib.)

Also, the Hon'ble Authority of Advance Ruling, New Delhi in ***Domino Printing Science Plc., In re***[6] has further observed that the provision of Section 47A(4) of the Income Tax Act, 1961 stipulates for charging capital gains tax on failure to comply with the conditions prescribed in Clause (xiiib) of Section 47 of the Income Tax Act, 1961. In the instant case the requirement of the proviso to Section 47(xiiib) was not complied in the year of conversion of the company into LLP itself. Also, since the mode of computation of capital gains tax is prescribed in Section 48, the capital gain shall be basically computed by deducting from the 'full value of consideration', the cost of acquisition of the asset, if there is no other expenditure involved.

On the conversion of a company into a LLP, the shares in the hand of the shareholders of the company are converted into capital in the LLP. Thus, the shareholders relinquish their shareholding in the company and acquire capital in the LLP in the same proportion as was the shareholding in the private limited company. The full value of the consideration received/accrued to each shareholder, because of relinquishment of shares, will be the value of the capital in the newly formed LLP for the purpose of computation of capital gains under Section 48 of the Income Tax Act, 1961. If any of the shareholders of the private limited company receives any extra consideration or benefit, directly or indirectly, in any form or manner, the full value of the consideration received must be enhanced accordingly for the purpose of computation of capital gains under Section 48 of the Income Tax Act, 1961. Further, necessary adjustments shall also be made to the full value of the consideration, if the capital contribution and profit-sharing ratio in the limited liability partnership are not in the same proportion, as their shareholding in the company, as on the date of conversion. On the other hand, the cost of acquisition of shares shall be the amount paid by such shareholder at the time of purchase of shares, for the purpose of computation of capital gains under Section 48 of the Income Tax Act, 1961. The receipt of bonus share, if any, will not have any cost since it is out of the reserves of the company.

The conversion of a company into an LLP presents several advantages, including tax savings, simplified compliance, and greater flexibility in managing capital and profit distributions. Legal professionals must carefully navigate the requirements set forth under the LLP Act and Companies Act to ensure compliance and mitigate any tax liabilities.

For businesses seeking a more flexible and tax-efficient structure, the conversion to an LLP represents a viable option, provided that the conversion process is carefully managed, and all statutory conditions are met.

6. [2021] 124 taxmann.com 187 (AAR - New Delhi)

Capital Gains related to Partnership Firms/LLP(s) — Specific issues

CA Pilar Shivanand Nayak

CA Puja Borar

Overview

1. *Capital gains is usually a tax on transfer of capital asset. The recent amendments [by insertion of sections 9B and 45(4)] made to capital gains taxation in the hands of partnership firm are strangely worded. The capital asset being transferred (partnership interest) and the event of transfer are missing. The characterization of assets is conditional upon multiple variables. The liberal use of deeming fictions makes the provisions unreal and unworkable at various junctures. The offloading and decentralization of substantial provisions to Rules adds to the woes. Save the intent of the amendment, rest is enigmatic.*
2. *This article has cherry picked six issues relating to capital gains taxation of partnership firm emerging in connection with its reconstitution and dissolution. These issues are bisected into rejig of partnership interest intra and inter-organisation. The attempt is to unravel the issues, deliberate the alternative thoughts and suggest a possible way out. Despite the effort there are many more and deeper aspects which emerge. The write-up brings the curtain down with a hope that the Income-tax statute in its new Avataar should address these concerns.*

1. Partnership is the creation of a contract. It is an agreement between two or more persons to carry on activities (often commercial). The profits/ losses therefrom are usually shared in an agreed ratio. Like any other genre of assessee, gains could arise in the hands of a partnership firm on the transfer of capital assets held by it. The uniqueness in capital gains taxation of partnership under the Income-tax Act, 1961 (**the Act**) lies in the capital gains tax consequences on cessation or alteration of the contractual relationship between the partners. The reasons for such change or undoing of the contractual arrangement could be multifarious. It could be a misalignment of cultures (commercial or otherwise) or a realignment of motives. It often is an outcome of familial dynamics.

2. The attempt in this write-up is to focus on a few issues in capital gains taxation on a rejig of partnership (and some attendant nuances). This article has chosen six issues around

   (a) The reconstitution of partnership firm involving payment or outflow by the firm to partners; and (b) the sale or assignment of partnership interest amongst partners or to an outsider.

The article is 'issue centric'. The fundamentals of capital gains taxation and relevant provisions of the Act are therefore highlighted below in brief (and elaborated only on need basis).

Relevant provisions of the Act

3. Chapter IV-E of the Act contains provisions relating to "Capital Gains". Section 45 is the charging section. Under section 45(1), profits and gains arising from the transfer of a capital asset effected in the previous year is chargeable to tax. Section 48 outlines the methodology for computing capital gains. As per section 48, capital gains are arrived at by deducting two items from consideration for transfer, namely, cost of acquisition/improvement (suitably indexed in appropriate cases) and cost of transfer.

4. Finance Act 2021 inserted section 9B and substituted section 45(4). Section 9B provides that there must be a specified entity [or a partnership firm[1]]. Such partnership firm must have been reconstituted or should have been dissolved. The specified person [or the partner] in such firm should receive a capital asset or stock in trade from the firm in connection with such reconstitution or dissolution. On satisfaction of these conditions, sub-section (1) of section 9B provides for a deemed transfer of assets (more of this later).

5. Section 45(4) seeks to fasten capital gains tax if a specified person [partner] receives during the previous year any money or capital asset in connection with the reconstitution of the specified entity [partnership firm] if the money or capital asset is in excess of the balance in the capital account of such partner [in the books of the firm]. Sub-section (4) requires examination of money/ capital asset received and the comparability with the capital account balance of the partner.

6. Section 9B requires an examination of the distribution of assets [capital asset or stock-in-trade] by the firm to partner. The statute fastens capital gains tax on such distribution on the firm. The gains under section 45(4) on the other end of the pendulum is viewed from a partner's perspective. In short, the objective is whether the partner has received any asset(s) or monies over and above his capital account balance. Section 9B and 45(4) are two sides of the same transaction, namely, the settlement of the capital account balance of the partner. The former (section 9B) refers to gain on transfer; while the latter (section 45(4)) gauges the return on investment by the partner. In this background, the ensuing paragraphs examine some of the issues in capital gains tax space in relation to partnership firms.

7. Section 48(iii) stipulates that the amount chargeable to tax under section 45(4) shall be reduced from the sale consideration of capital assets (which remain with the partnership firm) as and when these are transferred by the specified entity in future.

1. In addition to Association of Persons or Body of Individuals.

8. Much water has flown under the bridge since the introduction of these provisions. Multiple literatures are available which explain the schematics of these new provisions. The present write-up, therefore, proceeds to deliberate on some of the capital gains issues in relation to partnership firm(s) which we believe could interest the readers.

Issue 1: Distribution of stock-in-trade on dissolution or reconstitution

9. Section 9B is a charge of tax on the transfer of a capital asset or stock-in-trade by a partnership firm to a partner[2]. The section outlines the following conditions for applicability of this provision:

    (a) There must be a specified entity [partnership firm];

    (b) Such specified entity must have been reconstituted or should have been dissolved;

    (c) The specified person must have received a capital asset or stock in trade from the specified entity in connection with such reconstitution or dissolution.

10. On satisfaction of these conditions, the fair market value of the parted asset [capital asset or stock-in-trade] constitutes the full value of consideration for the purposes of taxing the gains.

11. The transfer of stock-in-trade by the partnership firm is chargeable to tax under section 9B. The section fastens tax on gains (ie, net of purchase cost). Such distribution of stock-in-trade is not chargeable to tax under section 45(4). This is because section 45(4) is only applicable on receipt of capital asset or money. The question thereby is whether, the distribution of stock-in-trade to a partner entails only 'one-point' taxation, namely under section 9B?

12. Unlike the distribution of capital asset, which involves a 'two-point' taxation under section 9B and 45(4), the distribution of stock-in-trade appears to be taxed only under section 9B. There is no parallel provision in section 28 [being the charging section for business income] which seeks to tax the difference between the capital account and the fair value of stock-in-trade parted by the firm. Thus, section 9B taxes on the transfer of stock-in-trade, however, section 28 does not tax the return of investment angle to this transaction. The two-step taxation is not apparent in a stock transfer to the partner. The *intelligible differentia* in the taxation on movement of these two assets is obscure. On the contrary, transfer or sale of stock-in-trade to partners may be recorded as sales in the books/ financial statements. In such an eventuality, the consideration at which such stock transfer is recorded in the Revenue statement would form part of the business income. The value at

2. The phrases specified entity and specified person have been replaced by the partnership firm and partners hereinafter in the write-up for ease of reading.

which it is so recorded would naturally be charged to tax as business income. Such a taxation under section 28 would result in both the provisions (section 9B and section 28) attempting to tax the parting of asset by the firm. While this may not have been the legislative intent, an argument of dual taxation cannot be ruled out since the Act does not provide for the two provisions to be mutually exclusive. The interpretation gets even more tougher if there is a transfer of stock-in-trade along with a capital asset.

13. The quagmire gets deeper when there is a differential in the value at which the stock-in-trade is transferred to the partner and the fair value of asset. This challenge emerges from the mandate of Income Computation and Disclosure Standard 2 requiring the inventory to be valued at net realisable value on dissolution of the firm [para 24 of the standard]. However, section 9B requires a transfer at fair market value. The applicability of section 43CA in case of transfer of land/ building as stock-in-trade may also be examined, especially the transfer made in lieu of settlement of partnership interest.

14. With a strained effort to make the law workable in the present structure, one may adopt a view that on distribution of stock-in-trade by firm to partners, there is no double taxation. This proposition is on the premise that provisions of section 9B routes the taxation to relevant heads of income. Thereby, in case stock in trade is received by the partner, it would be taxed as income under section 28 of the Act[3]. The quantum of income chargeable to tax under section 28 is influenced by section 9B, which requires capping of the full value of consideration to fair market value. This solution is not sacrosanct. This places the stature of section 9B in a precarious position.

15. Section 9B is enacted as a separate and independent charge of tax. This understanding is confirmed by Explanation 2 to section 45(4). The Explanation states that the provisions of section 45(4), which is an undisputed charging section, shall operate in addition to section 9B. Further, the taxation under section 9B shall be worked out independently. The statute states that there is an additional charge of tax under section 9B which is independent and distinct. Thereby, the status of section 9B is ‘on par’ with section 45(4) as a parallel charging provision. This setting cannot suffer a jolt merely because the ‘parted asset’ is a stock-in-trade and not a capital asset.

Issue 2: Determination of nature of capital gains chargeable to tax under section 45(4) on revaluation of assets including stock-in-trade

16. Section 45(4) fastens tax on receipt by a specified person [which includes a partner] from a specified entity [like a partnership firm]. The receipt should be - ‘capital asset’ or ‘money’. Any receipt (like a stock-in-trade) by the partner is outside the gamut of section 45(4). The receipt should be in connection with reconstitution. Reconstitution

3. Supported by the Technical Guide issued by ICAI on Income Tax on Reconstitution of Firm [Page 25].

connotes the three instances captured in Explanation to section 9B [not delved herein presently]. On such a receipt, the money and fair market value of capital asset received by the partner is compared with the capital account balance of the partner in the books of the firm. Such capital account balance should be shorn off any element of revaluation of assets. The difference between the fair value of 'incoming asset'/ money and the capital account balance is chargeable to tax under the head 'Capital gains'. Such income and the burden of tax thereon is statutorily shifted to the partnership firm.

17. Sub-section (4) of section 45 does not specify the manner of reckoning the nature of the aforesaid capital gains. As a ground norm, one can resort to section 2(42A) which houses the manner of determining the period of holding. As per clause (ii) therein, the Board wields an authority to make rules for determining the period of holding for assets that are not covered in other limbs of the provision. Under the aegis of such empowerment, Rule 8AA read with Rule 8AB emerged.

18. Sub-rule (5) to Rule 8AA deals with characterization of capital gains chargeable to tax under section 45(4). The characterization is based on the capital asset to which the gains are attributed. The manner of attribution is outlined in Rule 8AB. Before reckoning such 'manner of attribution', one must unravel the theory of attribution emerging in the present context. To step back, reconstitution of a firm usually entails 'enterprise revaluation' followed by release of identified assets in favour of certain partners. This is done to revise and realign the asset holdings and interest stakes of the partners in accordance with the reconstitution scheme. Thus, the asset(s) which is released (or the outgoing asset) represents an aliquot portion of the enterprise value. Thus, the gain that the partners enjoy on receipt of the released asset 'represents' or 'is attributable to' other assets (and their revaluation) in the partnership firm. This understanding of inner re-engineering is pivotal in appreciating the interplay of Rule 8AA and 8AB. In short, on reconstitution, the statute visualises the release of a portion of the net assets of the firm. In spirit, a part of every asset and liability of the partnership firm is released. This settlement obligation is satisfied through the outflow of one or more assets in the partnership firm. The outgoing asset(s) thereby represent a portion of the various other assets in the firm. Rule 8AB statutorily provides for a manner of reckoning such as 'representation' or 'attribution'.

19. Each of the limbs in Rule 8AB houses an instance of attribution. Presently, sub-rule (2) [housing one of such instances] has been chosen for discussion. Sub-rule (2) therein, inter alia, deals with a partner receiving the fair market value of capital asset(s) from a partnership firm in excess of his capital account balance which is chargeable to tax under section 45(4), such gain being relatable to the revaluation of capital asset(s). In such an eventuality, the capital gains chargeable to tax under section 45(4) is attributable to the remaining assets of the firm in the following ratio:

Increase in or recognition of revaluation of asset
Increase in or recognition of revaluation of all assets

20. In short, capital gains on receipt of capital assets under section 45(4), entailing a revaluation, is to be attributed to 'remaining' assets of the firm. Having understood the connect between the parted asset and the assets remaining in the firm, the stage is set to discern the mandate of Rule 8AA(5) [referred earlier]. Sub-rule (5) states that the amount chargeable to tax under section 45(4) as 'Capital gains' would be 'short-term' if the remaining asset is a (i) short term capital asset; or (ii) capital asset forming part of the block of asset; or (iii) capital asset being a self generated asset or goodwill. The capital gains would be characterized as 'long-term' if it is attributed to any long-term capital asset. Rule 8AA(5) thus visualizes the basket of remaining assets to contain only 'capital assets'. The rule conspicuously does not deal with the firm holding revalued stock-in-trade as a part of remaining assets. Legislative critics would snap into this opportunity to plead a failure of charge in the absence of computation mechanism. One possible and harmonious interpretation could be to carve out capital gains attributable to stock-in-trade. Such quarantined gains should not be subject to tax under section 45(4). This view garners support from the proposition that when receipt of stock-in-trade should not be charged to tax under section 45(4), the revaluation gain(s) on such stock-in-trade should also be outside the noose of section 45(4). Further, the attribution rule in Rule 8AB(2) refers to revaluation of 'all assets'. It does not restrict only to capital assets. Accordingly, one may attribute capital gains to stock-in-trade and exclude such gain from the charge of section 45(4).

21. An interesting angle on the 'nature of assets' that the readers may have to consider is whether the characterization of these parted assets must be viewed from the lens of the firm or the recipient-partner? Since the legislation articulates a tax on 'receipt' of asset, a subtle thought creeps in whether the nature of asset should be viewed from the partner's perspective? This view is further fuelled by the schematics of section 45(4) which requires initial determination of income in the hands of the partner then followed by a deliberate statutory fiction of moving the income and the tax liability thereon to the firm. This makes one wonder whether the nature of assets should also be viewed from the partner's prism? However, this may not be appropriate as both sections 9B and 45(4) are fastening a charge on the firm. The former states the movement of assets from firm to partner as a "deemed transfer". This being the case, such transfer cannot be ignored for the purposes of section 45(4) [despite the section not referring to the term 'transfer' in the section]. In any case Rule 8AB (which deals with period of holding) refers to such movement as 'transfer'. The capital gain is therefore on transfer. One facet of gain is arising on transfer of asset (being the difference between transfer consideration and cost qua the firm). The other facet is the gain arising to the partner on the same transfer [being value received over and above the capital account balance]. The charge is therefore on transfer of assets. The nature of assets must be viewed

from the transferor's perspective. Section 45(4) does not specify that the capital asset should be 'of the recipient', unlike a specific mention in Explanation to section 56(2)(vii) which requires the determination of nature of the asset from the recipient perspective. The transferor in both these provisions is only the firm. The mandate of Rule 8AB which requires comparison of the parted asset with other assets of the firm also syncs with this thought process. In any case, the opening portion of section 9B and 45(4) are identical which refers to assets being received by partners from the partnership firm. The language being identical, their interpretation should also be consistent. Accordingly, it may be appropriate to classify the assets from firm's perspective.

Issue 3: Treatment in case of negative capital

22. The determination of capital gains chargeable to tax under section 45(4) is formula driven. The equation is A = B + C – D. In this, **A** is income chargeable to tax under section 45(4); **B** is the value of money received by the partner; **C** is the fair market value of the capital asset received; and **D** represents the balance in the capital account of the partner in the firm's books.

23. The sub-section clarifies that the capital account may be represented in any manner. The balance in capital account is to be calculated without considering the increase due to revaluation of any asset or due to self-generated goodwill or self-generated asset. The first proviso also specifically provides that if the value of A in the formula is negative, its value shall be deemed to be zero. However, the statute does not provide clarity on whether the formula would be implemented if the component **D** is negative. In other words, whether a debit balance in the capital account would make the formula unworkable?

24. The section does not provide for negative capital account balance explicitly. The opening portion of Rule 8AB(2) as well the memorandum to Finance Bill, 2021 states that section 45(4) is chargeable when the capital asset (and money) received is 'in excess of' the balance in the capital account. Accordingly, the legislature visualized a 'differential' between the capital assets and monies received vis-à-vis the capital account balance. If the balance in capital account is negative, the formula would result in value of capital asset or money received being increased by the amount lying in the debit balance of capital account. There would be no differential or excess computation in such a situation. On the contrary, there would be an aggregation. One may therefore argue that negative or debit balance in capital account is not visualized in section 45(4).

25. The aforesaid conclusion could lead to absurd results. A negative capital account balance is usually indicative of the partner having 'overdrawn' the capital. In effect he is the loanee for the firm. Despite such debt, if the firm proceeds to distribute monies or capital assets to such partners, the gain, qua the partner, should naturally be summation of the debt and the value of parted assets. Settlement of such negative balances cannot be ousted on hyper-technical grounds. One may also rely on some of the judicial precedents [in the context of section 50B] that negative figure of net worth cannot be

ignored for computing the capital gains[4]. Extending this rationale, a negative balance in the capital account should also be considered in computing the capital gains under section 45(4) of the Act.

Issue 4: Applicability of sections 45(4) and 9B on receipt by legal representative of deceased partner

26. Sections 9B and 45(4) are attracted on receipt of asset/ monies by the partner from the partnership firm in connection with reconstitution/ dissolution[5]. A firm is reconstituted if one or more partners of such firm ceases to be a partner [Explanation to section 9B]. The cessation of a partner of firm on his death results in reconstitution of the specified entity. The partnership deed may stipulate that the deceased partner's share in the partnership be transferred to his legal heir. In some cases, the legal heir becomes a partner under a will of the deceased partner. The balance in capital account of the deceased partner is owned and carried over by the new partner who is his legal heir. In such an eventuality, there is no transfer of assets to the deceased partner or his legal heir by the specified entity. The application of sections 9B or 45(4) is ruled out[6].

27. In some cases, the partnership deed may provide that the account of deceased partner be settled at fair value in favour of his legal heir without admitting him as partner. Whether the receipt of money, capital asset, stock in trade by the legal representative of the deceased partner from the partnership firm trigger applicability of sections 9B and 45(4)? A legal heir steps into shoes of deceased partner. The payment is made to the legal heir pursuant to vested rights of the deceased partner in terms of partnership deed. The receipts by the partner on exiting from the firm would have attracted tax implications under sections 9B and 45(4). The amounts which were receivable by the partner are now received by the legal heir. The question is whether receipt by the legal heir should attract the same consequences as receipt by the partner himself?

28. Sections 9B and 45(4) are charging sections. They should be interpreted strictly. The sections mandate that the recipient is a partner at the time of receipt. This pre-condition fails in the case of legal representative. One may recollect that judiciary in the context of section 40(b) has held that interest paid by a firm to estate of the deceased partner administered by the trustee, is not hit by section 40(b) as such trustee was never admitted as a partner in firm[7]. Further the legislature has expressly provided for taxing of income in the hands of the recipient by reason

4. *DCIT vs. Summit Securities Ltd. (2012) 19 taxmann.com 102 (Special Bench of the Mumbai tribunal).*
5. Section 45(4) only on reconstitution.
6. Discussed under Frequently asked question number 3 of Technical Guide on Income Tax on Reconstitution of firm issued by the Institute of Chartered Accountants of India.
7. *Colombo Stores (1984) (17 Taxman 183) (Madras HC).*

of death of the assessee in whose hands such income ought to have been taxed [Explanation (iii) to section 45(5)]. In the absence of such provisions, the receipt by the legal heir may not attract the applicability of sections 45(4). However, the interesting question is whether the receipt of consideration can be taxed under the provisions of section 45(1)? A clarification in this regard could avoid this dilemma.

Issue 5: Definition of specified person

29. The phrase 'specified person' for both the sections 9B and 45(4) is defined in Explanation to section 9B. The definition is an exclusive one. It defines specified person to mean a partner in a firm in any previous year. There is no reference to such person to be the person who should cease to be the partner pursuant to reconstitution or dissolution. Thereby, the definition should encompass every partner (present or past) who may have received the specified distributions from the firm in connection with reconstitution or dissolution. This thought process gathers muster from the fact that both the sections 9B and 45(4) never explicitly express that the distribution is in lieu of his/ her interest in partnership firm. Thereby, any payment made to partners in connection with reconstitution/ dissolution, even if it is for not for the settlement of capital accounts could possibly be covered. For instance, there could be a payment made to any partner as a consideration for the possible dispute that may arise in respect of the reconstitution/ dissolution. It could be a payment to put a quietus to a possible dispute. The question is whether such payment would also be covered? Readers may ponder.

Issue 6: Transfer/ assignment of partnership interest to a third party

30. A partner's interest in a firm is transferable[8]. The interest of a partner in a firm is not an interest in any specific item of the partnership property[9]. It is a right to obtain (i) his share of profits from time to time during the subsistence of the partnership and (ii) to receive his share in the net partnership assets on dissolution of the partnership or retirement from partnership. Such a share in the partnership qualifies as a capital asset[10].

31. The partner's rights in such capital asset are extinguished upon transfer of the share in the partnership to a third party. The consideration in such a case would flow from a third party. The return is not from the firm. The application of sections 9B and 45(4) is therefore ruled out. However, the gains arising on such transfer should attract capital gains tax. The capital gains shall be computed in accordance

8. Section 29(1) of the Indian Partnership Act, 1932 and section 42(1) of the Limited Liability Partnership Act, 2008.
9. Circular No. 768 dated 24.06.1998.
10. Special Bench of Delhi Tribunal in *DLF Universal Ltd vs. DCIT 36 SOT 1; Savitri Kadur vs. DCIT (2019) 177 ITD 259 (Bang.).*

with section 48. The consideration received from the third party shall constitute full value of consideration. The initial capital contribution or further capital contribution would be part of the cost of acquisition. The capital contribution constituting cost is not often found in a litigation-free terrain. The taxpayers would often argue that the expression cost of acquisition signifies some expenditure or outlay in terms of money by the assessee. An expenditure or outlay is something which goes irretrievably out of the coffers of the payer[11]. This attribute of 'cost' is absent in capital contribution. A partner is entitled to receive back the initial capital contribution under certain circumstances. It may therefore be difficult to conclude with conviction that the capital contributed by a partner should be characterised as cost of acquisition of interest in a firm.

32. The transfer or assignment of the share in partnership in favour of a third person is distinct from a case where a partner constitutes a sub-partnership with his share in the main partnership[12]. In case of assignment the assignee gets limited right or interest in the main partnership. A sub-partnership acquires a special interest in the main partnership.

33. Parting thoughts: Conceptually, the (in)separability of partners from the partnership has been an impasse in which neither the statute nor judiciary has dared to intervene. This deadlock has morphed into the vagueness in capital gains taxation. The legislation has matured over years. The judiciary has often shed the guiding light. However, many of the legislative amendments, like the one discussed above, are 'reactive'. The drafting appears to be sporadic. The issues discussed herein above are only a few which intrigued us. We admit that these are only the peripheral ones. There is lot more to be done. It is hoped that the new tax code (which is the current murmur) would cement the potholes and not merely give a pitstop support.

11. *CIT vs. E. C. Jacob (1973) 89 ITR 88 (Ker).*
12. *CIT vs. Sunil J. Kinariwala (2003) 259 ITR 10 (SC).*

Tax implications on the exemption under Sections 54 and 54F

CA K Prasanna

Overview

The words of wisdom from the Apex Court in Aravinda Reddy aptly summarize the object behind Section 54 of the Act "If you sell your house and make a profit, pay Caesar what is due to him. But if you buy or build another subject to the conditions of section 54(1) you are exempt". *While the object appears to be simple, the issues surrounding the section are numerous. Considering the nature of issues and interpretations surrounding the sections, one may echo the feeling from the passage of the Apex Court ruling in Aravinda Reddy's case:* "Where ignorance is blist; 'Tis is folly to be wise"

While the two sections have been in statute for over four decades and have undergone numerous amendments, several issues still stem from them. In this article, I have explored some issues that could affect the exemption under this section and persist to date.

1. Introduction

To promote reinvestment in certain assets or schemes, the Central Government has introduced several exemptions from the levy of capital gains accrued to the taxpayers. The exemptions were granted subject to reinvestment and comply with specific conditions prescribed therein. In the case of Individuals, the benefit of exemption is conferred on investment in a residential property through sections 54 and 54F of the Income-tax Act, 1961 ('the Act'). The differences between the sections are discussed in the ensuing paragraph. These exemptions allow twofold benefits to taxpayers: (i) not required to pay taxes on the capital gains reinvested subject to fulfillment of conditions and (ii) Promote investments in the Housing Sector.

2. Exemption under section 54 of the Act

The Income-tax Act, 1922, contained Section 12B(4)(b), which corresponds to Section 54(1) of the Act, allowing concession in respect of investment made in new assets at the option of the Assessee in writing before the assessment is made. Section 54 of the Act was introduced by the Finance Act, 1978 with retrospective effect from 1974, provides for exemption from capital gains in respect of transfer of capital assets being building or lands appurtenant thereto and the income of which is chargeable to tax under the head 'income from house property' ('IHP') upon

reinvesting. Several key amendments have been made to overcome judicial precedents.

(a) Conditions for claiming exemption

The law as it stands today vide Finance Act (No.2) 2024, provides for the exemption of capital gains subject to the following conditions:

- The transferor is an Individual or Hindu Undivided Family ('HUF');
- Long Term[1] Capital asset transferred being buildings or land appurtenant thereto being a residential house, the income of which is chargeable to IHP ('Original Asset')
- The investment is made in one residential house in India[2] ('New Asset'), which should be either constructed or purchased.
- In case of purchase, the investment can be made within one year before or two years after the date of transfer of the Original Asset, and in case of construction, it is three years;
- If the capital gains do not exceed INR Two Crores, then investment in two residential houses is permitted. This option can be exercised only once during the assesse's lifetime;
- In case the cost of a new asset exceeds INR Ten Crores, the amount invested in excess of INR 10 Crores shall be ignored;

(b) Consequence of transferring the new asset within three years

In case the New asset is transferred within three years from the date of purchase or construction, then the taxpayer will be subject to capital gains on the transfer of the new asset as follows:

- If the capital gains from the transfer of the original asset are more than the cost of a new asset, then the new asset cost will be taken as Nil.
- If the capital gains from the transfer of the original asset is equal to or less than the cost of a new asset, then the cost of the new asset is reduced to the extent of exemption already availed under Section 54.

From the above, it can be observed that the consequence of a transfer of a new asset within the time limit is more severe i.e., the long-term gain from the original asset is clawed back through the reduction from the cost of new asset. This effectively results in a short-term gain chargeable to tax at a higher rate in certain instances.

Further, it is relevant to note that vide Finance Act (No.2), 2024, the period of holding under Section 2(42A) is reduced from 36 months to 24 months (discussed later in detail). However, the clawback period of exemption under 54/54F is still three years from the date of purchase or construction of the new

1. *Held for a period more than 24 months as amended by Finance Act (No. 2), 2024*
2. Introduced by Finance Act 2014; Before that investment in residential property outside India was allowed

asset. Therefore, if the new asset is held for at least 24 months prior to its transfer, the gains would be treated as long-term; otherwise, it would be short-term.

(c) Capital Gains Deposit Scheme ('CGDS')

In case the taxpayer cannot utilize the sum for investment in a new asset before the date of filing the return of income ('ROI') under Section 139 of the Act, the unutilized sum shall be deposited by him before furnishing the ROI under 139(1) in an account in any such bank or institution as may be specified in and utilized in accordance with any scheme notified by Central Government[3].

The amount already utilized by the taxpayer and the amount deposited shall be regarded as the deemed cost of the new asset.

(d) Non-utilization of the amount deposited in CGDS

Suppose the amount deposited is not utilized wholly or partly towards investment in a new asset within the time specified. In that case, such a unutilized amount shall be chargeable as capital gains (long-term) of the previous year in which the specified period expires (three years), and it will be long-term gains i.e., in effect the year of charge is deferred.

3. Exemption under Section 54F of the Act

The section was introduced by the Finance Act, 1982 w.e.f from 1984, which allowed exemption from capital gains from the transfer of long-term capital asset (not being a residential house) by an individual or HUF in case of investment of net consideration[4] in one residential house.

(a) Conditions for claiming exemption

The law as it stands today vide Finance Act 2024, provides for exemption of capital gains subject to the following conditions:

- The transferor is an Individual or Hindu Undivided Family ('HUF');
- Capital asset transferred is other than a residential house ('Original Asset');
- The investment is made in one residential house in India ('New Asset') and it should be in the form of construction or Purchase;
- In case of Purchase, the investment can be made within one year before or two years after the date of transfer of Original Asset and incase of construction, three years;
- In case of the cost of new asset exceeds INR Ten Crores, the amount invested in excess of INR 10 Crores is ignored;

3. Capital Gains Deposit Scheme, 1988 – GSR 724(E) dated 22 June 1988
4. Full value of consideration reduced by expenditure incurred wholly and exclusively in connection with such transfer

(b) Computation of Capital Gains

The capital gains shall be computed as follows:

(i) Cost of new asset is more than the net consideration, then no capital gains in respect of original asset shall be charged

(ii) Cost of new asset is less than the net consideration, then the exemption shall be on a proportionate basis, which is based on the cost of new asset to the net consideration

(c) When the exemption is not available

The provisions of section 54F are not applicable in the following circumstances:

(i) Owns more than one residential house other than a new asset on the date of transfer of original asset;

(ii) Purchase any residential house, other than the new asset, within a period of one year after the date of transfer of the original asset;

(iii) Construct any residential house, other than new asset, within a period of three years after the date of transfer of Original asset;

(iv) The income from such residential house, other than one residential house owned on the date of transfer of Original asset is chargeable under the head IHP

To summarize, the Act does not want to provide an exemption if the Assessee owns more than one residential houses either before the date of transfer of the original asset or after investing in one residential house.

The Section also provides for the deposit of unutilized amounts in capital gains; the provisions are similar to the one addressed in Section 54 of the Act.

The consequence of transferring a new asset within three years of purchase or construction is slightly different from Section 54. Section 54F(3) specifically provides that if the new asset is transferred within 3 years, the exemptions claimed on the original asset will be chargeable as capital gain relating to the long-term capital asset in the year the new asset is transferred.

Before we move on to specific issues, a few aspects require an understanding, and they are dealt with in the following paragraphs:

4. Certain Aspects for Consideration

(a) Land Appurtenant thereto

The term' land appurtenant' is not defined under the Act, and its meaning has to be understood non-technically. The extent of land appurtenant to a building transferred has to be based on facts and circumstances, and common tests cannot be applied. The **Madras High Court** in the case **Kalpagam**[5] has laid out the following tests for understanding (although not exhaustive) the term:

5. *CIT vs. Kalpagam (M) (1997) 227 ITR 733 (Mad)*

i. Whether building together with the land is treated as an individual unit and enjoyed by the person occupying it;

ii. If a building has extensive lands appurtenant, an inquiry can be made whether any land contiguous to the building can be put to independent use without causing any detriment to the enjoyment of the building[6];

iii. Any indication that a portion of land contiguous was applied other than the enjoyment of building;

iv. Any income derived from land that is not assessed under IHP.

(b) *Residential House and income chargeable under IHP*

The term 'residential house' is not defined in the statute and is construed as having a liberal meaning[7]. Ideally, it should constitute an abode or residence, and it should not be causal as in the case of a hotel or choultry[8]. The Property constructed for residential purposes does not lose its character merely because it is temporarily used for office purposes[9]. The distinction between a residential building and a house is very important since every "residential building" would not be a "residential house", though every residential house has to be a residential building[10]. Sale of rights in a flat vide allotment letter cannot be regarded as a residential house[11]. When the building was not occupied on account of being uninhabitable, it could not be regarded as a residential house, and the assessee was not allowed an exemption under 54[12].

The Central Board of Direct Taxes vide their circular[13] has clarified that merely a residential house is assessed as Nil under Section 23(2) of the Act; it does not mean the property is not chargeable to tax under IHP; hence, the same is entitled to exemption under Section 54.

Recently, Explanation 3 to Section 28 was introduced[14], which states that letting out a residential house or a part thereof shall not be chargeable under profits and gains ('PGBP') and shall be charged to tax under IHP. Before this amendment, the income from this residential house was never assessed under IHP but under PGBP, hence not considered for Section 54 or 54F, but the impact of the amendment could be as follows:

6. *S Radhakrishnan vs. CIT (1984) 145 ITR 170 (Mad)* – Vacant plots other than bunglow was sold; *CIT vs. Zaibunnisa Begum (1985) 151 ITR 320 (AP)*
7. *Guruprasad Angisetty vs. ITO, 2016 (9) TMI 385 – ITAT Chennai*
8. *Poonen vs. Rathi Varghere – AIR 1956 Mys 57*
9. *CIT vs. Purushottam Dass (2001) 247 ITR 516*
10. *Rajesh Surana vs. CIT, (2008) 306 ITR 368 (Raj)* – Rendered in the context of Section 53 of the Act.
11. *CIT vs. Kalpana Hansraj (2019) 102 taxmann.com 228 (Bom)*
12. *D.P. Meha – 251 ITR 529 (Del)*
13. Circular No 538 dated 13 July 1989
14. Finance Act (No.2), 2024 applicable from AY 2024-25

(i) Section 54 – Capital Gain realized from the sale of such house can be reinvested in new asset

(ii) Section 54F – The residential house may required to be counted to decide the eligibility of reinvestment i.e, whether the assessee has more than one house at the time of transfer of eligible asset

5. Specific Issues

As per Section 2(42A), residential property is regarded as a short-term capital asset if held for less than 24 months; otherwise, it is a long-term capital asset. Therefore, the property's acquisition date, whether done through purchase or construction, is critical in determining the holding period and implication on the time limit prescribed under Sections 54 and 54F of the Act. Therefore, the period of holding and the date of acquisition are dealt with as part of the following issues:

(i) Purchase vs Construction

Neither of the terms is defined under the Act, and both aspects are different. The **Hon'ble Supreme Court** in **Aravinda Reddy's**[15] case held that the word 'purchased' in Section 54(1) of the Act must be given its ordinary meaning as buying for a price by payment in kind or adjustment towards old debit or for other monetary consideration. The **Andhra Pradesh High Court** in ***CIT vs. Shahajada Begum***[16] has observed that the expression 'purchase' would undoubtedly connote the domain and control of the property given into the assessee's hands.

'Construction' means the action of building something. Therefore, payment to a builder for a flat that is yet to be constructed cannot be treated as a purchase and should be regarded as construction[17]. Booking of semi-finished property is to be regarded as construction and not a purchase[18]. Construction should not be restricted to new construction alone; it can be extended to remodeling[19] and encompasses substantial renovation to make a house habitable[20].

(ii) Own vs. Held

Section 2(42A) uses the term 'held' by the Assessee as against the term 'own'. The dictionary meaning of 'held' is to possess or be the owner, holder, or tenant of a property, stock, land, etc. An assessee enters into the purchase agreement for a flat and takes possession of the flat; however, the consideration was discharged over a period of time. The Court[21] held that the possession was handed over to the taxpayer through the agreement, and he became a beneficial owner at this juncture. Upon payment

15. *120 ITR 46, 48 (SC)*
16. *173 ITR 397*
17. *Farida A. Dungerpurwala vs. ITO (2014) 67 SOT 208*
18. *Akshay Sobti (2019) 177 ITD 92 (Del ITAT), Seema Sobti (2019) 177 ITD 370 (Del ITAT)*
19. *Mathavan Pillai 219 ITR 696 (Kerela)*
20. *Meher R Surti (2013) 27 ITR (Trib) 340 (Mum ITAT)*
21. *CIT vs. Ved Prakash & Sons (HUF) [1994] 207 ITR148 (Punjab & Haryana).*

of the final installment, he became the legal owner of the property. Going by the usage of the word 'toward' before the 'purchase' in Section 54(2), it is not used in a real sense of legal transfer. Hence, holding legal title within a specified period is not a condition precedent for attracting section 54[22].

In **Ved Prakash & Sons (HUF)**[23], the Court expounded on the scope of 2(42A) and the term 'transfer'. The Court observed that 'transfer' does not refer to physical form of property or possession of the property, it refers to subject matter of transfer i.e., the nature of rights and interest in the property. Therefore, the question has to be what has been transferred and when it was acquired are relevant.

(iii) Delay in registration of property/ execution of Conveyance Deed

In case of acquisition, there are instances where the date of possession and date of registration are different. In such instances, an issue may arise regarding the relevant date for determining the holding. This is also crucial for determining satisfaction of reinvestment under Sections 54 or 54F of the Act.

The intention of the exemption under these sections is the reinvestment of gains/net consideration in a residential house. The Act of Registration confers a legal title to the property; a mere delay in property registration cannot take away the beneficial title if the consideration is paid and absolute possession is obtained[24]. This is fortified by the extended definition of transfer under Section 2(47) of the Act[25]. The Supreme Court in **Poddar Cements**[26], in the context of allowing depreciation, considered the beneficial ownership despite the title deeds not being registered. The Delhi High Court in **Kuldeep Singh**[27] suggested that the word purchase used in Section 54 should be interpreted pragmatically in a practical manner and legalism shall not be allowed to play and create confusion or linguistic distortion and in fact the Court went on to observe that section 54(2) should not be restricted to registered sale deed or even possession but has a wider connotation. The **Andra Pradesh High Court** in ***Shahjaga Begam (supra)*** allowed the benefit of Section 54 by observing that the delay in obtaining formal registration of the sale deed is immaterial as the assessee has satisfied other requirements of payment of consideration and securing possession.

(iv) Entering into an Agreement to Sell

In many instances, the parties initially enter into an agreement to sell the property (constructed or under construction). Whether an agreement

22. *Prakash Timaji Dhanjode 258 ITR 114 (Nagpur ITAT); Laxmichand Narpal Nagda (Dr) – 211 ITR 804*
23. *207 ITR 408 (P&H)*
24. *Balraj - 254 ITR 22 (Delhi)*
25. *Refer to Clause (v) and (vi) to Section 2(47)*
26. *226 ITR 625 (SC)*
27. *270 ITR 561*

to sell confers any right to the acquirer, satisfying the reinvestment condition. The **Supreme Court in G.H. Ariff & Others**[28] held that 'property' is a term of wide import. The **Bombay High Court** in **Vijay Flexible Containers**[29] held that the right to obtain conveyance of immovable property falls with the expression' property of any kind' under 2(14) of the Act.

The **Supreme Court** in **Sanjeev Lal's case**[30], where the assessee inherited the property, entered into an agreement to sell it (2002). Before a sale deed could be executed, an injunction was granted. Later, the injunction was removed, and the assessee sold the property (2006). In the meantime, the Assessee invested in a property (2003) within the limit if reckoned from the agreement to sell, claiming exemption under Section 54. By executing an agreement to sell, the right in the asset for the seller is extinguished in as much as the *right in personam* is created in favor of the agreement holder. The relevant extracts are reproduced:

"*23…In practical life, there are events when a person, even after executing an agreement to sell an immovable property in favour of one person, tries to sell the property to another such an act would not be in accordance with law because* ***once an agreement to sell is executed in favour of one person, the said person gets a right to get the property transferred in his favour by filing a suit for specific performance and therefore, without hesitation one can say that some right, in respect of the said property, belonging to the assessee had been extinguished and some right had been created in favour of the vendee/transferee, when the agreement to sell had been executed***"

The **High Court of Gujarat** in **Kishobhai Harijibhai Patel**[31] and **Kolkatta ITAT** in **Gautam Jhunjunwala**[32] has allowed a claim under Section 54/54F as the new property was purchased within time limits[33] from the date of agreement to sell. The **Delhi ITAT** in **Smt. Anjali Bhadoo**[34] considered the agreement for sale as an agreement of construction to allow a claim under 54 of the Act. The ITAT considered the circulars issued by the board (*infra*), which is discussed subsequently in this article.

Due care must be taken regarding an agreement to sell, whether such agreement confers any irrevocable and unconditional right to enforce the conveyance of property pending possession or discharge of full consideration so as to argue that the requirement of reinvestment/transfer is satisfied.

28. *76 ITR 47 – rendered in the context of the Wealth Tax Act*
29. *186 ITR 693*
30. *365 ITR 389 (SC)*
31. *[2019] 107 taxmann.com 295 (Gujarat)*
32. *[2018] 98 taxmann.com 220 (Kolkata Trib)*
33. *One year before the date of agreement to sell*
34. *(2024) 204 ITD 124*

(v) Obtaining Allotment Letter vs actual possession vs payment of installments

In the case of property construction, a conveyance deed is entered into after construction. The taxpayer may make an advance and book a flat, and as part of that, the builder may issue an allotment letter against the booking. Post booking, the assessee pays installments over a period and receives possession. A question arises as to whether obtaining an allotment letter satisfies the requirement of reinvestment.

When a letter of allotment is issued by a builder to the allottee or an agreement to purchase is executed between the allottee and the builder, the allottee gets valuable rights in the units to be constructed and these rights are irrevocable and will continue till the allottee complies with the conditions mentioned in allotment letter including payment of installments by the specified date. The allotment letter/agreement to purchase prevents the builder/transferor from selling the same unit to another intended buyer. Therefore, the holding period commences from the date of issue of the allotment letter/agreement to purchase as the allottee gets clear rights in the property, and the date of periodic payment of installments is only a consequential action upon which the delivery of possession flow.

The Central Board of Direct Taxes ('CBDT') issued a clarification[35] in the context of the Self-financing Scheme of the Delhi Development Authority (DDA). The CBDT accepted that investment in a flat under construction for 54 and 54F. The CBDT, vide its clarification[36], extended the proposition in an earlier circular to schemes of allotment and construction of flats/houses by the Cooperative societies or other institutions, provided the schemes are similar to para 2 of the earlier circular. The Department took cognizance of the **Bombay Court** observation in **Mrs Hilla J.B. Wadia**[37] and accepted that the payment of installments was a follow-up action and taking possession is only a formality.

The above principles are expounded when booking flats with a private builder for construction purposes under Section 54 of the Act. The **Bombay High Court** in **Vembu Vaithyanathan**[38] has accepted the circular principles and applied them to the agreement with the builder. The Court accepted that the scheme with the builder is similar to DDA's terms of allotment and construction, allowing a claim under Section 54F. The Apex Court dismissed the Special Leave Petition[39].

35. *Circular 471 dated 15 October 1986*
36. *Circular 672 dated 16 December 1993*
37. *[1993] 69 Taxman 114 (Bom.)*
38. *413 ITR 248*
39. *(2019) 265 Taxmann 535 (SC)*

After the full consideration payment, the assessee was allotted a site (original site) long ago. Later, the allotment was canceled, and a new site was allotted. The asset has to be regarded as a long-term asset, i.e., from the date of allotment of the original site. Hence, a deduction under 54F cannot be denied[40].

If a shareholder[41] acquired membership in a cooperative society with a right to allotment of a flat after construction, he should be deemed to have become the owner of the flat even before he had taken possession of the flat.

Other notable rulings include RL Sood[42], Gulshan Malik[43], Hilla JB Wadi[44], K. Ramakrishnan[45], and Sumit Exports[46], wherein the court/tribunal applied the principles of the circular. In Narendra Kumar Jain[47], the Mumbai ITAT, in the context of 56(2)(x), held that the date of the allotment letter is relevant for the determination of the stamp duty value of the property.

(vi) Delay in Possession of the Constructed Property

The Tribunal and High Court in R L Sood (supra) held that exemption under 54 cannot be denied when a substantial amount of the cost of the new house was paid within a year, acquiring substantial control and domain during the period. Further, various Courts[48] have taken the view that exemption under 54F cannot be denied on the ground that complete construction could not be done or possession of construction of a new house not granted to assessee in view of the application of liberal construction and also considering the practical reality that construction by builders takes an unusually longer time.

Where the Assessee has substantially completed construction of the property by the year in which the permissible period ends, there is no reason to deny relief under Section 54 of the Act[49]. The **Bombay High Court**[50] allowed the claim based on the payment made even though there was a significant delay in obtaining the allotment letter and approval for construction in the Housing Board scheme under the Maharashtra Ownership of Flats Act, 1963.

6. Other Issues for consideration

Other issues (illustratively) that were discussed in various jurisprudence are tabulated below for kind consideration:

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40. *CIT vs. A. Suresh Rao [2014] 41 taxmann.com 475 (Kar.).*
41. *Anilaben Upendra Shah - 262 ITR 657 (Guj)*
42. *[2000] 108 Taxman 227 (Delhi)*
43. *223 Taxman 243 (Delhi)*
44. *216 ITR 376 (Bombay)*
45. *365 ITR 59 (Delhi)*
46. *[2023] 148 taxmann.com 475 (Mumbai - Trib.)*
47. *[2024] 165 taxmann.com 797 (Mumbai - Trib.)*
48. *Shakunthala Deve – 389 ITR 366 (Kar); C Gopalaswamy – 284 ITR 307 (Kar); Kuldeep Singh (Supra); Sambandam Uday Kumar – 345 ITR 389 (Kar)*
49. *Bhavna Cuccaria (2017) 9 ITR(T) 231 (Chandigarh)*
50. *393 ITR 536*

Sr. No.	*Nature of Issues*	*Comments*
1	Construction of a house on a plot owned by others	Construction could be on a plot owned by the assessee, spouse, or others. Under English law, both superstructure and plot should belong to the same person, which is irrelevant or not required under the Transfer of Property Act of 1882[51]. Hence, land and superstructure could belong to two different persons, which is recognized for depreciation purposes by segregating the cost[52]. Hence, arguably, a claim under 54/54F could not be denied[53]
2	Payment of Advance could be regarded as utilization	As long as the deal for construction is completed before the outer time limit, applying the reasoning of the CBDT's circular[54] In the context of 54E, the advance is considered as utilization and it should be applicable for section 54/54F as well.
3	Despite paying substantial consideration, construction could not be completed within three years	Claim for 54F allowed following the principles of satisfying substantial conditions: Smt B.S. Shanthakumari[55]; Sardarmal Kothari[56]
4	New Asset purchased under the joint name of assessee or on family members	Claim were allowed considering the liberal view in following cases (i) Kamal Wahal[57], Ravinder Kumar Arora[58]– Investment in Joint name with Wife (ii) V Natarajan[59] – in the name of wife (iii) Gurnam Singh[60] - Son (iv) Purchased in the name of members of HUF – Vaidya Panalalmanilal (HUF)[61], Jeniffer Bhide[62]

51. Page 7115 of Sampath Iyengar's Law of Income Tax – 13th Edition Volume 5
52. *Alphs Theatre – 65 ITR 377 (SC)*
53. *Smt. Savita Rani (1983) 5 ITD 621 (Del ITAT)*
54. Circular No 359 dated 10 May 1983
55. *2015 60 taxmann com 74*
56. *302 ITR 286*
57. *351 ITR 4 (Delhi)*
58. *342 ITR 38 (Delhi)*
59. *287 ITR 271 (Mad)*
60. *371 ITR 278 (P&H)*
61. *(2018) 259 Taxman 19 (Guj)*
62. *349 ITR 80 (Kar)*

Sr. No.	***Nature of Issues***	***Comments***
		Contrary Views in the following cases (i) Investment in the name of adopted son - Prakash[63] (ii) Investment with brother – Kamal Kant Kamboj[64]
5	Commencement of Construction of Property before the sale of original asset	The Act only requires the completion of construction within the prescribed period. It does not provide for the date of commencement of construction; hence, the same was treated as immaterial, applying a beneficial view in the under-noted cases while allowing the claim: (i) Anandraj[65] (ii) H.K. Kapoor[66] (iii) J.R. Subramanya Bhat[67] (iv) Bharti Mishra[68] Contrary in Ushaben Jayantilal Sodhan[69]
6	Implication of 50C on allowing exemption under 5F/54F	In the context of 54EC, the **Bombay High Court**[70] has held that 50C has to be given full effect at the time of capital gains and exemption computation. Given that Section 54 is on a similar pedestal, it is arguable that 50C should equally apply here, and the Assessee is required to invest net gains computed applying section 50C.

63. *312 ITR 40 (Bom)*
64. *397 ITR 240 (P&H)*
65. *[2015] 56 taxmann.com 176 (Kar)*
66. *(1998) 150 CTR 128 (All)*
67. *(1987) 165 ITR 571 (Kar)*
68. *[2014] 41 taxmann.com 50 (Del)*
69. *[2018] 93 taxmann.com 453 (Guj.)*
70. *Jagdish C.Dhabhalia (2019) 161 ITD 721*

Sr. No.	*Nature of Issues*	*Comments*
		In case of Section 54F, the Assessee is required to invest net consideration, and the Courts[71]/Tribunals[72] have taken a view that section 50C[73] was not applied for computing exemption under section 54F of the Act.
7	Death of the Assessee – How exemption or unutilized deposit will be dealt in the hands of the representative assessee	The claim under 54 cannot be rejected on the representative assessee and he cannot be differentiated from the assessee for income tax purposes. Therefore, if the son makes the reinvestment, the benefit of Section 54/54F should be granted[74] Regarding the receipt of unutilized deposits from the CGDS, they cannot be charged to tax in the hands of a legal representative as they would be capital receipts. Reliance can be placed on the CBDT Circular[75].
8	Non-deposit of money during the intermittent period; however, the reinvestment is made within the stipulated time	In the under-noted cases, the claim for 54/54F was allowed on the satisfaction of the fact that it was reinvested in a property (acquired or constructed) within a stipulated time, although the amount was not deposited in the CGDS during the intermittent period. (i) Ramaiah Dorairaj[76] (ii) K Ramachandra Rao[77] (iii) Venkata Dilip Kumar[78]
9	Gift of one residential property before the date of transfer of original asset to avail benefit of 54F	One of the requirements under section 54F is that the assessee should not own two residential houses at the time of transfer of original asset and to overcome this, a settlement or property gift is entered in relatives' favor.

71. *Gouli Mahadevappa (2013) 215 Taxman 145*
72. *Gyan Chand Batra (2010) 133 TTJ 482 (Jaipur ITAT); Baskarababu Usha [2022] 135 taxmann.com 307 (Chennai Trib)*
73. Assume sale of land and investing in residential house
74. *Ramanathan (CV) 125 ITR 191 (Mad); Mir Gulam Ali Khan (Late) – 165 ITR 228 (AP)*
75. Circular No 743 dated 06 May 1996
76. *[2021] 124 taxmann.com 243 (Bangalore Trib)*
77. *(2015) 277 CTR 522 (Kar)*
78. *[2019] 111 taxmann.com 180 (Mad)*

Sr. No.	***Nature of Issues***	***Comments***
		In the under-noted cases, the Tribunal has accepted the gift/settlement and allowed relief under Section 54F (i) Sajida Begum[79] – Oral Gift under Muslim law recognized (ii) Maya A. Ajwani[80] - Gift to wife
10	Gift of Property in respect of which exemption is claimed	The Assessee sold a property in April 2010, invested in the new asset in August 2010, and claimed exemption under 54. In November 2010, the Assessee settled the new property in favour of his daughter out of love and affection. The Tribunal[81] interpreted Section 47(iii) and stated that the gift of property is not regarded as a transfer; hence, the Assessee has not violated the conditions of Section 54.

79. *(2015) 56 taxmann.com 269 (Bang)*
80. *(2015) 56 taxmann.com 255 (Mum)*
81. *Abdul Hameed - (2016) 65 taxmann.com 211 (Chennai)*

Flat Owners Tax Issues relating to Development Agreement

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Overview

The Article deal with tax issues arising out of Redevelopment Agreement in the hands of flat owner. The tax implications under capital gains arise with reference to the year of transfer and computation of capital gains with reference to consideration to be received by the flat holders. It further deals with tax treatment of receipts from builder like hardship allowance, amount paid to corpus of the society, alternate rent accommodation, furniture etc in the light of judicial precedents. The exemption u/s 54 can be claimed to the extent of the cost of such new flat subject to fulfilment of conditions u/s 54. The consequences of delay in completion of the project if will result into disentitlement of exemption with reference to the interpretations of courts and the liberal approach adopted them has been referred. The period of holding in case of new flat is also relevant for the purpose of capital gains that would arise on sale of new flat. Other related issues are the tax implications if the person is a tenant and if the flat owner occupied the flat for commercial use. An effort is made to provide overall view of the tax treatment in the hands of the flat owner.

A. Introduction

The subject "Redevelopment of Societies" is seeking much attention of the tax students and experts due to exponential increase in redevelopment of societies across the cities. A redevelopment project faces multiple challenges for the parties involved, the tax considerations need due deliberation. Some of the relevant issues are discussed in this write up.

B. Redevelopment

A typical Redevelopment Agreement involves an existing residential society through its members and the Developer/builder coming together for the arrangement where the old building structure is agreed to be demolished and a new building is constructed. It is strictly understood as a commercial deal between the parties achieving or fulfilling their respective commercial motives. For the Society through its individual members, the intention is to get rid of old structure and obtain new structure with required amenities. For the developer, the arrangement is a business opportunity to make profit through selling the additional new flats constructed out of additional FSI available on that land.

C. Redevelopment Agreement

A Redevelopment Project involves land and/or other immovable rights/properties and the agreement in this regard is formally executed and registered. A tri-partite Development Agreement is generally entered into between the Society as Owner, Developer and the Members of the Society usually as a confirming party. The terms and clauses decide the nature and character of rights and obligations under the agreement. The terms and conditions of the Agreement therefore, are to be looked upon to decide any question or dispute including the tax laws.

D. Ownership of Land

The ownership or title of land of the existing building is determining factor in such arrangement especially for tax implications. The ownership or title of land will in turn depend on the form of the existing Society i.e., "Tenant ownership housing society" and "Tenant co-partnership housing societies". In respect of "tenant ownership housing society" commonly known as "Plot owners Society", the land is held by Society as a lessee/owner and the members are the owners of the Building on such plot of Land. In respect of "Tenant co-partnership housing societies", which are of the nature of "Flat Owners Societies" in which the flats are acquired by the members from the builder on ownership basis and thereafter Society is formed, and land as well as the building are conveyed to the society and the member has what is known as occupation rights.

E. Capital Gains Implications for Flat Owner

Society or Member

The redevelopment agreement involves transfer of rights in immovable property and thus, tax implications under the head Capital Gains are involved. The members of the society or the flat holders transfer development rights in favour of the developer and in turn receive the right to receive new constructed unit. Usually, the title in land is not transferred and remain with the society. A Redevelopment Agreement simplicitor involves capital gains tax implications in the hands of the members or flat holders who are the beneficiaries of the agreement and to whom the entitlements under the agreement accrue. As per CBDT Circular : No. 9 [F. No. 8/2/69-IT(A-I)], dated 25-3-1969 it is stated that in case of "Tenant co-partnership co-operative housing societies" the legal ownership in the flats can be said to vest in the individual members themselves and not in the co-operative society and hence, for all purposes (including attachment and recovery of tax, etc.) the individual members should be regarded as the legal owners of the property in question."

A tax dispute may appear to be surfacing when the Assessing Officer may resort to tax the society for the capital gains holding that the society being the owner of land, the tax considerations arise in the hands of the Society. In ***Raj Ratan Palace Co-operative Housing Society Ltd vs. DCIT (2011) 46 SOT 217 (Mum)(URO)***, the tribunal deleting the addition held that: "It was also seen that the some of the individual members had offered the receipts from the developer to tax and the same had also been brought to tax in the hands of the individual members.'; In an appeal filed by the revenue against the above order of ITAT, the Hon'ble Bombay High Court in ***CIT vs. Raj Ratan Palace Cooperative Housing Society (ITA No 2292 of 2011) vide order dated 27-2-201***3 confirmed the order of ITAT. SLP against the above decision of the High court was dismissed. [***CIT vs. Raj Ratan Palace Cooperative Housing society ltd (2014) 362 ITR 1(SC)(St)***]. Reference may also be made to the decisions in case of ***MIG-Co-operative Housing Society Group-II Limited vs. ITO ITA No 896&1099/M/16 dated 17/2/2017(Mum)(Trib).***

Year of Chargeability

The capital gains liability would arise in the year of transfer. Transfer within the meaning of Section 2(47) would have to be considered and in turn depend on the terms of agreement. The incidence of extinguishment of right u/s 2(47)(ii) would fall in the year in which the possession of land is irrevocably given in absence of any other conditions being the essence, and such year may reasonably be construed as the year of transfer. The date of Agreement, thus, needs to be coupled with irrevocable legal possession being handed over. Needless to mention that the conditions of Section 2(47) would be strictly seen with reference to the terms of the Redevelopment Agreement. The question of transfer, thus, would depend on various terms as to possession, other compliances required by the developer which are the essence of the agreement and upon which the legal possession is understood to be given under the agreement. The time of accrual of consideration is also relevant and crucial to decide capital gains liability and income will arise in the year in which the right to receive consideration accrues without any fetters.

In the case of ***CIT vs. Balbir Singh Maini, reported at 398 ITR 531 (SC),*** the Hon'ble Supreme Court considered the question of transfer u/s 2(47)(vi). The Supreme Court on reading of the Joint Development Agreement held that the owner continues to be the owner throughout the agreement and has at no stage purported to transfer rights akin to ownership to the developer, possession alone is given under the agreement, and that too for a specific purpose—being to develop the property as envisaged by all the parties. It, thus, held that clause (vi) will also not rope in the transaction. It was also held that the assessee did not acquire any right to receive income, inasmuch as such an alleged right was dependent upon the necessary permissions being obtained. Reference may also be made in this context to the case of ***Bhatia Nagar Premises, Co-operative Society Ltd. vs. Income-tax Officer, Ward-24 (3)(1)*** reported at [2013] 37 taxmann.com 9 (Mumbai-Trib.) Subsequent events such as not obtaining approvals or cancellation of the agreement have to be taken into consideration. The year of transfer would largely and essentially depend on the terms and conditions of the development agreement.

In case of ***Land Breez Co.-Operative Housing Society Ltd. vs. ITO ([2013] 55 SOT 103 (Mum. Trib.)*** and ***Maheshwar Prakash-2 Co-op. Hsg. Society Ltd. vs. ITO ([2009] 121 TTJ 641 (Mum. Trib.))*** [Confirmed by Bombay HC in ITA No. 2346 of 2009 dated 24/4/2015], it was held that transfer of development rights would be subject to capital gains.

Entitlement of Area Including Additional Area

A Redevelopment Agreement involves negotiations where the members may seek new flat equal to existing area or additional constructed area from the builder for free or on payment of consideration by the member. The members may also receive cash consideration in addition to constructed area. For the purpose of computation of capital gains, cash consideration, the total area entitlement, the existing and the additional area for free of cost, would be considered as full value of consideration.

Furniture

The value of any other extra amenities like furniture, fixture or equipment agreed to be provided by the builder in the new flat would be included in the full value of consideration.

F. Availability of Tax Exemptions to Flat Owner

Section 54 of the IT Act provides for exemption if any residential property which was held for a period of more than 3 years is transferred and the new flat is purchased or

acquired within a period of 1 year before or 2 years after the sale or constructed within 3 years after the sale, capital gain arising on the transfer of the old flat will be exempt from tax to the extent of the cost of such new flat. In the case of redevelopment, the new flat to be acquired is treated as "constructed" for the purpose of the Section 54. Allotment of a flat or a house by a cooperative society, of which the assessee is the member, is treated as construction of the house. [Circular No. 672, dated16-12-1993]. Thus, if the new flat is acquired by the owner within a period of 3 years from the date of transfer of the original flat then the capital gain arising from the sale of the original flat can be claimed to be exempted u/s. 54 of the Income Tax Act subject to fulfilment of conditions u/s 54.

The question would arise whether the value of extra amenities agreed to be provided by the builder in the new flat like kitchen equipment or any other gadgets would be included in the value of new asset for the purpose of section 54. The amenities that are not inbuilt and are detachable separate assets or equipment would not be construed as a part of cost of new flat and will not be treated as investment for the purpose of Section 54.

G. Tax Consequences of Project Delays

The tax exemptions claimed under redevelopment agreement may become vulnerable mainly due to delays in the completion of the project by the developer and anxieties would crop up as to denial of tax exemption due to non fulfilment of conditions. The conditions of completion in Redevelopment Agreement would be relevant and relied upon to decide fulfilment of the conditions of time limits for the purpose of tax exemption. If the agreement provide for handing over of possession of new flat within the stipulated time as per Section 54, the conditions may be construed to have been fulfilled. The judicial precedents show that the Courts have adopted a liberal interpretation and allowed the exemption if it can be shown that delay in obtaining possession was not due to the default of the assessee but by the builders for situations beyond control of the assessee.

In ***Girish L Ragha. Panaji vs. Department Of Income Tax -Tax Appeal no.66 of 2015,*** the Bombay High Court held that since assessee had invested money within stipulated period and delay in obtaining occupancy certificate was beyond control of assessee, assessee would be entitled for deduction under section 54. Few of the favourable decisions are-

1. ***ACIT vs. Vinay Girish Bajpai (ITA 7676/MUM/2019 Mumbai)***
2. ***Kishore H. Galaiyas vs. ITO f20121 24 taxmann.com 11 (Mum.)***
3. ***Mrs. Hilla J.B. Wadia [1993] 69 Taxman 114 (Bom.) Rajendra Pal Verma vs. ACIT (ITA No.6814/Mum/2016).***
4. ***Sardarmal Kothari 302 ITR 286 (Mad)***

H. Tax Treatment of Hardship Allowance From Builder

The redevelopment of a society requires demolition of old structure and construction of new building. This essentially requires displacement of the existing flat holders during the period from demolition of old building till completion of construction of new building. The builders offer certain payments to compensate the hardship caused during the displacement period. The payment may be made under different considerations and nomenclatures i.e. alternate accommodation, hardship allowance, transit rent and rent allowance. The tax treatment of such sum of money becomes critical and needs to be deliberated upon.

Hardship Allowance/Transit Rent

The taxability of such payments is a matter of dispute where the Assessing Officer seeks to

tax the receipt as revenue receipt under the head income from other source. The receipts are paid to the flat holders during the period of construction. It is contended by the assesses that since the payment is made towards the hardship caused, the same is not a revenue receipt which is chargeable to tax. Recently Mumbai ITAT in cases (i) ***Smt. Delilah Raj Mansukhani in ITA No. 3526/MUM/2017***, and (ii) ***Ajay Parasmal Kothari in ITA No. 2823/ MUM/22*** held that compensation received by the assessee towards displacement in terms of Development Agreement is not a revenue receipt and constitute capital receipt as the property has gone into re-development. In such scenario, the compensation is normally paid by the builder on account of hardship faced by owner of the flat due to displacement of the occupants of the flat. The said payment is in the nature of hardship allowance/ rehabilitation allowance and is not liable to tax. Both these decisions were considered by Hon'ble Bombay High Court in case of Sarfaraz S. Furniturewalla (Writ Petition No. 4958 of 2024) while deciding question of TDS on transit Rent u/s 194I wherein the Hon'ble Bombay High Court held that 'Transit Rent' is not to be considered as revenue receipt and is not liable to be taxed.

In cases where it is treated as taxable under the head income from other sources then it is seen that the AO does not allow deduction of rent paid on the ground that it amounts to application of income and same cannot be allowed u/s 57. In Ji***tendra Kumar Soneja vs. ITO [2016] 161 ITD 269 (Mum)(Trib)*** it was held that the rent received was utilized for paying rent and hence, it cannot be said to be income of Assessee. In ***P Madhusudan vs. ACIT [2019] 419 ITR 194 (Mad)(HC)*** where rent was directly paid by the developer and assessee was provided rent free accommodation, it was held that same cannot be assessed as capital gains in the hands of the assessee.

Amount Paid Towards Corpus

In a redevelopment agreement, the builders also make payment of a lump sum amount towards the corpus of the Society. The question of taxability of the same arises firstly in respect of the right person to be taxed i.e., either the Society or the members and secondly as to the head of income under which it is to be taxed. The Corpus Fund is generally created from the contributions from the members to meet the maintenance of the society. In that sense it is the obligation of the members as mutually agreed upon between them. One may, therefore, treat the Corpus amount paid by the builder as paid on behalf of each member and therefore, consider as the benefit or consideration paid to respective members. The same can be considered as part of consideration while computing capital gains in the hands of the respective member. In case before Mumbai ITAT in Pradyot Borkar ITA No 7060/MUM/2016, it was held that the amount received by the assessee is integrally connected with the transfer of his old flat to the developer for re– development in lieu of which he received the amount and a new residential flat. Therefore, the amount, has to be treated as income under the head "Capital Gain

In ***MIG-Co-operative Housing Society Group-II Limited vs. ITO ITA No 896&1099/M/16 dated 17/2/2017(Mum)(Trib),*** the assessee society offered the amount of corpus amount received from builder as capital gains. It was held that Corpus Fund received by the Society shall be taxable as under the head Capital Gains and not Income from other Sources.

In cases i) ***Kaushal K. Bangia vs. ITO, [2012] 18 taxmann.com 31 (Mum.);*** ii) ***Jitendra Kumar Soneja vs. ITO, [2016] 72 taxmann. com 318 (Mum.) (Trib.)***; and iii) ***Rajnikant D. Shroff vs. ACIT, ITA no.4424/M./2014, dated 23.09.2016***, the courts have held that the receipts be treated as a capital receipt not chargeable to tax, and further held that the

same has to be reduced from the cost of new flat. This view is based on observations that Section 2(24)(vi) provides that income includes "any capital gains chargeable under section 45", and, thus, a capital receipt simplicitor cannot be taken as income. The receipts, therefore, would be considered not connected with the transfer of capital asset, however, would be reduced from the cost of new flat.

I. If Occupier is a Tenant Getting a Property on Ownership after Redevelopment

Many times, the societies may have few tenants occupying the old tenements. Tenants are made party to the Redevelopment Agreement and are provided compensation in the form of new flat or monetary compensation. Tax implications would arise in the hands of the tenants whereby they transfer their tenancy or possessory rights for a consideration. The income would be chargeable as capital gains on transfer or surrender of tenancy rights for a stated consideration. The tenants may claim exemption on consideration in the form of construction of new flat u/s 54F subject to fulfilment of all conditions specified therein.

J. Occupier is of Residential House used as a Commercial Property

In some cases, the existing flats may be used for commercial purposes even though the flat being a residential flat originally allotted to the flat holder. If the user of flat is converted for the use as a commercial property, the implications of capital gains would arise like other flat holders. The claim of exemption u/s 54 may be subjected to dispute by the Assessing Officer on the ground that words used in Section 54 are 'residential house'. The assessee may argue that the asset is a residential house even though the use was for commercial purpose. Litigation becomes inevitable. It is relevant to note that if the new constructed unit is a commercial property like shop or show room, the claim of exemption u/s 54 would not survive and the capital gains liability needs to be discharged on such transaction.

K. Period of Holding of New Flat

If the new flat is sold subsequently, the capital gains liability would arise in the year of sale. The date of acquisition of the capital asset needs to be determined i.e. either from the date of redevelopment agreement or the date of possession or actual conveyance. Section 2(42A) defines short term capital asset as a capital asset held by an assessee for not more than thirty-six months immediately preceding the date of its transfer. As per this section, the period for which the asset was held by the assessee is to be seen. If the assessee is in possession of the property as a beneficial owner and is beneficially enjoying it, such date can be adopted for computing the period of holding. The relevant and supporting factors for claiming beneficial ownership could be the municipal bill, the electricity connection or income from the property if assessed in his hands [ref ***CIT vs. Ved Parkash & Sons (HUF) 207 ITR 148 (P & H)*** and ***A Suresh Rao vs. ITO 144 ITD 677 (Bang)***]. On the other hand, if the rights to obtain conveyance are transferred, the date of agreement would be the date relevant for computing period of holding as held in ***Gulshan Malik vs. CIT 102 DTR 354 (Del)*** in which case the booking rights were transferred.

L. Conclusion

Multiple issues may emerge depending on each Agreement. Within the given constraints, an effort is made to simplify some of the common issues in the light of judicial precedents.

Tax implications on conversion of capital asset into stock-in-trade and Vice-versa

CA Madhukar Dhakappa

CA Keerthana Prabhu

Overview

This article explores the tax provisions of converting capital assets into stock-in-trade and vice versa, a practice commonly employed by businessmen to meet their dynamic business objectives. The conversion of a capital asset into stock-in-trade is governed by section 45(2), which treats the transaction as a deemed transfer and taxable as capital gains, with tax liability deferred until the converted asset is sold. Conversely, the conversion of stock-in-trade into a capital asset is governed by section 28(via), which provides that the market value of stock-in-trade on the date of conversion would be taxed as business income.

While these provisions strive to balance the dual nature of such transactions, unresolved issues remain particularly the year of computation of capital gains, year of chargeability, valuation related issues etc. Specifically in the real estate sector, considering the dynamic nature of their business, complexities arise in capital gains tax due to varying valuations or disputes over tax timing—whether on possession or title transfer in case of part performance of contracts.

It is therefore crucial for taxpayers to thoroughly evaluate their transactions and agreements, maintain supporting documentation/ valuation and ensure they align with the specific provisions of the Act.

Background

A businessman is always looking to deploy his available sources (including assets) in a manner that can help grow his business, and one of the rather common practices is the conversion of a capital asset into stock-in-trade and vice-versa. While these conversions are pivotal for businesses (especially those operating in sectors like real estate) to meet their dynamic business objectives, they do come with intricate tax implications under the Income-tax Act, 1961 (hereinafter referred to as 'the Act').

Under the Act, a 'capital asset' is defined in Section 2(14) *interalia* as property of any kind, movable or immovable, except stock-in-trade. Stock-in-trade is generally defined as inventory held for business purposes. A conversion occurs when a taxpayer changes the nature of an asset: for instance, consider a scenario where a piece of land acquired

as a long-term investment is subsequently proposed to be used by the taxpayer for business purposes as inventory for real estate development or trading. Alternatively, consider the reverse scenario where a business asset such as unsold inventory is being converted into a capital asset for long-term holding. Such reclassifications, though strategic and often aimed at optimizing profitability, could trigger significant tax consequences.

Section 45(2) of the Act governs the tax treatment when a capital asset is converted into stock-in-trade. On the other hand, when stock-in-trade is converted into a capital asset, the taxability is determined as per Section 28(via) of the Act. These provisions are designed to prevent tax revenue loss while ensuring fair taxation based on the change in the nature of asset. Whether the taxpayer is a real estate developer converting land to inventory or a trader diversifying holdings into long-term investments, understanding the intricacies of these provisions would be crucial.

This article outlines the tax provisions surrounding these conversions, a brief background of the said provisions and the open issues that could possibly lead to litigation in the future.

Conversion of capital asset into stock-in-trade

Up to the Assessment Year (AY) 1984-85, the Act did not contain a specific provision regarding the taxability of conversion of a capital asset into stock-in-trade by the taxpayer.

In the absence of specific provisions governing the taxation of such transactions, a range of interpretations emerged, ultimately leading to protracted litigation. One view which emerged in such cases was that conversion is merely a transaction with oneself and therefore, not a taxable event. This view further raised questions around the fact that, if conversion is to be considered as a taxable event, it could lead to taxation of future notional/fictional profits which was not the intent of the tax law. In contrast, another view that emerged was that the taxable event should be triggered by the actual sale of converted asset, rather than the conversion itself.

The Supreme Court[1] in its landmark judgment, delivered by a bench of seven judges, held conversion of a capital asset to stock-in-trade to be a non-taxable event and that the business profits arising from the sale of shares, which were converted from a capital asset to stock-in-trade, should be calculated based on the difference between the sale price and their market value at the time of conversion, rather than the original cost to the businessperson. The Court affirmed the principle that, although a person cannot engage in a transaction with themselves, the most equitable method of determining the profits attributable to the business on sale of the stock-in-trade is to use the market value on the conversion date which is the actual cost to the business of such stock-in-trade.

Key provisions and tax implications

With a view to prevent leakages of capital gains tax on such conversions, the Act

1. *CIT vs. Bai Shirinbai K. Kooka [1962] 46 ITR 86 (SC)*

was amended (from AY 1985-86 onwards) to include the conversion of capital asset into stock-in-trade as a "transfer" within the meaning of section 2(47)(iv) of the Act. Further, section 45(2) of the Act was introduced to provide that such conversion or treatment of a capital asset into stock-in-trade would be chargeable to income-tax as capital gains in the previous year in which the stock-in-trade is sold or further transferred. The Fair Market Value (FMV) of the asset on the date of such conversion or treatment into stock-in-trade shall be deemed to be the full value of consideration received or accruing because of transfer of such asset.

The FMV of a capital asset is defined to mean the price it would typically sell for in the open market on the relevant date. If that price cannot be determined, the price as per the Rules specified under the Act is to be considered. Currently, there is no specific valuation rule that is prescribed for this purpose.

Further, the date of conversion of capital asset into stock-in-trade must be determined either on basis of entry passed in books of account of the assessee or intention of the assessee to exploit capital asset as stock-in-trade for its business purpose[2].

Thus, section 45(2) of the Act treats the conversion of a capital asset into stock-in-trade as a deemed transfer, taxable under the head capital gains. However, taxation is deferred to the year in which the converted stock in trade is sold.

The capital gains are computed as:

FMV on Date of Conversion less (Indexed) Cost of Acquisition/Improvement.

Availability of indexation

Even though the capital gains are chargeable to tax in the year of sale of the converted asset, indexation benefit on long term capital gains is available only until the date of conversion (i.e., the date on which the capital asset is converted into stock-in-trade). However, as per recent amendment by Finance Act 2024 (No.2), indexation benefit has now been withdrawn for transfers that take place on or after July 23, 2024 except for land and building acquired before 23 July 2024 by a resident individual and HUF. Hence, the availability of indexation is dependent on the status of the taxpayer and the timing of the conversion.

Business income on sale of stock-in-trade

On sale of the converted asset i.e., stock-in-trade, the sale price less FMV as on the date of conversion being the purchase cost of the stock, shall be treated as business income and taxed under the head "Profits and Gains of Business and Profession." This business income would be taxable in the year in which such stock-in-trade is sold.

Rate of capital gains tax

The rate of capital gains tax would depend on the nature of capital gains i.e., long term or short term which in turn would be dependent

2. *Puran Ratilal Mehta vs. ACIT [2019] 175 ITD 190 (Mumbai)*

on the period of holding of the capital asset so converted. As per the recent amendments made in the Finance (No. 2) Act, 2024, with effect from July 23, 2024, all capital assets (excluding listed securities) would be treated as long term capital asset if held for more than 24 months prior to its transfer.

Further, the rate of long-term capital gains tax would be as follows:

- 20% with indexation for transfers which take place before July 23, 2024.
- 12.5% without indexation for transfers which take place on or after July 23, 2024. However, in case of resident individuals/HUF, on transfer of a long-term capital asset being land or building or both acquired before July 23, 2024, any excess of capital gains over the earlier 20% with indexation rate shall be ignored.

Short term capital gains would be taxed at the slab rate/applicable rates as specific to the taxpayer.

Year of computation of capital gains under certain provisions

A question also arises as to whether the computation of capital gains should be done based on the law prevailing in the year of conversion/transfer or the year in which the capital gains become chargeable to tax i.e., when the converted asset is sold. This becomes relevant specifically in the context of whether the amended (reduced) period of holding as per the Finance (No 2) Act 2024 should apply in computing the capital gains chargeable to tax under section 45(2) i.e., where the sale of converted stock-in-trade occurs on or after July 23, 2024 while the conversion of capital asset into such stock in trade took place earlier.

The Pune Tribunal[3] held that if a particular asset is converted into stock-in-trade in year 1 and such stock is sold in year 2, it is in year 2 that the capital gain and business income would be computed and included in the income of the assessee. However, given the intent of the law, a stronger view may be that as per section 45(2), the chargeability is merely postponed to the year in which the stock-in-trade is sold and the actual quantification of gains should be carried out in the year of transfer i.e., conversion of the capital asset.

Provided below is an illustration on the computation of profits/gains

Mr. X converted land held as capital investment (purchased on 01 April 2018 for INR 10,000) into stock-in-trade on 01 Jan 2023 (when Stamp duty value/FMV of such land was INR 15,000). Such converted land was sold on 30 September 2024 for INR 20,000 at the prevailing stamp duty value.

In this case, the transfer i.e. conversion would occur in FY 2022-23 and chargeability of capital gains tax will be in FY 2024-25.

3. *Ms. Seema Ramesh Dere vs. ITO [2019] 107 taxmann.com 366 (Pune - Trib.)*

Indicative computation of capital gains for FY 2022-23 (taxable in FY 2024-25):

Nature of asset – Long term capital asset

Particulars	*Amount (in INR)*	*Remarks*
FVOC[4]	15,000	FMV of converted asset on the date of conversion
Index cost	(11,821)	Actual cost of the converted asset with the benefit of indexation ((10,000*331)/280). ***Note***: *Income is chargeable* in FY 2024-25, however was taxable in FY 2022-23 (i.*e., upon conversion) and therefore the provisions as of FY 2022-23 should apply*.*
Long term capital gains	**3,179**	Provision for calculating period of holding in the year of conversion to be considered (i.e., FY 2022-23) and as per FY 2022-23 provisions, asset (being land) held for more than 24 months was considered as long-term capital asset.
Tax at 20%	**636**	***Note***: *Income is chargeable in FY 2024-25, however was taxable in FY 2022-23 and therefore the provisions as of FY 2022-23 applies wherein long term was taxable at 20% with indexation*.*

**As discussed above, the workings are based on the view that the computation should be carried out based on the law prevailing in the year of transfer i.e., upon conversion. However, an alternate view as upheld by the Pune Tribunal above is also possible.*

Computation of profit and gains from business (in FY 2024-25):

Particulars	*Amount (in INR)*	*Remarks*
Sale Consideration	20,000	
Cost	(15,000)	FMV of converted asset on the date of conversion (which is considered as FVOC for the purpose of computing capital gains)
Profit/(loss) from business	**5,000**	

4. *Full value of consideration*

Conversion of stock in trade into capital asset

The Supreme Court in Sir Kikabhai Premchand[5] in context of taxability of stock-in-trade into capital asset had principally held that it is wholly unreal and artificial to separate the business from its owner and treat them as they were separate entities trading with each other and then by means of a fictional sale introduce a fictional profit which in fact, is non-existent. It was further held that a person cannot be supposed to sell something to himself and making a profit out of the transaction, which on the face of it is not only absurd but against all canons of mercantile and income tax law.

Even though the principles of taxing conversion of stock-in-trade into capital asset arrangement was upheld by Supreme Court, the law makers when incorporating sub-section (2) into section 45 of the Act, did not amend the specific section(s) under the Act. In the absence of a specific provision addressing the taxability of such arrangements, an element of ambiguity prevailed, leading to divergent interpretations.

Key provisions and tax implications

The Act introduced provisions relating to taxability of cases where stock-in-trade is converted into or treated as capital asset w.e.f. AY 2019-20. The reason for the said amendment as per the memorandum was to provide symmetrical treatment with section 45(2) and discourage the practice of deferring the tax payment by converting the inventory into capital asset.

Section 28(via) was thus inserted in the Act which provided that the FMV of stock-in-trade as on the date of conversion into a capital asset, determined in the prescribed manner, shall be chargeable to tax as business income (the prescribed manner is as per Rule 11UAB which provides rules for determining FMV of immoveable property and other assets/ property).

Upon sale/transfer of the said converted asset, where a capital gain arises from the transfer, the cost of acquisition of such asset shall be deemed to be the FMV which has been taken into account for the purposes of section 28(via). The period of holding of such capital asset shall be reckoned from the date of conversion of such inventory into capital asset.

Year of chargeability of business income under section 28(via)

- Although the Finance Act, 2018 addressed several key ambiguities, it did not specifically clarify the 'Year of Chargeability' in cases where stock-in-trade is converted into or treated as a capital asset under section 28, unlike the provisions in section 45(2) of the Act.
- In line with the legislature's intent to provide symmetrical treatment like the conversion of a capital asset under section 45(2) of Act, it can be interpreted that business income is taxable in the year of conversion but is chargeable to tax in the year when such converted stock (capital asset) is sold. There is however a need for further

5. *Sir Kikabhai Premchand vs. CIT [1953] 24 ITR 506 (SC) [09-10-1953]*

clarity in the law regarding the 'Year of Chargeability' in such cases.

Provided below is an illustration on the computation

Mr. X started real estate activity (buying and selling of land and building) on April 01, 2001. He had taken a land parcel from his existing business inventory having a cost of INR 10,000 for his personal use on March 31, 2021 when the FMV (the stamp duty value) of such land parcel was INR 50,000. Subsequently, on July 01, 2024, the land parcel was sold by X at a prevailing market rate of INR 75,000.

Computation of profit and gains on conversion in FY 2020-21:

Particulars	***Amount (in INR)***	***Remarks***
Consideration	50,000	FMV of converted asset on the date of conversion
Cost	(10,000)	
Profit/(loss) of business	**40,000**	Chargeable in year FY 2020-21 or FY 2024-25 is an open question.

Computation of capital gains on sale of the converted asset (in FY 2024-25) (transfer prior to July 23, 2024):

Particulars	***Amount (in INR)***	***Remarks***
FVOC	75,000	
Index cost	60,230	FMV of converted asset on the date of conversion (FY 2022-23) and indexation benefit till FY 2024-25 (the year of sale of capital asset) [50,000*363/301]
Long term capital gains	**14,770**	Provision for calculating period of holding from the year of conversion to be considered.
Tax at 20%	**2,954**	

Real estate issues

Differential valuation in Strata Sale

When a real estate developer converts land from a capital asset into stock-in-trade for a large-scale property development project and thereafter undertakes the sale of various individual units across the project (referred as strata sales), tax issues arise. Under Section 45(2) of the Act, the conversion triggers capital gains tax on the FMV of the land as of the conversion date. However, tax is payable only when the converted stock-in-trade is sold, often in phases or tranches as individual units are completed and sold.

In such cases, each unit may have a different valuation based on factors like size, location within the development, market demand, timing of the sale etc. These differential valuations can complicate the computation of capital gains thus affecting the overall tax liability and leading to disputes over the correct valuation and timing of taxation. Hence, it would be important for developers to meticulously track and document the valuation and sale proceeds of each unit to ensure accurate tax reporting.

Implications on transfer of possession but not title

In real estate transactions, especially in development agreements, the timing of "transfer" for tax purposes can be a contentious issue. Section 2(47) of the Act defines "transfer" to include transactions where possession is handed over under a development agreement in part performance of a contract, even if the title transfer does not occur immediately. This aligns with Section 53A of the Transfer of Property Act, 1882 which grants the transferee certain rights based on part performance of a contract.

The tax authorities often deem the transfer to have occurred at the time of possession, triggering capital gains tax in the year possession is handed over. However, this can lead to practical challenges for landowners as they may not have received full consideration by that time. Disputes frequently arise in such cases, as taxpayers argue that taxation should occur only when the title is formally transferred or when they receive the final payment. Developers and landowners must take cognizance of the timing of the taxability of the transaction, determining possession and title transfer terms.

Conclusion

The Government, through the introduction of specific provisions addressing the conversion of capital assets into stock-in-trade and vice versa, has sought to bring clarity to this complex area. While these provisions strive to balance the dual nature of such transactions, unresolved issues remain, particularly concerning the timing of taxability, valuation etc., which could still lead to disputes. It is therefore crucial for taxpayers to thoroughly evaluate their transactions and agreements, maintain supporting documentation/valuation and ensure they align with the specific provisions of the Act to avoid disputes and ensure compliance.

"Karma means law, and it applies everywhere. Everything is bound by Karma."

— *Swami Vivekananda*

Capital Gains implications on Depreciable Assets

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Overview

The chapter on 'Capital Gains' under the Income Tax Act, 1961 provides for the charge as well as computation of capital gains. These provisions cater to general circumstances and special circumstances where capital gains are applicable. Section 50 is one such special provision regarding capital gains computation on the transfer of depreciable assets. This section modifies the capital gains computation mechanism under section 48 and 49 having regard to the special circumstances that in case of depreciable assets, depreciation on cost of the asset is allowed as an expense deduction. The resultant capital gains under section 50 on the sale of depreciable assets is deemed as short-term capital gains for the purposes of section 48 and 49. This article discusses the limited scope of this deeming fiction and details the consequential impact on various other connected provisions such as the tax rates on capital gains from transfer of depreciable assets, availability of capital gains exemption, set off and carry-forward of losses, etc. While discussing these issues, the article also brings out the judicial interpretation adopted by various courts.

1. The capital gains under the Income Tax Act, 1961 ("the Act") is generally derived by reducing the cost of acquisition and expenses in relation to transfer from the amount of sale consideration. The capital gains are classified as either long-term gains or short-term gains, primarily depending upon the period of holding of the asset. This classification has a significant bearing on the tax rate applicable to the gains. Even in case of losses, varying rules apply for set-off and carry-forward of such losses depending upon classification as long-term or short-term capital gains.

2. While the equation for computing capital gains is simple, the Act provides a variety of stipulations with reference to the full value of consideration, the cost of acquisition, and the nature of capital gains. One such prescription under the Act is made with reference to the computation of capital gains on depreciable assets.

3. Section 50 provides the capital gains computation mechanism on the transfer

of depreciable assets, which form part of the block of assets. The gains arising under this section is deemed to be from short-term capital assets. Section 50A states that in case of a capital asset on which deduction of depreciation under Section 32(1)(i) is obtained, the written down value ( ) of the asset shall be deemed to be the cost of acquisition.

4. This article analyses the capital gains computation on the transfer of depreciable assets and the interplay with a few other provisions, such as exemption, losses set-off & carry-forward, applicable tax rates, etc.

Overview of provisions allowing depreciation on capital asset

5. The Taxation Laws (Amendment and Miscellaneous Provisions) Act, 1986 w.e.f. 01.04.1988 introduced the concept of depreciation on the block of assets under section 32, replacing the system of allowing depreciation on individual assets. Under the block of assets method, the assets of the same nature on which the same rate of depreciation is prescribed are aggregated, and the depreciation is allowable on the written-down value of the block at the end of the year.

6. The written down value is defined under section 43(6)(c) for assets forming part of the block. The written down value of the block shall be computed as follows:

Particulars	*Details*	*Amount (Rs.)*
Written down value of the block as on the beginning of the year	I	xxxxxxx
Add: Actual cost of asset falling within the block acquired during the previous year	II	xxxxxxx
Less: Moneys receivable in respect of any asset falling with the block, sold or discarded or demolished or destroyed during the year, including the scrap value; subject to maximum of (I) + (II)	III	xxxxxxx
Value of the block at the end of the year on which the depreciation is allowable	I + II - III	xxxxxxx

7. The capital assets that are used for business purposes are eligible for allowance of depreciation under the head Profits and Gains of Business or Profession. It is trite that once an asset forms part of the block, it is inseparable and loses its identity[1]. Thus, the use of each individual asset for the purposes of business is not a pre-requisite.

1. *CIT vs. Oswal Agro Mills Ltd. (2012) 341 ITR 467 (Delhi).*

Capital Gains on depreciable assets - overview

8. Section 50 of the Act, as was originally enacted, provided for computing the cost of acquisition in the case of depreciable assets. The provision allowed the substitution of the fair market value of the depreciable assets at specified dates, subject to the reduction of depreciation already claimed. Depreciation at that time was allowable for individual assets. The gains arising from the transfer of depreciable assets were classifiable as long-term or short-term capital gain, subject to the period of holding criteria.

9. With the introduction of the concept of block of assets for depreciation purposes, the provisions of section 50 also underwent changes w.e.f 1.4.1988. Some of the salient features of this section are enumerated below:

   A. Section 50 overrides section 2(42A), which provides for the period of holding for an asset to be classified as a short-term capital asset (or a long-term capital asset as a necessary corollary).

   B. The special provision in section 50 now provides the methodology for computation of capital gains in case of assets forming part of a block of assets in respect of which depreciation has been allowed.

   C. The special provision expressly modifies the provisions of sections 48 and 49 to the extent specified therein. No change is envisaged under any other provision of the Act.

   D. When all the assets in the block are not transferred, capital gains are triggered when the consideration received for the transfer of the depreciable asset exceeds the aggregate of the following:

      (i) opening WDV of the block;

      (ii) value of assets acquired during the year; and

      (iii) expenditure incurred wholly and exclusively in connection with transfer(s).

      Such excess of consideration shall be deemed to be the capital gains arising from the transfer of short-term capital assets [Section 50(1)].

   E. When the block of assets ceases to exist upon all the assets forming part of the block being transferred, the cost of acquisition with reference to the block being transferred shall be the aggregate of (i) opening WDV of the block and (ii) cost of asset acquired during the year. The income accruing consequent to such transfer(s) shall be deemed to be the capital gains arising from the transfer of short-term capital assets [Section 50(2)]. If any asset is existing in the block at the end of the year, section 50(2) shall not apply[2].

2. *CIT vs. Eastman Industries Ltd. (2008) 219 CTR 593 (Delih).*

F. Goodwill of a business or profession is not eligible for depreciation under Section 32 of the Act w.e.f 01st April 2021. The reduction of goodwill already forming part of the block for the assessment year 2020-21 shall be subject to short-term capital gains as per rules prescribed under Rule 8AC. Since the capital gains implications on the transfer of goodwill is currently not taxable under Section 50, this article does not deal with this issue in detail.

10. Considering the scheme of section 50 read with section 32, it can be deduced that the transfer of some of the assets in the block without wiping out the WDV is not taxable. However, the sale consideration would reduce the WDV of the block for further claim of depreciation.

11. Likewise, if the consideration received by an assessee on the transfer of a depreciable asset is invested back in replacing or purchasing assets in the same block, no capital gains shall arise. This can be understood using the following illustration:

S. No.	***Particulars***		***Amount (Rs.)***
Facts			
1.	Block – Plant & Machinery eligible for 15% depreciation		
2.	WDV of the block as on 01.04.2023 – consisting of 3 plants (A, B and C)		10,00,000
3.	Sale consideration for transfer of Plant B and C		12,00,000
4.	Purchase of Plant D		7,00,000
Calculations			
5.	WDV as on 31.03.2024 – Plant A and D		
	Opening WDV	10,00,000	
	Add: Actual cost of asset purchased	7,00,000	
	Less: Consideration for transfer	12,00,000	5,00,000
6.	Capital Gains		NIL

12. In the above example, capital gains shall not arise since neither the WDV of the block at the end of the year was wiped out nor did the block extinguish due to the transfer of all assets in the block. Further, the capital gains in this situation did not arise due to investment into Plant D. If such

investment was not made, capital gains would have arisen in the hands of the assessee.

13. Section 48 of the Act provides the method of computing the capital gains, whereas section 49 prescribes the cost of acquisition under different scenarios. Section 50 provides for different methodology for computing the capital gains and the cost of acquisition in case of depreciable assets and modifies the provisions of Section 48 and 49 to that extent.

Short-term capital gains on sale of depreciable assets

14. The capital gains arising under Section 50 on account of the transfer of depreciable assets are deemed as gains arising from the transfer of short-term capital assets, i.e. Short-term capital gains[3] ("STCG"). Clause (1) of section 50 shall apply only when there is a gain arising on the transfer of a depreciable asset. However, if the block of asset ceases to exist due to the transfer of all assets in the block, the assessee shall consider the WDV as the cost of acquisition and compute the capital gains under clause (2) of section 50. The resultant income shall be deemed to be short-term capital gains. Since income includes losses, even the loss arising under section 50(2) shall be classified as short-term capital loss.

15. The classification of gains as short-term capital gains is only for the purposes of Section 48 and 49 of the Act. The immediate resultant impact is with reference to not allowing indexation benefit under the second proviso to section 48, which otherwise was admissible on a long-term capital asset[4]. Another implication is with reference to not allowing the full cost of acquisition of the assets being transferred, but the amount net of depreciation already allowed.

16. Notably, Section 50 also does not deem the depreciable capital assets to be a short-term capital asset but only deems the capital gains as short-term capital gains[5]. Also, section 50 does not create separate capital gains charge for depreciable assets but only modifies the computation mechanism under section 48 and 49. Now, in the context of this interplay, multiple issues emerge for consideration, which are discussed hereafter.

Tax rates applicable on capital gains arising from the sale of depreciable assets

17. With reference to the application of tax rate to capital gains arising on the sale of depreciable assets, the Special Bench of the ITAT Mumbai[6] has recently ruled on the controversy to hold that the tax rates provided under Section 112 of the Act shall be applicable if the

3. Refer Section 2(42B).
4. Indexation benefit is not applicable on or after 23rd July 2024, as per amendment to Section 48 vide Finance (No.2) Act, 2024, except in a limited case involving land or building held by resident individuals or HUF u/s 112.
5. *CIT vs. Ace Builders (P.) Ltd (2006) 281 ITR 210 (Bombay).*
6. *SKF India Ltd. vs. DCIT: (2024) 168 taxmann.com 328 (Mumbai - Trib.).*

depreciable asset being transferred has been held for a suitable period of holding to qualify as a long-term capital asset. The Tribunal held the deeming fiction under Section 50 cannot convert a 'long-term capital asset' into a 'short-term capital asset' for the purposes of the rate of tax or any other provision of the Act. The Tribunal considered both positive as well as negative orders by co-ordinate benches on this issue, while ruling in favour of assessee by a majority. Pertinently, this issue is also pending before the Bombay High Court in appeal[7].

18. Section 112 is applicable where the total income of an assessee includes any income arising from the transfer of a long-term capital asset, which is chargeable under the head "Capital gains". The opening phrase of the section refers to the transfer of long-term capital assets and does not directly state where the total income includes long-term capital gains. It is arguable that, since the deeming fiction under section 50 does not extend to section 112, income from the transfer of a depreciable asset, which is not a short-term capital asset (thus, a long-term asset), chargeable under the head "Capital gains" shall be covered under section 112 of the Act and be eligible for tax rates specified under the section.

Claim of exemption under the head capital gains

19. The deeming fiction of considering gains from the transfer of depreciable assets as short-term capital gain is restricted to Section 48 and 49 alone. The sections providing capital gains exemption, say Section 54, 54EC, 54F, etc., apply to capital gains arising from the transfer of any long-term capital asset. These sections do not directly employ the words that only long-term capital gains under the Act shall be eligible for exemption. Thus, for the purposes of these exemption sections, capital gains arising from a depreciable capital asset held for a period satisfying the long-term capital asset criteria should be eligible for exemption.

20. The availability of capital gains tax exemption on depreciable assets held for the long term is judicially settled[8].

Carry forward and Set off of losses

21. Under the scheme of the Act, there are restrictions on the set off of losses under the head capital gains. Loss arising on long-term capital asset is not available for set off against gains arising on short-term capital assets as intra-head adjustment in the same year (Section 70). A loss under the head capital gains is not eligible for set off against any other head of income as an inter-head adjustment in the same year (Section 71).

7. *Rathi Brothers Madras Ltd. vs. ACIT: ITA 871 of 2015 (Bombay High Court).*

8. Illustrative list of cases - *CIT vs. V. S. Dempo Company Ltd. (2016) 387 ITR 354 (SC); Ace Builders (P.) Ltd. (2006) 281 ITR 210 (Bombay); CIT vs. Aditya Medisales Ltd. (2014) 362 ITR 600 (Gujarat).*

22. In case of losses carried forward, loss relating to short-term capital asset shall be set off against any capital gains arising in a given assessment year. However, a loss relating to long-term capital assets is available for set off only against the gains arising in a given assessment year from long-term capital assets.

23. For the purposes of the carry forward and set off provisions, the capital gains arising from depreciable assets could be considered as gains arising from long-term capital assets if satisfying the long-term period of holding conditions, based on the reasoning that the deeming fiction of considering gains from depreciable assets as short-term capital asset is restricted only for the purposes of sections 48 and 49 and do not extend to provisions of set-off.

24. The capital gains arising from depreciable capital assets, which satisfy the period of holding criteria for long-term capital assets, shall be eligible for set off against other long-term capital loss incurred for the same assessment year or against any short-term or long-term capital loss brought forward. This interpretation has been judicially approved in multiple cases[9].

25. An interesting question to consider is, whether business loss can be set off against short-term capital gains computed under Section 50. It is true that the transfer of depreciable assets used in the business essentially is an income arising out of business carried on by the assessee, even though the gains are deemed to be chargeable under the head capital gains. One can draw support for this proposition in the early decisions of the Supreme Court in ***Cocanada Radhaswami Bank Ltd.***[10] wherein the court allowed the set off of income from securities chargeable under a head "interest on securities" against carried forward business losses by considering the income from such securities being trading assets, forming part of the business.

26. The language of Section 72 allows set off brought forward business loss against profits and gains, if any, of any business or profession carried on by the assessee and assessable for that assessment year. The requirement of the section is broad to include gains from business carried on by the assessee and does not provide that such gains shall also be chargeable under the head 'profits and gains of business or profession'. On the basis of this language, it is arguable that gains from depreciable assets chargeable under section 50 can be set off against brought-forward business losses. Further support can be drawn from a few judicial precedents[11].

27. The short-term capital gains arising from the transfer of depreciable asset

9. Illustrative list of cases - *PCIT vs. Peerless General Finance & Investment Co. Ltd. (2023) 146 taxmann.com 285 (Calcutta HC); CIT vs. Parrys (Eastern) (P.) Ltd. (2016) ITR 264 (Bombay).*

10. *(1965) 57 ITR 306 (SC).*

11. *Sri Padmavathi Srinivasa Cotton Ginning & Pressing Factory vs. DCIT (2009) 125 TTJ 411 (Vishakapatnam); ITO vs. Smart Sensors & Transducers Ltd. (2019) 176 ITD 104 (Mumbai).*

shall also be available for set off against carried forward unabsorbed depreciation since such depreciation forms part of the depreciation claim of the subsequent previous year by virtue of section 32(2) of the Act. Current year short-term capital gains are eligible for set off against business losses under section 71(2).

Other ancillary issues

28. A few other issues relating to capital gains on depreciable assets are discussed below in brief:

A. ***Section 50 to apply only when depreciation was claimed on the asset***

The application of section 50 is triggered when the capital asset is an asset forming part of a block of assets in respect of which depreciation has been allowed under this Act. Thus, if the assessee held a capital asset which is otherwise eligible for depreciation due to use in business, but does not avail the benefit of depreciation, the transfer of such capital asset will not attract the provisions of section 50.

In the undernoted case[12], the Madras High Court held that foreign cars utilised in business on which no depreciation was claimed, loss arising from the sale of those cars was considered as a business loss and not a loss under the head Capital gains. However, if depreciation is once claimed on the asset, even upon discontinuation of depreciation claim due to non-use, it would not escape the application of this section on transfer of such asset[13].

B. Slump sale

A slump sale involves a transfer of a business undertaking in its entirety without attributing values to individual assets. Such business assets could also include depreciable assets. In such cases, the provisions of section 50 shall not be triggered since a slump sale is essentially a transfer of a business undertaking as a standalone capital asset and transfer of depreciable assets cannot be carved out from the transaction for applying section 50[14]. Additionally, the provisions of Section 50B, dealing with capital gains on slump sale, provides that in computing the net worth of the undertaking, the written down value of depreciable assets forming part of such undertaking shall be considered. This adjustment gives effect to the intended object of section 50 to compute the gains after considering the WDV of the depreciable assets, instead of their actual purchase cost.

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12. *K. D. Madan vs. ITO (2017) 297 CTR 437 (Madras)*
13. *Sakthi Metal Depot vs. CIT (2021) 436 ITR 1 (SC).*
14. Refer *CIT vs. Equinox Solution (P.) Ltd. (2017) 393 ITR 566 (SC).*

C. Application of Section 50C – in case of building forming part of the block

Section 50C of the Act deems the consideration received or accrued in case of capital asset being land or building or both to be the stamp duty value adopted by the statutory authorities or actual consideration received, whichever is higher, subject to certain tolerance limits. Section 50C does not create any exception for buildings being depreciable assets forming part of a block of assets.

Further, Section 50 is a deeming provision with reference to computation methodology for capital gains on the transfer of depreciable assets and also for computing the cost of acquisition in case of a block of assets. The section does not provide that the consideration for transfer of depreciable assets shall be the actual sum received. Thus, a cogent reading of both section 50 and 50C would lead to an inference that, for the purposes of section 50, the stamp duty value of building as per section 50C could be substituted[15].

Capital gains in case of power generating units (Section 50A)

29. In case units engaged in generation or generation and distribution of power are allowed depreciation under Section 32(1)(i) on the basis of the Straight line method or written down value method on individual assets, based on the option availed by such units.

30. Section 50A requires that for the purposes of capital gains computation on transfer of assets on which deprecation under section 32(1)(i) has been claimed, the cost of acquisition for the purposes of section 48 and 49 shall be the written down value of such assets. Interestingly, the section does not deem the capital gains arising therefrom as short-term capital gains.

Conclusion

31. The jurisprudence around the chargeability of capital gains on depreciable assets has evolved over the time to touch upon multiple facets under the Act, being the fallout of a transaction involving the transfer of a depreciable asset. Such facets include tax rates applicable on such gains, set off of losses, claim of exemption, etc. In terms of the discussion in this article, it can be clearly inferred that the Courts time and again have emphasised that the scope of section 50 is limited to the computation of capital gains and does not enlarge the impact to other provisions under the Act, which has a bearing on the ultimate tax outcome from transactions involving such depreciable assets. With the substantial portion of the existing language of Section 50 remaining unamended since the year 1988, the narrow interpretation placed by the Courts on the scope of the said section appears to align with the intent of the legislature.

15. Refer *ITO vs. United Marine Academy (2011) 130 ITD 113 (Mumbai) (SB).*

Tax Consequences on Sale of Assets held Outside of India by Residents

CA Siddharth Kaul

Overview

In our globalized business world, Indian residents, both corporate and individuals, often make investments in foreign capital assets. Typically, these investments are made in foreign currency and income from sale of such capital assets is also received in foreign currency. Subsequently it may be realized in India through banking channels in equivalent Indian rupees. For Indian tax residents, such income would be subject to income-tax in India despite the situs of asset being outside India and irrespective of where the income arises. Further, it may also be subject to tax in the foreign country where the capital asset is situated depending on the domestic income-tax regime in that country read in conjunction with double tax avoidance treaty that may exist between such country and India. The article delves into two aspects: first, the potential issues relating to foreign exchange conversion in computing the Indian income-tax on such a transaction and second, the potential aspects involved in double taxation relief through foreign tax credits in India.

In our globalized business world, Indian residents, both corporate and individuals, often make investments in foreign capital assets. Typically, these investments are made in foreign currency and income from sale of such capital assets is also received in foreign currency. Subsequently it may be realized in India through banking channels in equivalent Indian rupees.

For Indian tax residents, such income would be subject to income-tax in India despite the situs of asset being outside India and irrespective of where the income arises. Further, it may also be subject to tax (through a withholding tax at transaction stage or later when statutory compliance reporting for the tax year is due) in the source country where the capital asset is situated depending on the domestic income-tax regime in that country read in conjunction with double tax avoidance treaty that may exist between such country and India. Generally, treaties either divide the taxation rights between the two countries involved or provide both countries the right to tax the same income while allowing a mechanism for providing relief from double taxation to the taxpayer in state of residence, here India.

This article delves into two aspects: first, the potential issues relating to foreign exchange conversion in computing the Indian income-tax on such a transaction and second, the potential aspects involved in double taxation relief through foreign tax credits in India.

1. Foreign exchange conversion aspects in computation of income from capital gains

The main issue in computing the income from capital gains is the currency conversion for determining the value of taxable gains in INR. In this regard, Rule 115 of the Income-tax Rules, 1962 (Rules) specifically provides that income from capital gains accrued, arising, or received in foreign currency shall be converted into INR at TT buying rate on the last day of the immediately preceding month in which the asset was transferred. However, it is important that the income should be earned in foreign currency to apply this rule though it may have been repatriated back to the resident seller's INR bank account subsequently. This approach of applying Rule 115 can be referenced as method 1 in this article. Alternatively, if the income is earned in INR, then the application of this rule may not be correct[1] and then another method (method 2) would have to be used for calculating the taxable capital gains. Both methods are further explained with help of couple of numerical examples below:

Example A

Sale proceeds from sale of shares of foreign (USA) company in December 2024 – USD 750,000

Cost of acquisition of above shares in December 2014 – USD 250,000 (rate then was say 62 INR= 1 USD). Hence, INR cost recorded as 1,55,00,000 in accounts.

Method 1 (income in foreign currency, applying Rule 115): Income from (long term) capital gains = USD 500,000 (USD 750,000-250,000). Converted to INR at rate of 30 Nov 2024 (say 82 INR= 1 USD) = INR 4,10,00,000

Method 2 (income in INR): Let us assume the buyer is an Indian resident and the sale proceeds were agreed and received from buyer in equivalent INR instead ie INR 6,15,00,000. Here the calculation of income would be in INR as follows: 6,15,00,000 – 1,55,00,000 = INR 4,60,00,000

In the above example A, that the Rule 115 appears beneficial however the outcome could vary depending on different scenarios. Taking another example:

Example B

Sale proceeds from sale of shares of foreign (Sri Lankan) company in December 2024 – LKR1,000,000

Cost of acquisition of above shares in December 2014 – LKR 500,000 (rate then was say 0.5 INR= 1 LKR). INR cost recorded as 250,000 in accounts.

Method 1 (income in foreign currency, applying Rule 115): Income from (long term) capital gains = LKR 500,000 (LKR 1,000,000-500,000). Converted to INR at rate of 30 Nov 2024 (say 0.25 INR = 1 LKR) = INR 125,000 gain.

Method 2 (income earned in INR): Let us assume the buyer is an Indian resident and the sale proceeds were agreed and received from buyer directly in equivalent INR instead ie INR 250,000. Here the calculation of income would be in INR as follows: 250,000 – 250,000 = NIL.

In above example B, method 2 turns out to be more beneficial to the taxpayer.

The principle in applying method 1 (Rule 115) is that the effect of foreign currency movement (gain/loss) is sought to be eliminated[2] in the computation as can be seen in both the examples above.

Lastly, it may be noted that the taxable income reported above could differ from accounting

1. *235 ITR 1 (Bom)*
2. *ITA 2407/Mum/2021, ITA 4695/DEL/2012*

income due to method of accounting and conversions under GAAP. This should not impact the above analysis.

2. Double tax relief related aspects

Where the foreign country (source state) imposes a tax on the gains from sale of capital asset, then Indian resident would have the ability to take credit of such foreign taxes while offering such income to tax in India in accordance with the provisions of the treaty between the countries. In cases involving countries where there is no treaty, relief can be unilaterally claimed under the domestic tax provisions under Section 91 of the Income-tax Act, 1961 (Act) and related Rule 128. Some key aspects that may arise in the foreign tax credit claims are discussed below:

Coverage of foreign taxes

For granting credit in India under the treaty, the coverage of foreign taxes depends on the language of the relevant provisions of domestic law and treaty. It may be noted that the scope of foreign taxes under Section 91 of the Act, which facilitates credit of foreign taxes charged in a country with which India has no treaty, is wide and covers any income tax charged by any Government or by local authority. Many of India's tax treaties are similarly wide in scope. For example, India-Germany treaty specifically cover taxes on income imposed by any political subdivision including local authority and hence covers trade tax which is levied by local municipality/city in Germany. On the other hand, India-USA treaty only covers federal income tax and hence other state/ city levies would not be eligible for credits in India. In such case, an alternative claim of a deductible expenditure may be explored by the taxpayers based on favourable jurisprudence in similar context for deductibility of foreign taxes and stamp duties[3].

Computational aspects

The method of computing the foreign tax credit can also vary depending on the treaty wordings. Most of India's treaties prefer the ordinary credit method wherein the credit is restricted only to the Indian tax which is attributable to such foreign income. Similar concept is also enshrined in Rule 128.

Full credit or exemption of the foreign income from tax altogether is rare but few of India's treaties do have such beneficial provisions for example India-UAR (Egypt) treaty.

In this regard it may be noted that there are various general issues on claim of foreign tax credit which are not elaborated in this article but could be equally relevant for capital gains tax.

Other aspects in Rule 128

Noteworthy foreign tax credit computational aspects emanating from the Rule 128 are summarized hereunder for completeness:

— Foreign tax to be converted to INR as per the TT buying rate of the last date of the preceding month prior to the payment/deduction of such tax.

— Mismatch of foreign financial year with Indian tax year: As per Rule 128 (1) proviso, the credit will be permitted in the same proportion as income is offered to tax in India.

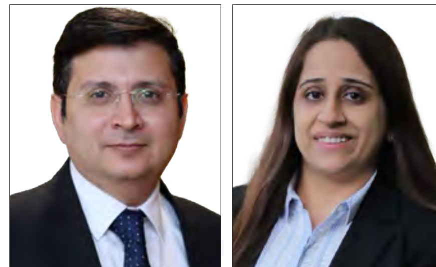
— No credit will be granted for disputed tax unless the dispute is settled and tax is finally paid, and an undertaking is furnished that no refund will be claimed.

— Credit to be computed for each source separately for a particular country. Pooling of credits is not specifically allowed under the Rules.

— Form 67 and related documents such as proof of payment of tax, to be filed as per specified due date.

3. *390 ITR 271 (Bom), 198 taxation 220 (Del)*

Key Direct Tax Aspects for Convertible Instruments



CA Rohinton Sidhwa   CA Namrata Arora

Overview

This article explores the tax implications of Convertible Instruments viz., Compulsorily Convertible Preference Shares (CCPS) and Compulsorily Convertible Debentures (CCDs), at different stages. It focuses on key direct tax implications with respect to such convertible instruments:

1. *Period of Holding: Essential for determining whether capital gains are categorized as short-term or long-term, impacting applicable tax rates.*
2. *Tax Treatment of Income: Interest income from CCDs and dividend income from CCPSs before conversion are discussed, including tax rates applicable for resident and non-resident investors.*
3. *Capital Gains on Conversion: Conversion of CCPSs or CCDs into equity shares is treated as a tax-neutral event under Indian tax law, with no capital gains tax liability. While the investor must be mindful of implications under section 56(2)(x) of the Act upon conversion.*
4. *Post-Conversion Taxation: After conversion, regular income generated from equity is classified as dividend and taxed accordingly. Capital gains on the sale of converted equity shares are computed based on the original cost of acquisition.*
5. *Valuation Guidelines: The law provides that a transferor is required to pay capital gains tax on the higher of the actual sales consideration and the value determined as per the formula prescribed in Rule 11UA of the Rules.*

This comprehensive overview aids in understanding the tax implications for convertible instruments within the Indian tax regime.

Introductory overview

With business horizons and funding scenarios continuously evolving, various hybrid instruments are being used for funding. While the traditional debt and equity instruments continue to thrive, newer quasi-equity instruments have also gained in popularity, especially by start-ups. Such hybrid instruments offer a mix of both debt and equity and hence, lend flexibility to align funding instruments with the commercial aims of the investors as well as the issuer companies. Needless to say, these instruments come with their own nuances and complexities.

Compulsorily convertible debentures (CCDs) and compulsorily convertible preference shares (CCPSs) are two common hybrid instruments

that have been around for some time now. As the names suggest, CCDs and CCPSs are compulsorily convertible into equity shares once the pre-decided period lapses. Under the exchange control regulations, CCPSs and CCDs are treated at par with equity shares. The price/ conversion formula of CCPSs and CCDs is required to be determined upfront at the time of issuance of the instrument.

For CCPSs, the fixed rate of dividend or amount per share is decided upfront. CCPS holders have priority over equity shareholders when it comes to receiving dividends and in case of distribution of assets in the event of liquidation of the company. CCPSs holders have the right to vote in case of resolutions affecting their rights.

CCDs are debt instruments until they are converted into equity shares. CCDs carry a fixed coupon rate of interest and have priority over CCPSs and equity in case of liquidation of the company. CCDs can be secured by creating a charge on the assets of the company. CCD holders do not carry voting rights till conversion into equity shares.

From an Ind AS accounting standpoint, such hybrid instruments are required to be recognized in two parts – the liability component and the equity component are depicted separately in the financial statements, based on fair valuation.

These instruments allow for structured capital inflows and often come with specific tax considerations that need careful analysis by investors and companies alike. In this article, we will discuss the tax issues specifically for CCPS and CCDs.

Let us look at the key tax considerations for CCPS and CCDs at various point of time (i.e., before conversion, at the time of conversion and after conversion), particularly focusing on the following aspects:

- Period of holding to be considered for computing capital gains;
- Tax treatment of regular income generated from these convertible instruments;
- Capital gains implications when the instruments are converted to equity; and
- Valuation guidelines as per Rule 11UA of the Income Tax Rules, 1962 (the Rules), for tax computation.

Tax Implications prior to conversion

Generally, the profits or gains arising from the transfer of a capital asset are chargeable to tax under the head 'Capital Gains'. The tax treatment depends on the type of asset and the period for which the asset was held.

Accordingly, the period of holding is critical to determine if the capital gains arising on conversion or transfer of the instruments may be categorized as short-term or long-term capital gains (STCG or LTCG). Such categorization is necessary to determine the applicable tax rates, which is different for both the categories.

LTCG is taxable at the rate of 12.5 percent (without indexation benefit) whereas STCG for listed equity shares is taxable at the rate of 20 percent and unlisted securities are taxable as per the investor's slab rates (for non-resident investors, the tax rate would be 35 percent plus applicable surcharge and cess, subject to the beneficial provisions of the relevant tax treaty, if any).

The classification of capital assets as short term capital assets and long term capital assets basis the period of holding are as follows:

Nature of capital assets	*Period of holding for classification as short term capital assets*	*Period of holding for classification as long term capital assets*
Listed securities, unit of equity oriented fund, unit of the Unit Trust of India or zero coupon bond	12 months or less	More than 12 months
Other capital assets	24 months or less	More than 24 months

Period of holding in case CCPs are sold before the date of conversion into equity

In case the CCPS are held for less than 24 months, then capital gains arising therefrom is classified as STCG. Where CCPS are held for more than 24 months, capital gains would be considered as LTCG.

The period of holding is calculated from the date of acquisition of such CCPS till the date of sale

Period of holding in case CCDs are sold before the date of conversion into equity

Prior to 23 July 2024, incase CCDs are held for 36 months, the capital gains are classified as STCG. Where CCDs are held for more 36 months, capital gains would be considered as LTCG.

However, capital gains arising on or after 23 July 2024 on account of transfer, redemption or maturity of unlisted CCDs would be classified as STCG (irrespective of the period of holding). Accordingly, in case of transfer, redemption or maturity of unlisted CCDs, the period of holding may not be relevant.

Further, for listed CCDs, in case period of holding is more than 12 months then the capital assets would be classified as long term capital assets.

Tax treatment of income generated from convertible instruments

Interest Income from CCDs

CCDs may be considered as borrowed funds (debt) till their conversion into equity shares. The interest income from CCDs to resident investor is taxable at the investor's slab rate.

Whereas interest income to non-resident is taxable under section 115A of the Income-tax Act, 1961 (the Act) at the rate of 20 percent as per applicable surcharge and cess. In case of non-resident investor, the relevant tax treaty provisions may also be analysed. In case the tax treaty provides beneficial rates then such beneficial rate may be availed subject to availability of relevant documents and qualification of conditions prescribed in the tax treaty.

Dividend Income from CCPS

Income arising from CCPS before its conversion into equity shares classified as dividend in the hands of the investors. The

dividend income in the hands of investors is subject to tax at the investor's slab rate.

In case the tax treaty provides for beneficial rate for taxation then the beneficial rate may be availed by the investors.

The tax withholding implications are as under:

Particulars	Withholding tax implications on dividend distributed to resident investor	Withholding tax implications on dividend distributed to non-resident investor
Under the Act	10 percent	20 percent (increased by surcharge and cess)
Under the Tax Treaty (subject to availability of relevant documents and fulfillment of tax treaty conditions)	Not applicable	As per dividend income clause of the tax treaty

Deductibility of expense in the hands of the issuer company

With respect to CCDs, the deduction of interest expense in the hands of the issuer company is subject to thin capitalization rules as prescribed under section 94B of the Act. Thin Capitalization refers to a situation where an entity has a high proportion of debt as compared to equity. In such a case, the taxpayer can claim excessive deduction of interest payment on such debt from taxable income.

To address the issue of thin capitalization, the Act provides preventive measure to counter cross-border shifting of profit through excessive interest payments and thus aim to protect country's tax base. In case, interest payment to Non-Resident Associated Enterprises (AEs) exceeds INR 1 crore, interest deduction will not be allowed for lower of the following:

- Total interest paid less 30 percent of its earnings before interest, taxes, depreciation and amortization (EBITDA); or
- interest paid or payable to AE.

Interest disallowed is eligible to be carried forward to subsequent eight assessment years.

With respect to CCPS, the payment of dividend is not allowable as an expenditure for the issuer company as per the provisions of the Act.

Sale of convertible instruments

Section 9(1)(i) of the Act provides that all income accruing or arising, whether directly or indirectly, through the transfer of a capital asset situated in India will be deemed to accrue or arise in India and thus, will be taxable in India.

- The term 'capital asset' includes shares and securities of a company.
- The term 'transfer' includes sale, exchange or relinquishment of the asset and extinguishment of any rights therein.

In view of the above, upon transfer of the convertible securities of the Indian Company,

it can be said that the income accrues or arises in India. Further, section 45 of the Act provides that any profits or gains arising from the transfer of a capital asset shall be chargeable to income-tax under the head 'capital gains'.

As per section 48 of the Act, capital gains on transfer of capital assets are computed as per the following formula:

Capital gains = Sale consideration less cost of acquisition (COA) less expenditure incurred wholly and exclusively in connection with such transfer

The capital gains tax rate for resident and non-resident investor under the Act is discussed below:

Type of Gain	*Capital gains tax on listed instruments*	*Capital gains tax on unlisted instruments*
Short Term Capital Gain (STCG)	Applicable slab rates/20 percent depending on the nature of financial instrument being transferred as per section 111A of the Act	As per the investor's slab rate
Long Term Capital Gain (LTCG)	12.5 percent (without indexation)	12.5 percent (without indexation)

Availability of tax treaty benefit on capital gains for non-resident investor

A non-resident investor may claim a capital gains tax exemption under the applicable tax treaty if a specific exemption is provided therein. Such an investor is eligible to utilize the favorable provisions of the relevant tax treaty, provided conditions like the Limitation on Benefits (LOB) and Principal Purpose Test (PPT) are met. Additionally, the non-resident investor must maintain essential documents, such as a tax residency certificate and Form 10F to avail tax treaty benefit.

Pursuant to amendment to the India-Singapore tax treaty and India-Mauritius tax treaty, the capital gains exemption is not available for investment in shares of an Indian company (acquired on or after 1 April 2017). However, transfer of any other capital instruments (i.e., other than shares) of an Indian company, shall continue to be not taxed in India. Typically, the convertible instruments may not be construed as "shares" for tax purposes, thus, capital gains arising on transfer of these convertible securities of an Indian company by the non-resident seller based out of Singapore or Mauritius may not be subject to capital gains tax in India under the respective tax treaties.

It is to be noted that Special Bench of Income Tax Appellate Tribunal (ITAT) in case of ***Ashima Syntex Ltd. vs. ACIT [2006] 100 ITD 247 (Ahm.)(SB)*** held that the raising of funds by issue of convertible debentures was to raise capital by ultimately converting debentures into equity share without giving an option to debenture holder to get repayment or a say in conversion. Substance of the transaction was issue of equity capital partly on the date of allotment of debentures. The contention of the assessee that expenditure relating to conversion partly after 15 months could at

least be held as the revenue had no force as the nature of such retention was akin to share application money pending allotment of shares.

Accordingly, there would be a risk of re-characterization of convertible instruments as equity for computing capital gains and accordingly the tax treaty exemption may be denied. Therefore, it becomes pertinent to analyse the CCD terms and commercial rationale before issuance of CCDs.

The above-mentioned capital gains exemption would not be available for CCPS.

Implications of Rule 11UA of the Rules

Valuation of convertible instruments are crucial for various regulatory and compliance purposes, including taxation, and can directly impact the amount of tax liability.

Section 50CA of the Act read with Rule 11UA of the Rules provides that, a transferor of shares of an Indian company is required to pay capital gains tax on the higher of the actual sales consideration and the FMV determined as per the formula prescribed in Rule 11UA of the Rules. Similarly, as per Section 56(2)(x) of the Act, a buyer/ transferee of shares of an Indian company is liable to pay income tax on the difference between the FMV of the said shares determined as per the formula prescribed in Rule 11UA of the Rules and the price actually paid by it for those shares, where the price actually paid by the buyer is less than the FMV determined as per Rule 11UA of the Rules.

Rule 11UA of the Rules, provides specific guidelines for the valuation of unquoted shares and securities, including convertible instruments.

Rule 11UA(1)(C)(c) provides that the FMV of unquoted shares and securities other than equity shares in a company which are not listed in any recognized stock exchange shall be estimated to be price it would fetch if sold in the open market on the valuation date and the assessee may obtain a report from a merchant banker or an accountant in respect of which such valuation. Accordingly, for the purpose of computing sales consideration, as provided in the said rule the assessee has option to obtain fair market value on the basis of valuation done by the accountant.

This on the basis of the contention that CCDs and CCPS may not be construed as equity shares even though in essence, they are akin to equity shares.

Capital gains on conversion of CCPSs or CCDs to equity shares

The treatment of capital gains arising from the conversion of CCPS or CCDs into equity shares is a critical consideration for the companies planning to invest in the Indian market. The key provisions of the Act are discussed below:

Implications in the hands of the investor

Section 47(x) of the Act explicitly provides that any transfer by way of conversion of bonds/ debentures into shares of that company will not be treated as a transfer and no capital gain tax liability will arise. Herein, the term shares could be interpreted as preference shares or equity shares.

Similarly, section 47(xb) of the Act provides that upon conversion of preference shares into equity shares of that company, capital gain provisions would not be attracted.

Given the above, the conversion of CCDs or CCPSs into equity is considered as a tax-neutral event not liable to capital gains tax.

Section 56(2)(x) of the Act inter-alia provides for taxation of receipt of any property

(including shares and securities) for no consideration or inadequate consideration in the hands of the recipient.

Section 47(x) and section 47(xb) of the Act (which provides exemption upon conversion of CCDs or CCPSs into equity shares) are not covered as an exception to section 56(2)(x) of the Act and accordingly, section 56(2)(x) of the Act would apply even if transfer is exempt u/s 47(x) and section 47(xb) of the Act. Therefore, the FMV of convertible securities given up should be at least equal to the FMV of equity shares received. In case the FMV of equity shares received on conversion is higher than the FMV of convertible securities, section 56(2)(x) would apply in the hands of investors.

Accordingly, it is advisable to obtain a valuation report upon conversion of securities.

Period of holding for computing capital gains tax post conversion of the convertible instruments into Equity shares

The Central Board of Direct Taxes (CBDT) issued a Notification No. 18/2016 dated 17 March 2016, notifying a new Rule 8AA. As per the said rule, w.e.f. 1 April 2016, the period for which a bond, debenture, debenture-stock or deposit certificate, was held by the taxpayer prior to conversion, shall be considered for determining the period of holding of such shares or debentures acquired upon conversion.

Accordingly, the period for which such bond, debenture, debenture-stock or deposit certificate, was held by the taxpayer prior to conversion, shall be considered for determining the period of holding of such shares or debentures acquired upon conversion.

Further, section 2(42A)(hf) of the Act defines, in case of a capital asset, being equity shares in a company, which becomes the property in consideration of a transfer referred to in clause (xb) of section 47 (conversion of preference shares into equity shares) of the Act, there shall be included the period for which the preference shares were held. Hence, for the computation of period of holding of the converted equity shares, the period for which the CCPSs are held by the investors would be included.

This method is advantageous because it allows the holding period to be extended, potentially qualifying the gains as LTCG, which usually have a lower tax rate compared to STCG.

Conclusion

In conclusion, convertible instruments offer versatile and strategic financing option for both companies and investors. They provide a unique blend of debt and equity characteristics, giving companies access to capital with flexible terms while allowing investors to participate in potential future growth.

The issuance of hybrid instruments would be subject to detailed analysis related to the needs of the issuer as well as desires of the investors. Apart from the above discussed issues, deduction of issuance cost and General Anti Avoidance Rules (GAAR) needs to be considered by the issuer before raising the funds through the convertible instruments.

As convertible instruments continue to evolve, they remain a valuable tool in modern finance, bridging the gap between traditional equity and debt to meet diverse funding and investment needs.

Capital Gains implications on sale of property by a registered Charitable Trust

CA Sambhav Mama

Overview

This article examines the taxation of capital gains for registered charitable trusts under the Income Tax Act, 1961 ("Act"), emphasizing the special tax exemptions they enjoy when fulfilling specific conditions. These include spending 85% of current year's income on charitable activities, adhering to registration requirements, etc. Unlike regular assessee, charitable trusts compute capital gains based on commercial accounting principles rather than the standard provisions of section ("s.") 45 to 55 of Act. While s. 11(6) of Act disallows repeated deductions for asset acquisition costs, s. 11(1A) of Act grants exemptions if the net consideration from sale of asset is reinvested in new capital assets. The charitable trusts applying 85% of capital gains to charitable purposes or reinvesting the net consideration for acquisition of another capital asset qualify for exemptions, while non-exempt capital gains can be accumulated for spending in future years. The capital gains income which is not exempt under s. 11 of Act is taxed as income of an Association of Persons at normal tax rate (i.e. slab rat) and not as per Maximum Marginal Rate. The article also underscores the importance of compliance for charitable trusts to retain income tax exemptions, showcasing their privileged tax status as entities dedicated to public welfare and providing guidance for managing capital asset transactions.

1. Brief background of tax exemption available to charitable trusts under the Income Tax Act, 1961 ("Act")

A trust or institution carrying out activities for "charitable purposes"[1] is entitled to claim a tax exemption under the separate set of provisions[2] of Act. The exemption is allowed basis the rule of application for charitable purposes. The provisions require 85% of

1. Section (s.) 2(15) of Act defines "charitable purposes" to include includes relief of the poor, education, yoga, medical relief, preservation of environment (including watersheds, forests and wildlife) and preservation of monuments or places or objects of artistic or historic interest and the advancement of any other object of general public utility.
2. Refer provisions of s. 11 to 13 of Act. Further, certain specified charitable trusts are eligible to claim tax exemption u/s. 10(23C)(iv)/(v)/(vi)(via) of Act. However, vide Finance (No. 2) Act, 2024, the provisions of Act are amended to the effect that, going forward, charity exemption shall be available only under the scheme of s. 11 to 13 of Act.

current year's income to be applied for charitable purposes during the year or accumulate it to be spent over a period of next 5 years. Such application can also be in respect of purchase of capital asset for the objects of charitable trust. There are certain other conditions and compliances which charitable trust is to observe. For instance, a trust should be registered under s. 12AB of the Act, to file income tax return and audit report within a specified time, charitable trust's funds should remain invested only in specified modes, etc. Once these conditions are satisfied, charity exemption is available for entire income.

2. Computation of income (including capital gains) in the hands of a charitable trust

a. Income of a charitable trust is to be computed as per the provisions of s. 11 and 13 of the Act. The concept of five heads of income[3], as is applicable to any other assessee, is not applicable to a registered charitable trust.

b. From time to time, the Central Board of Direct Tax ("CBDT") kept clarifying[4] that income of a charitable trust is to be computed in its commercial sense i.e. book income. In other words, income which is computed basis the commercial principles of accounting and as per the books of accounts become the basis for charitable trust for exemption and other compliances under s. 11 to 13 of the Act. Accordingly, the capital gains income is also be reckoned at par with any other income of charitable trust. Accordingly, the provisions of capital gains chapter (i.e. s. 45 to 55 of Act), as is applicable to any other assessee, are not applicable to charitable trust for computing capital gains income.

c. Hence, capital gains income shall be computed as difference between actual sale consideration as reduced by cost of acquisition[5] or Written Down Value ("WDV"), as the case may be, as appearing in the books of accounts. Consequently, the provisions dealing with deemed consideration (e.g. s. 50B/50C/50CA/50D of the Act) are not applicable. Refer,

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3. Illustratively refer *CIT v. Rao Bahadur Calavala Cunnan Chetty [1982] 135 ITR 485 [Madras High Court ("HC")], A.P. Olympic Association v. ADIT(E) [2014] 151 ITD 627 (Hyderabad Tribunal), United Educational Society v. JCIT [2019] 107 taxmann.com 127 (Delhi Tribunal).*
4. Refer Circular No. 5-P(LXX-6) of 1968 dated 19 June 1968, Circular No. 52 dated 30 December 1970 and Circular No. 72 dated 6 January 1972. This principle is also now affirmed by the Hon'ble Supreme Court ("SC") - refer *CIT v. Programme for Community Organisation [1997] 228 ITR 620 (Kerala HC)* which is approved by the Hon'ble SC in case of *CIT v. Programme for Community Organisation [2001] 248 ITR 1.*
5. In case where capital asset is purchased by charitable trust, the cost incurred by the charitable trust can be considered as cost of acquisition for the purposes of computing capital gains income. However, an interesting issue may arise on determination of cost of acquisition of a capital asset which was received by way of donation i.e. whether cost of such asset shall be taken as 'Nil' or an amount which was considered as 'income' in the hands of charitable trust in the year of acquisition of capital asset by way of donation.

illustratively the decision in the case of ***Sri Guru Dattatreya Mattum vs. ITO(E)***[6] wherein in the context of income arising on transfer of immovable property by a charitable trust, the Hon'ble Tribunal has held that the provision of s. 50C of the Act as applicable on transfer of land or building or both to any other assessee is not applicable in the hands of a registered charitable trust.

d. Similarly, provisions dealing with deeming fiction for determining cost of acquisition u/s. 49/55 of the Act (including indexation benefit) are also not applicable[7].

3. Impact of s. 11(6) of the Act to determine cost of acquisition of a capital asset

i. Prior to introduction of s. 11(6) of Act, there was a controversy as to whether the charitable trust is eligible to claim benefit of depreciation on the capital assets in case where actual cost of such asset is already claimed as application in the year of acquisition. This was leading to claim of double benefit for charitable trust once by way of application of income in the year of acquisition and another by way of yearly deprecation.

ii. The Finance (No. 2) Act 2014 introduced s. 11(6) of the Act, with effect from 1 April 2015[8], which provides that if acquisition of capital asset is claimed as application of income, then no deduction in the form of depreciation or "otherwise" is allowed in respect of such asset. The intent of the provision is to deny duplicated deduction of application once, at the stage of acquisition of asset and again at the stage of claim of depreciation or otherwise.

iii. It may be interesting to evaluate whether reference to the expression "or otherwise" in s. 11(6) of Act is wide enough to deny deduction of cost of acquisition of asset for computing capital gains income on its transfer in respect of which actual cost is already claimed as application in the year of acquisition. This issue is not free from doubt.

6. *[2020] 115 taxmann.com 491 (Visakhapatnam - Tribunal)*

7. There are few contrary decisions in favour of the proposition that capital gains in the hands of registered charitable trust is to be computed basis provisions of capital gains chapter [e.g. *Akhara Ghamndas Dass v. ACIT [2001] 114 Taxman 27 (Chandigarh Tribunal)* and *Al Ameen Educational Society v. DIT(E) [2012] 139 ITD 245 (Bangalore Tribunal)*]. However, to my understanding, both these tribunal rulings have not noted the earlier judicial precedents of HCs or SC as well as the CBDT Circular and arguably may not be laying down the correct position of law and hence may be distinguishable.

8. The Hon'ble SC in case of *DIT v. AI-Ameen Charitable Trust [2016] 242 Taxman 4* held that the provisions of s. 11(6) of Act are applicable prospectively.

4. Exemption from capital gains in the hands of charitable trust

a. Like any other income, charitable trust can seek exemption also for capital gains income under 85% application rule in the same year or through accumulation for spending over a period of next 5 years.

b. Additionally, s. 11(1A) of the Act provides deemed application to capital gains income if "net consideration" is utilised for acquisition of another capital asset to be held for charitable purposes. This is a beneficial provision which allows charitable trust re-investment benefits. There is no restriction to re-invest in any specific capital asset. Instead, the provision is open-ended and can apply in relation to any capital asset held for charitable objects.

5. Scheme of re-investment benefit in another capital asset (S. 11(1A) of the Act)

a. S. 11(1A) of the Act provides for 'computation' of deemed application where net consideration from transfer of a capital asset is re-invested in another capital asset. This section does not deal with computation of 'capital gains' income in the hands of a charitable trust which as aforesaid is to be computed basis the commercial principles as per the books of account. This section only provides a fictional mechanism for ascertaining the "deemed application" in respect of re-investment made.

b. **Dissection of s. 11(1A) of the Act:**

i. There is a capital asset being property held under trust wholly[9] for charitable purposes which is transferred during the year (i.e. "transferred capital asset").

ii. On re-investment of "net consideration"[10] for acquiring another capital asset (i.e. "new capital asset"), it will be deemed to have been applied for charitable purposes for the purposes of s. 11(1)(a) of the Act.

iii. Following amount of capital gains income shall be considered as deemed to have been applied for charitable purposes:

9. Where capital asset transferred is held under trust 'partly' for charitable purposes, then separate computation mechanism is provided for computing deemed application benefit. In essence, deemed application benefit is available on proportionate basis.

10. Net Consideration is defined under Explanation (iii) to s. 11(1A) of Act to mean sales consideration as reduced by expenditure incurred wholly and exclusively in connection with such transfer.

Scenario	***Amount of capital gains income deemed to be applied for objects of charitable trust***
If entire net consideration is utilised for acquisition of new capital asset	Entire capital gain is deemed to be applied
If part of the net consideration is utilised for acquisition of new capital asset	Deemed Application = Cost of new capital asset (-) "cost of the transferred asset" *"Cost of the transferred asset" means the aggregate of the cost of acquisition (as computed u/s. 48 and 49 of Act) and cost of improvement (as computed u/s. 55(1)(b) of Act) of the transferred capital asset.*

c. The above computation mechanism can be understood by way of a following example:

Particulars	**Amount (in lacs)**
Sales consideration net of expenditure incurred on transfer (A)	1000
WDV of transferred capital asset as per books of accounts[11] (B)	(400)
Capital gains income as per books of accounts and for the purposes of the Act (C) = (A) – (B)	**600**

Consider further that a charitable trust acquires new capital asset for consideration and wants to claim the benefit of deemed application u/s. 11(1A) of the Act. This may be understood under two different scenarios referred to in the following table:

Computation of deemed application of capital gains of INR 600 u/s. 11(1A) of Act				
Particulars	**Scenario 1**	**Scenario 2**		
Description	Entire net consideration is utilised for acquisition of new capital asset	Part of net consideration is utilised for acquisition of new capital asset		
Cost of acquisition of new capital asset (D)	1000	900	650	500

11. The assumption is that charitable trust has not claimed acquisition of transferred capital asset as application of income in the year of its acquisition.

Computation of deemed application of capital gains of INR 600 u/s. 11(1A) of Act				
Particulars	**Scenario 1**	**Scenario 2**		
Cost of acquisition as determined u/s. 48/49 of the Act (E)	Academic since the entire net consideration is utilised for new capital asset	550 (assumed)[12]		
Amount of capital gains deemed to be applied for charitable objects as per s. 11(1A) of the Act (F)	**600**	**450 (D) – (E)**	**100 (D) – (E)**	**Nil[13]**
Balance Capital gains income (C) – (F)[14]	**Nil**	**150**	**500**	**600**

i. As can be seen from above, for a scenario where only part of net consideration is re-invested, then re-investment benefit u/s. 11(1A) of Act is available only where the cost of the new capital asset is more than deemed cost of transferred asset as computed u/s. 48/49 of the Act. However, where cost of new asset is equal to or less than the deemed cost of transferred asset as computed u/s. 48/49 of Act, there will be no case of deemed application for the purposes of s. 11(1A) of Act. This may be contrasted with s. 54F of Act as applicable to an Individual and Hindu undivided family wherein where entire sale consideration is not re-invested, then the benefit of exemption is allowed with respect to the cost of new asset in the ratio of capital gains to the net consideration.

ii. An interesting issue may arise when this new capital asset is sold or transferred in future, whether cost of acquisition in computing capital gains

12. In case where capital asset was originally acquired by charitable trust out of its own funds, section requires to adopt original cost of acquisition for the purposes of s. 11(1A) of Act. However, in case if capital asset was acquired by charitable trust by way of donation, cost of acquisition for charitable trust for the purposes of s. 11(1A) of Act could be cost to the previous owner in terms of s. 49 of Act.
13. Since net consideration applied for acquisition of new capital asset is less than "cost of asset transferred" as computed in terms of s. 48 / 49 of Act.
14. The balance amount of capital gains (if any) can be claimed as exempt if the same is utilised for any other objects of the charitable trust during the year or is accumulated for spending in future years subject to satisfactions of conditions of accumulation.

income on such sale/transfer will be INR 1000 or INR 400 since in respect of INR 600 under Scenario 1 above, charitable trust has already availed benefit of deemed application in the year of acquisition. Similar issue may also arise under Scenario 2 above.

d. **Legislative history of s. 11(1A) of Act:** The CBDT vide its Circular No. 2-P(LXX-5) dated 15 May 1963, clarified that where charitable trust transfers a capital asset forming part of the corpus of its property solely with a view to acquire another capital asset for the use and benefit of the trust and utilises the capital gains arising from the transaction in acquiring the new capital asset, the amount of capital gain so utilised should be regarded as having been applied for charitable purposes within the meaning of s. 11(1) of Act. This was reiterated by the CBDT in Circular No. 52 dated 30 December 1970. Subsequently, vide Finance (No. 2) Act, 1970, s. 11(1A) of Act was introduced with retrospective effect from 1 April 1962 to codify the relief granted by the CBDT in its previous circulars[15]. The CBDT clarified that obligation to utilise the capital gains income during the year has an effect of progressively reducing the corpus of the charitable trust and hence the provision was introduced to encourage capital investment by charitable trust.

Interestingly, it may be noted that while the circulars issued prior to the introduction of s. 11(1A) of Act provided for re-investment benefit if capital gains is utilised for acquisition of another capital asset, the construct of provisions of s. 11(1A) of Act is different as it requires utilisation of net consideration for acquiring new capital asset and provides fictional manner of computation of deemed application for cases where only a part of the net consideration is utilised for acquiring new capital asset.

e. **Othe relevant points on scope of s. 11(1A) of the Act:**

i. *Interplay of s. 11(1)(a) and s. 11(1A) of Act:* S. 11(1A) of Act beings with the expression "For the purposes of sub-section (1) ……" and hence acts as supplement to s. 11(1)(a) of Act. To that extent, both these provisions are alternate to each other. Taxpayer who feels that it is not in position to avail benefit of application under one provision is entitled to rely on other provision

15. Refer para 73 to 76 of CBDT Circular No. 72 dated 6 January 1972 explaining the rationale for amendments made vide Finance (No. 2) Act, 1970.

under which it can seek relief. Further, s. 11(1A) of Act is not a non-obstante clause which overrides s. 11(1)(a) of Act. It merely provides some relief and facilitates a charitable trust which otherwise may not be allowed if capital gain is not utilised for the objects of the trust during the year[16].

ii. While there is no time limit prescribed u/s. 11(1A) of the Act for acquisition of capital asset, the same shall be carried out during the year unless charitable trust exercises an option to apply the income in the next year under Explanation 1 to s. 11(1) of Act[17]. The courts have denied benefit of s. 11(1A) of Act where investment in new capital asset is made after the end of the financial year in which capital gains income arose[18]. In this case, assessee unfortunately did not adopt option to defer application in next year in facility provided under Explanation 1 to s. 11(1) of Act or accumulation of income u/s. 11(2) of Act which could have also entitled the charitable trust for claim of application.

iii. Acquisition can be of any capital asset such as land or building, vehicles, investments specified u/s. 11(5) of Act, etc. Further, the CBDT vide Instructions No. 883 dated 24th September 1975 also extended exemption to a charitable trust for investment of capital gains into bank fixed deposit of a period of 6 months or more[19].

iv. Unlike s. 54EC/s. 54F of Act, etc. no time limit has been provided u/s. 11(1A) of Act as lock-in period for the new capital asset. Further, there is also no requirement that the new capital asset shall be held till the end of the financial year[20].

6. What is the rate of tax applicable to a registered charitable trust on capital gains income which is not exempt u/s. 11(1)(a) or s. 11(1A) of the Act?

a. S. 164(2) of Act provides that any income which is derived from property held under trust wholly for charitable purposes (which

16. Refer *CIT v. Mehta Charity Trust (ITA No. 173 of 2017; order dated 19 March 2019) (Bombay HC)*
17. Refer *CIT v. Hindustan Welfare Trust [1993] 206 ITR 138 (Calcutta HC)*
18. Refer *Trustees of Dr. Sheth's Charitable Trust v. 7TH ITO [1982] 2 ITD 649 (Bombay Tribunal).*
19. Certain courts have held that fixed deposit of a duration less than 6 months shall also be considered as capital asset for the purposes of s. 11(1A) of Act. For instance, refer *CIT v. Hindustan Welfare Trust [1993] 206 ITR 138 (Calcutta HC).*
20. Refer *South Point Education Society v. ITO(E) [2015] 62 taxmann.com 320 (Kolkata Tribunal).*

includes capital gains income) and is not exempt u/s. 11 of Act, then such income shall be taxed as if it is the income of an Association of Person ("AOP").

b. S. 167B of the Act provides that income of an AOP where individual shares of the members of AOP is indeterminate or unknown shall be taxed at Maximum Marginal Rate ("MMR"). However, the CBDT vide its Circular No. 320 dated 18 January 1982 clarified that in the cases of charitable trusts where the members or trustees are not entitled to any share in the income of AOP, the tax shall be payable at the rate ordinarily applicable to the total income of an AOP (slab rate) and not at MMR.

c. The special rate of tax for capital gains income provided u/s. 111A/112/112A of Act are applicable only if such capital gains income is chargeable to tax under the head "Capital Gains". As stated above, since the concept of heads of income is not applicable to a registered charitable trust and capital gains income of charitable trust is chargeable under Chapter III of the Act and not under "Capital Gains" head, the special tax rates for capital gains income are not applicable in the hands of charitable trust.

7. What could be the tax implications on sale of charitable trust's building to a builder for redevelopment wherein consideration was deferred over time based on the milestones/project completion?

a. Now a days, the transactions of redevelopment are prevalent especially in the metro cities like Mumbai, Pune, etc. The determination of income tax implications for a redevelopment transaction is a very complex issue and has various facets such as what is the subject matter of transfer under redevelopment agreement, who is the owner of such asset (member or society), determination of point of transfer u/s. 2(47) of Act, quantifying sales considerations and point of time of receipt of such consideration, cost of acquisition, etc. The income tax implications for society redevelopment agreements on an assessee can only be determined based on fact specific analysis and in consultation with property law expert.

b. In the context of a registered charitable trust, as indicated above, the capital gains income shall be computed basis the commercial principles of accounting and as per books of account. Admittedly, the special provision of s. 45(5A) of Act dealing with determination of capital gains tax income under a joint redevelopment agreement for an individual or Hindu undivided family is not applicable to a registered charitable trust. Hence, in such scenario, the computation of capital gains income for charitable trust will be based on multiple aspects such as what is the nature of

asset transferred (if any) by the charitable trust, the point of time of such transfer depending upon terms and conditions of the agreement, quantification of consideration and point of time of its receipt, manner of recording the redevelopment transaction in the books of accounts and accounting entries passed, etc. Further, where consideration under redevelopment is received in kind, interesting issue may also arise whether charitable trust shall be entitled to claim application u/s. 11(1)(a) of Act or reinvestment benefit u/s. 11(1A) of Act, determination of point of time of trigger of capital gains in the hands of registered charitable trust and reinvestment into new capital asset, etc. and will require a fact based analysis.

8. Conclusion

a. Capital gains taxation for charitable trusts reflects their unique status as entities dedicated to public welfare, allowing for significant exemptions under the Act. By adhering to conditions such as applying 85% of their income toward charitable activities or reinvesting proceeds into new capital assets, the charitable trusts can ensure exemptions on capital gains, as provided u/s. 11(1)(a) and 11(1A) of the Act. Unlike regular assessee, charitable trusts compute these capital gains based on commercial accounting principles rather than conventional tax provisions. Such flexibility underscores the legislative intent to encourage charitable work while safeguarding compliance.

b. This tax framework positions charitable trusts as pivotal agents of societal change, akin to government functions. Their tax exemptions incentivize asset reinvestments that foster long-term sustainability and growth in public welfare. However, trusts must diligently maintain compliance—filing timely reports, renewing registrations, and adhering to investment disciplines—to retain these privileges. With proper management, these provisions serve to support charitable efforts without the burden of heavy tax obligations, reinforcing their contribution to community development. The exemptions, therefore, embody a balance between regulation and support, ensuring that public welfare initiatives thrive.

> “A fool may buy all the books in the world, and they will be in his library; but he will be able to read only those that he deserves to.”
>
> — *Swami Vivekananda*

HOT SPOT

Global Capability Centers – Policy landscape

CA Ajay Rotti CA Nimita Gandhi

Global Capability Centers (GCCs), also known as Global In-house Centers (GICs) or captive centers, have become a cornerstone of India's IT and IT-enabled services (ITES) sector.

In recent decades, India has earned the title of the "office of the world." In the early 2000s, multinational corporations, particularly from the United States and Europe, began to view India as an appealing location for establishing offshore centers. The main attraction was cost efficiency, as India provided access to a vast pool of highly skilled talent at a lower cost compared to developed markets.

Global capability centres are offshore units of multinational corporations that operate across the globe. These centres are set up for providing various support services, such as Information Technology, finance, human resources, and analytics, to their parent entities. The first GCCs were primarily focused on IT services, software development, and business process outsourcing. Companies like GE, American Express, and Citibank were among the pioneers, setting up their captive centers in cities like Bangalore, Hyderabad, and Pune.

The Government of India has also been supportive of setting up GCCs, providing various incentives and initiatives to attract foreign investment, including the establishment of Software Technology Parks (STPs) and Special Economic Zones (SEZs), which further facilitated the growth of these centers. The Government has also implemented policies to promote innovation and research and development, which has helped captive centres in India to develop cutting-edge technologies and services.

GCCs have undergone a significant transformation. They have grown beyond their initial roles, becoming influential players in the Indian tech sector. Multinational corporations have started leveraging on India not just for cost advantages but also for quality and expertise of talent pool. Today, GCCs are recognized as major tech hubs, deeply integrated with their parent organizations and serving as strategic assets that offer extensive access to digital talent.

This evolution has repositioned GCCs from being mere support centres to pivotal global hubs of strategic operations carrying out more complex and value-added functions such as research and development, product engineering, and knowledge process outsourcing within the tech industry. Over time and with the advent of technology, GCCs are now at the forefront of global innovation, creating cutting-edge solutions in

the areas of Artificial Intelligence, Machine Learning, Cloud computing, Cyber engineering, Advanced analytics and Data sciences.

Based on research carried out by ANSR[1]-

- Cost delivery centers have been set up globally, which include Mexico, Colombia, Brazil, Ireland, UAE, Vietnam and Malaysia, Central and Eastern Europe, China and Philippines.
- **It is interesting to note that India accounts for over 50% of the global GCC market and currently hosts around 1,600 GCCs, with the number expected to rise to 1,900 in the next year.**
- **Further, it is also interesting to note that 22% Forbes Global 2000 Companies are present in India.**

GCCs are a key part of India's economy, providing high quality employment opportunities and contributing to the country's Gross Domestic Product. At present, GCCs in India account for more than 1% of the country's GDP and the share is expected to grow further.

The key sectors attracting GCCs include, healthcare, manufacturing, software and engineering, transport and logistics, meals and entertainment, and Banking, financial services, insurance.

The key drivers to outsourcing include, better use of internal resources, access to skills that are unavailable locally, improved business for customer focus, availability of trained and skilled workforce, lower operational costs, politically stable environment, robust and good treaty network, accelerated business processes and competitive edge in the market.

Very recently, the Government of Karnataka unveiled the nation's first-ever GCC Policy, with an ambitious goal to establish 500 GCCs by 2029, thereby creating approximately 350,000 jobs. Karnataka is not alone in this pursuit—many other Indian states, like Telangana, Uttar Pradesh, Andhra Pradesh, are actively fostering the growth of GCCs, and the Government of India has been equally supportive in encouraging these centers as engines of innovation and employment.

Given the massive impact that the GCCs have created in the recent decades, it would now be imperative to analyse the operating structures and regulatory and tax considerations for setting up GCCs in India.

Operating structures for GCCs

There are several structures and models that the Foreign Entity could consider before setting up GCCs in India. Prior to setting up, the Foreign Entity would have to determine what services it seeks to outsource, and also demarcate reporting lines, ownership and control. A few prevalent structures are highlighted below –

1) Direct Ownership

Under this business model, the Foreign Entity locates its own dedicated resources in another entity in India for a project or a process to be executed remotely. The Foreign Entity retains complete control and ownership over the GCC entity and outsources only those tasks/processes that require specialised local support. The Foreign Entity would only be involved in supervising the services delivered by

1. As per the report released by ANSR Global dated March 2024 on GCC Quarterly Landscape Q4'23.

the captive unit. The Foreign Entity would enter into a service contract with the captive Indian subsidiary of the Foreign Entity for the required services and remunerate the captive on an arm's length (generally cost plus mark-up basis) for services rendered by the captive.

The entity could be set up as a wholly owned subsidiary, joint venture company, branch office or a limited liability partnership. Each of these entities have their own governing legal/ regulatory landscape in India, and hence would require regulatory approvals, compliances, disclosures from the parent Foreign Entity, and most crucially restrictions/limitations on permissible activities, transferability of funds from the Foreign Entity to and/or from the GCC. Internal support functions or software maintenance or customer support type of business processes are well suited for this model

2) ***Build-operate-transfer model (BOT model)***

The Build Operate Transfer model is a business arrangement or contractual framework that enables companies to outsource the design, construction, operation, and eventual transfer of a project or operation to a specialized partner. Under this model, a third-party service provider, either wholly or partly, sets up (builds) the GCC, operates the centre, and gradually transfers ownership and control to the Foreign Entity.

- Build – Foreign Entity to partner with third-party vendors to establish and stabilize centre, in India
- Operate – Vendor to set up a dedicated development team and run the operations for a specified period of time (usually 3-5 years), in India. Vendor is responsible for operations of the captive centre during the predefined period of time.
- Transfer - At the end of the contract period the ownership is transferred to the Indian entity of the overseas company for an exit charge. Transfer could be by way of slump sale/asset acquisition/ demerger.

Regulatory Considerations

A multinational corporation setting up a GCC in India would need to comply with various local laws. This includes compliance with corporate laws on the type of legal entity to be set up for incorporating the GCC and contract laws for governing the GCCs contractual relationships, corporate structuring, regulatory interventions, etc. A few key aspects which need to be considered are highlighted below:

- ***Corporate law compliances***

  The compliance requirements differ depending on how the GCCs have been organised in India, i.e., the type of legal entity and the corporate structure i.e., whether a direct ownership or BOT model. The choice of form of legal entity is influenced by various parameters such as flexibility in the form of capitalisation and level of compliance. For example, if incorporated as a Company under the Companies Act, 2013, and within its rules, the GCC would also need to comply with various requirements including composition of board of directors, review and preparation of charter documents and company policies, routine and event-

based reporting/filings, etc.

- ***Special Economic Zones/International Financial Services Centres/Software Technology Park regulations***
  No specific regulations exist for setting up of GCCs, however, GCCs set up in Special Economic Zones or International Financial Services Centres, would have to comply with regulations under the respective laws. Special Economic Zones or International Financial Services Centres offer certain concessions, including custom duties, indirect taxes on goods and services [income tax benefits are no longer available for Special Economic Zones and Software Technology Park].

- ***Labour laws***
  Individuals (irrespective of their citizenship) recruited/hired to work with the GCC would be rendering services in India. Accordingly, the GCC in India would be governed by labour laws in India. The GCC is required to ensure compliance with labour laws, including but not limited to establishing necessary policies and systems to prevent and redress employee-related grievances at the workplace. The GCC can employ Indian citizens and foreign nationals, but it should carefully evaluate and undertake additional compliances related to recruiting foreign nationals, for e.g., visa requirements, requirement to contribute to social securities in India, like employee's provident fund and tax implications for the foreign nationals.

  It is also pertinent to note that a new labour law is proposed to be introduced to simplify, amalgamate and rationalize the existing Central Labour laws.

- ***Indian Exchange Control Regulations***
  Under the Indian foreign exchange laws, foreign entities are permitted to conduct business in India only through an established 'place of business' in the country. A 'place of business' may be a branch office, project office, wholly owned subsidiary or limited liability partnership. The compliance requirements differ depending on how the GCCs have been set up. Further, it will be crucial to evaluate whether approvals would be required from the Reserve Bank of India depending on the sectors in which the GCC operates. Most GCC's operate in the IT/ITeS industry, where 100% foreign direct investment is permitted under the automatic route. Relevant compliances also need to be carried out for making and receiving remittances to and from GCCs.

Tax considerations

Taxation has a significant impact on GCCs, as it does on other industries. Setting up a GCC requires meticulous tax planning considering both domestic and international tax laws and foreign exchange requirements. It is crucial that a Foreign Entity desirous of setting up its GCC in India undertakes a comprehensive analysis from a tax perspective to understand and carefully evaluate the costs involved in operating in India. Given that the GCC will primarily serve the overseas company or the group, i.e., non-resident entity, some additional considerations – permanent establishment risks, transfer pricing, secondment arrangements, indirect tax benefits, etc. require an in-depth analysis.

- ***Business structure and form of business presence***
  Establishing a "place of business" is crucial for a GCC's tax structuring. Where a separate entity is formed in

India, the entity could be set up as **Wholly owned subsidiary** – Company treated as a separate legal entity, **Limited liability partnership** – Hybrid entity which is a body corporate or a **Joint venture** - with an Indian partner (equity stake).

Though not desirable, the GCC could also operate as a foreign entity with a presence in India, through liaison office, branch office or project office.

The form of capitalisation i.e., debt vis-à-vis equity is also an important aspect to be kept in mind in determining the optimal capital structure. A private limited company (PLC) and a limited liability partnership (LLP) are the most prevalent legal forms of GCCs set up in India.

With respect to taxation, a PLC structure has a lower effective tax rate (25.17%) compared to an LLP structure (34.94%). However, the distribution of profits from the PLC is subject to tax in the hands of the shareholder, depending on the jurisdiction of the holding entity. On the other hand, there is no tax on profits distributed by an LLP. Accordingly, determination of the business structure is the most important aspect for the GCCs as this would also have implications on repatriation of profits by the GCCs to the Foreign Entity. Further, the feasibility of claiming foreign tax credit in the jurisdiction of the parent company is also something which should be kept in mind.

- ***Transfer pricing***
  - **TP documentation, Intercompany agreements**

    Having an inter-company agreement aligned with the functions of the GCC is essential. This agreement should clearly define all terms and conditions, including pricing mechanisms, as well as the roles and responsibilities of each party. A thorough analysis of the functions performed, assets utilized, and risks borne by the GCC and its associated enterprises (including the overseas parent company) is critical. This analysis forms the foundation for determining an arm's length margin, ensuring compliance with transfer pricing regulations.

  - **Remuneration methodology**

    GCCs are typically compensated on a cost-plus markup basis for the services they provide to their foreign parent entities. As GCCs now operate across diverse sectors beyond IT and ITES, it is important to carefully assess the functions performed, assets employed, and risks assumed by the GCC. This evaluation helps determine the appropriate arm's length margin. Comprehensive transfer pricing documentation is essential to substantiate the arm's length price for various transactions, particularly in the event of scrutiny by Indian tax authorities.

  - **APA, Safe Harbour**

    To mitigate uncertainties in transfer pricing and reduce compliance risks or potential litigation, foreign entities should consider utilizing mechanisms such as safe harbour rules and advance pricing agreements (APAs). These options provide greater certainty and simplify compliance with Indian tax regulations, helping ensure smoother operations for GCCs.

In this context, it would be pertinent to note that the Central Board of Direct Taxes have very recently vide a notification extended the applicability of Safe Harbour Rules for international transactions, under Rule 10TD of the Income-tax Rules, 1962 to Assessment Year 2024-25.

— **Cost base components and related aspects**

There is considerable litigation around the components of cost to be captured and recorded in the Indian arm or the GCC in India. Items such as assets provided free of cost, access to common IT tools, internal IPs, etc need attention and evaluation before implementation.

- ***Other tax considerations***

— **Permanent establishment ('PE') taxation risk**

Owing to expat movement and nature of service provided to the Foreign Entity, there could be potential Permanent Establishment (PE) risks for the GCCs' overseas group companies in India, that may need to be evaluated. It is important to evaluate if the GCC is constituting a PE, given that the taxable profits of such PEs are subject to 40% tax on taxable profits of such PEs, along with an increased compliance burden in the form of filing of tax returns, maintaining books of accounts, withholding taxes and other associated obligations. To avoid such PE risks, it is crucial to establish clear standard operating procedures for GCC employees interacting with foreign entities, including appropriate documentation and clear bifurcation of responsibilities. Where the activities undertaken by the Foreign Entity are adequately compensated at arm's length, this would ensure that no additional profit (and consequent taxes) is attributed in India even if it is alleged that the Foreign Entity has constituted a PE in India through its GCC.

— **Secondment arrangement**

Evaluating tax implications is crucial when engaging employees of Foreign Entity moving from the home jurisdiction to the host jurisdiction on secondment/short-term assignments. This could trigger a PE exposure of the Foreign Entity in India and hence requires a detailed analysis. Documentation with respect to secondment arrangements should be maintained and carefully drafted to ensure there are no tax leakages. Secondment arrangements could have an impact from a GST perspective as well and would require a detailed analysis. In the recent past, we have seen the tax authorities assess the GCCs control, supervision, and management by the Foreign Entity, particularly on how employees in India report to the employees of the Foreign Entity.

— **Incentives for retention of employees – ESOPS/shadow stocks**

Often, employees are offered stock options/shadow stock by employers as an award to the employees in order to retain top talent. ESOPs entitles the option holder to the right to subscribe to the shares

of the foreign parent company at a concessional rate. Shadow stock in the form of a deferred compensation plan, provide an option to the employees to defer a certain percentage of their bonus and can opt to share in the growth of the company. Tax and regulatory implications, both for the GCCs and the employees, would have to be examined for issue of ESOPs/ shadow stocks to employees of the GCCs.

— **Withholding taxes on foreign payments**

Typically, GCCs enter into contracts with group entities for license fees, royalty payments, common administrative costs, reimbursement of costs etc. GCCs would need to assess the withholding tax obligation/equalization levy obligations under the provisions of domestic tax law and the tax treaties.

— **Impact of Two Pillar solution and BEPS Action Plans**

The GCC in India would be a part of the Multinational Enterprise and the impact of the recent developments in International Taxation particularly the Two-Pillar solution need to be borne in mind while determining tax aspects relating to the contracting and ownership structure of the GCC in India.

— **Indirect tax**

GCCs primarily offer services to their overseas group entity and all their sales are exported to overseas entity. Monthly and annual compliances as required to be carried out under the Goods and Services Tax (GST) laws. Under the GST laws, exports are categorised as zero rated supply. Zero rated supply means the entire value of the supply is exempt from tax and GST will not be levied on any kind of good or services.

The exporter has the option to export under bond/letter of undertaking without payment of tax and claim refund of input tax credit or pay GST by utilising input tax credit at the time of export and claim refund of GST paid, subject to specified conditions.

Concluding thoughts

As GCCs continue to play a pivotal role in driving economic growth and creating employment opportunities in India, it is essential for policymakers to foster a more supportive and conducive environment for their expansion. With the success of the GCCs and their massive impact on the Indian economy, the Government of India has increasingly focussed on driving reforms to facilitate ease of doing business to encourage Foreign Entities to expand their business operations in the country.

However, foreign entities looking to set up a GCC in India must conduct a thorough analysis of regulatory and tax considerations to ensure an optimal operational structure.

Critical areas for evaluation include managing risks related to permanent establishment status, adhering to transfer pricing regulations, structuring secondment arrangements, offering ESOPs, and identifying potential direct and indirect tax benefits.

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Advocate

DIRECT TAXES
Supreme Court

1 ***Joint CIT vs. Suman Paper and Boards Ltd.; [2024] 468 ITR 106 (SC): Dated 17/09/2024:***

Offences and prosecution — Wilful attempt to evade tax —Search and seizure — No specific provision between 1-7-1995 and 1-1-1997 for prosecution for wilful failure to furnish return of income in search cases — Prosecution quashed — Supreme Court dismissed special leave petition filed by the Revenue: Ss. 276C(1), 277 and 278B of ITA 1961: A. Ys. 1-4-1985 to 5-1-1996

On a criminal revision petition to quash a prosecution for alleged offences u/s. 276C(1) and 277 read with section 278B of the Income-tax Act, 1961, in respect of block assessment for the period April 1, 1985, to January 5, 1996, the Gujarat High Court, allowing the petition, held as under:

"i) The Court in ***N. R. Agarwal Industries Ltd. vs. Joint CIT [2019] 416 ITR 578 (Guj)*** held that upon introduction of section 158BFA and section 158BC(a)(ii) and section 276CCC from January 1, 1997, the Legislature had envisaged prosecution for wilful failure to furnish return of income in search cases, and in the absence of a specific provision between the period from July 1, 1995 to January 1, 1997, it could be inferred that the Legislature had intended to grant immunity in such type of cases.

ii) Essentially what had been emphasized is the lack of any provisions to prosecute an assessee during the period between July 1, 1995 to January 1, 1997. The issue involved in the present group of applications and ***N. R. Agarwal Industries Ltd. vs. Joint CIT [2019] 416 ITR 578 (Guj)*** appeared to be substantially similar and under such circumstances, the law laid down by the Court would also cover the issue in question in the present group of applications. The Court had held that there being no provision existing at the relevant point of time whereby the Income-tax Department could launch a prosecution as regards income disclosed in block assessments for the period between July 1, 1995 to January 1, 1997, automatically and as a direct consequence, quashing of prosecution was the only necessary corollary.

iii) The fact of the heads on which income had not been disclosed being different and distinct in the present group of cases and the decision by the Court in ***N. R. Agarwal Industries Ltd. vs. Joint CIT [2019] 416 ITR 578 (Guj)*** would not be of any material consequence. Consequently, the criminal complaints pending in the Court of the Chief Judicial Magistrate were hereby quashed and set aside."

[See ***Suman Paper and Boards Ltd. vs. Joint CIT; [2023] 454 ITR 296 (Guj)***.]

On a criminal revision petition to quash the prosecution for offences under sections 276C(1) and 277 read with section 278B of the Income-tax Act, 1961, in respect of block assessment for the period April 1, 1985 to January 5, 1996, the High Court held that in the absence of a specific provision between the period from July 1, 1995 to January 1, 1997 for prosecution for wilful failure to furnish return of income in search cases, it could be inferred that the Legislature had intended to grant immunity in such type of cases and quashed the criminal complaints pending in the Court of the Chief Judicial Magistrate. On a petition for special leave to appeal to the Supreme Court :

The Supreme Court dismissed the special leave petition filed by the Revenue and held as under.

> "We are not inclined to interfere with the impugned judgment and order of the High Court. Accordingly, the special leave petition is dismissed."

2 ***HDFC Bank Ltd. vs. State of Bihar; [2024] 468 ITR 650 (SC): Dated 22/10/2024:***

Offences and prosecution — Search and seizure — Prohibitory order — Violation of — Prohibitory order issued initially in respect of bank accounts and bank lockers of group of assessees — Prohibitory order partially lifted thereafter in respect of bank accounts of some assessees of group — Bank officials mistakenly reading order to extend to locker also and permitting operation of locker — Prosecution of bank for offences of fraud, criminal breach of trust, misappropriation and conspiracy — Held, bank was a juristic person and question of mens rea did not arise — Nothing in first information report or complaint to show bank or its staff members had dishonestly induced someone to deliver any property to any person, and that mens rea existed at time of such inducement — No allegation of entrustment of property which bank had misappropriated or converted for its own use to detriment of Department — First information report or complaint not showing that bank and its officers acted with common intention or intentionally co-operated in commission of any alleged offences — Continuation of criminal proceedings against appellant-bank would cause undue hardship to appellant-bank — Prosecution against bank and its officials quashed: Ss. 131(1A), 132(1) and 132(3) of ITA 1961 and Ss. 34, 37, 120B, 201, 206, 217, 406, 409, 420, 462 of Indian Penal Code 1860

In the course of search and seizure operations in the case of several Income-tax assessees, including SK (HUF), an order dated October 5, 2021, u/s. 132(3) of the Income-tax Act, 1961, was served upon the branch manager of the appellant bank by the authorized officer, directing the branch of the appellant bank to stop the operation of any bank lockers, bank accounts and fixed deposits standing in the names of SK (HUF) and Smt. SK, among several other individuals and entities, with immediate effect. In compliance, the appellant-bank stopped the operation of the bank accounts, bank lockers and fixed deposits of the individuals and entities mentioned in the order.

On November 1, 2021, the Deputy Director (Investigation) issued an order to the branch manager of the appellant bank directing the appellant bank to revoke the restraint put on the bank accounts of Smt. SK and three other persons, in view of the restraining order dated October 5, 2021, passed u/s. 132(3) of the Act. Accordingly, the persons, including Smt. SK, were to be allowed to operate their bank accounts. On November 20, 2021, the Deputy Director (Investigation) conducted a search and seizure operation at the bank locker in the concerned branch of the appellant bank, wherein it was found that Smt. SK had operated her bank locker with the assistance of officers of the appellant bank. The concerned officials of the branch of the

appellant bank were found to have breached the restraining order dated October 5, 2021. Pursuant to the issue of summons u/s. 131(1A) of the Act, the officials of the bank appeared before the Deputy Director (Investigation) and stated that there had been an inadvertent error on the part of the bank officials, that they had misinterpreted the order dated November 1, 2021, to assume that the revocation of the restraint extended to the bank lockers as well and under a bona fide assumption that the bank locker had been released as well, allowed Smt. SK to operate the locker. The Deputy Director (Investigation) did not find the explanation satisfactor and submitted a written complaint pursuant to which a first information report was registered against Smt. SK and the staff of the appellant-bank for the offences punishable u/s. 34, 37, 120B, 201, 206, 217, 406, 409, 420 and 462 of the Indian Penal Code, 1860.

The appellant-bank preferred a petition invoking the inherent power of the High Court u/s. 482 of the Code of Criminal Procedure, 1973, but the High Court dismissed the petition. (See ***HDFC Bank vs. State of Bihar [2022] 448 ITR 103 (Patna)***;

The Supreme Court allowed the appeal and held as under:

"i) For bringing out the offence under the ambit of section 420 of the Code, the first information report must disclose the following ingredients: (a) that the appellant-bank had induced anyone since inception ; (b) that the inducement was fraudulent or dishonest ; and (c) that mens rea existed at the time of such inducement. The appellant-bank was a juristic person and as such, the question of mens rea did not arise. However, even reading the first information report and the complaint at their face value, there was nothing to show that the appellant-bank or its staff members had dishonestly induced someone to deliver any property to any person, and that mens rea existed at the time of such inducement. The ingredients to attract the offence under section 420 of the Code would not be available.

ii) In so far as the provisions of section 409 of the Code were concerned, the following ingredients had to be made out : (a) that there had been any entrustment with the property, or with any dominion over property on a person in the capacity of a public servant or banker, etc. ; (b) that the person committed criminal breach of trust in respect of that property. For bringing out the case under criminal breach of trust, it had to be pointed out that a person, with whom entrustment of a property is made, has dishonestly misappropriated it, or converted it to his own use, or dishonestly used it, or disposed of that property. In the present case, there was not even an allegation of entrustment of the property which the appellant-bank had misappropriated or converted for its own use to the detriment of the Deputy Director (Investigation). The provisions of sections 406 and 409 of the Code would also not be applicable.

iii) Since there was no entrustment of any property with the appellant-bank, the ingredients of section 462 of the Code were also not applicable.

iv) Likewise, since the offences under sections 206, 217 and 201 of the Code required mens rea, the ingredients of these sections also would not be available against the appellant-bank.

v) The first information report or complaint also did not show that the appellant-bank and its officers acted with any common intention or intentionally co-operated in the commission of any alleged offences. The provisions of sections 34, 37 and 120B of the Code would also not be applicable.

vi) Therefore, the continuation of the criminal proceedings against the appellant-bank would cause undue hardship to the appellant-bank.

vii) The appeal is allowed. The impugned judgment and order dated June 8, 2022 passed by the learned single Bench of the High Court of Judicature at Patna in Criminal Writ Jurisdiction Case No. 1375 of 2021 2 is quashed and set aside.

viii) The First Information Report being Case No. 549 of 2021 registered at Gandhi Maidan Police Station, Patna on November 22, 2021, against certain officials of the appellant-bank working at its Exhibition Road Branch, Patna for the offences punishable under sections 34, 37, 120B, 201, 206, 217, 406, 409, 420 and 462 of the Indian Penal Code, 1860 is also quashed and set aside qua the appellant-bank."

3 ***Shriram Investments vs. CIT; [2024] 468 ITR 372 (SC): Dated 04/10/2024:***

Return — Revised return — May be filed within one year from the end of the assessment year or before completion of the assessment, whichever is earlier — Revised return filed after expiry of time— AO had no jurisdiction to consider the claim made in revised return — Tribunal directing AO to consider assessee's claim made in revised return — High Court right in setting aside the order of Tribunal: Ss. 139(5), 254 of ITA 1961: A. Y. 1989-90

The assessee filed a return of income on November 19, 1989, for the A. Y. 1989-90. On October 31, 1990, the assessee filed a revised return. Pursuant to an intimation issued u/s. 143(1)(a) of the Income-tax Act, 1961, on August 27, 1991, the assessee paid the necessary tax amount. On October 29, 1991, the assessee filed another revised return. The Assessing Officer did not take cognizance of the revised return.

The assessee preferred an appeal. The Commissioner (Appeals) dismissed the appeal on the ground that in view of section 139(5) of the Act, the revised return filed on October 29, 1991, was barred by limitation. The assessee preferred an appeal before the Tribunal. The Tribunal remanded the case back to the Assessing Officer, directing him to consider the assessee's claim regarding the deduction of deferred revenue expenditure.

The Department preferred an appeal before the High Court. The Madras High Court set aside the order of the Tribunal on the ground that after the revised return was barred by time, there was no provision to consider the claim made by the assessee. [See ***CIT vs. Shriram Investments [2024] 468 ITR 368 (Mad)***]

The Supreme Court dismissed the appeal filed by the assessee and held as under:

"i) Section 139(5) of the Act, at the relevant time, permitted the furnishing of a revised return at any time before the expiry of one year from the end of the relevant assessment year or before the completion of the assessment, whichever was earlier. When the revised return dated October 29, 1991 was filed, it was barred by limitation in terms of section 139(5) of the Act.

ii) The Tribunal had not exercised its power u/s. 254 of the Act to consider the claim. Instead, the Tribunal directed the Assessing Officer to consider the assessee's claim. The Assessing Officer had no jurisdiction to consider the claim made by the assessee in the revised return filed after the time prescribed by section 139(5) for filing a revised return had already expired.

iii) Therefore, we find no reason to interfere with the impugned judgment of the High Court. The appeal is, accordingly, dismissed."

DIRECT TAXES
High Court

Jitendra Singh
Advocate

Radha Halbe
Advocate

Harsh Shah
Advocate

1 ***CIT vs. Satish Kumar Agarwal [2024] 167 taxmann.com 510 (Rajasthan)***

Filing of appeal to High Court by revenue authorities - Section 268A of the Income Tax Act 1961 - Circular 9 of 2024 while enhancing the monetary limit, retained the exceptions of Circular 5 of 2024 and therefore, Circular No. 9 of 2024 is applicable to pending appeals also.

Facts

The Assessee filed his return of income for AY 2015-16 declaring total income of ₹ 20,04,170. The A.O. finalized the assessment order under section 143(3) of the Act disallowing the deduction of Rs.91,83,373/- claimed under Section 54B of the Act.

The Commissioner of Income Tax invoked revisionary proceedings under Section 263 of the Act and set aside the assessment Order on the ground that section 50C of the Act ought to have been invoked in the present case. The assessee being aggrieved by the order passed under section 263, challenged the same before the Income-tax Appellate Tribunal. The Tribunal accepted the plea of the assessee and quashed the order passed under section 263 of the Act. Aggrieved by the order of the Tribunal, the Department filed an appeal before the Hon'ble Rajasthan High Court.

During the course of hearing, it was pointed out by the Ld. Counsel for the assessee that the tax effect involved in this appeal is ₹ 13,93,590/-, thus, the appeal is non maintainable in view of Circular No. 9 of 2024. The department on other hand contended that the revision was done on the basis of the audit objection and therefore, the appeal falls within exceptions carved out in Circular No.3 of 2018 dated 11.07.2018.

Ruling of the High Court

Hon'ble Rajasthan High Court was pleased to dismiss the appeal of the department by observing that Circular 9 of 2024 enhanced the monetary limits and also retained the exceptions in Para 3.1 & 3.2 of Circular 5 of 2024. From perusal of Para 5 of Circular 9 of 2024, it is evident that the circular shall apply to the appeals to be filed henceforth and also to the appeals pending before the Supreme Court, High Court and the Tribunal. Thereby making monetary limit specified in it and exceptions in Para 3.1 & 3.2 of Circular 5 of 2024 applicable to all the pending appeals. In

other words, Circular 5 of 2024 was applicable prospectively but Circular 9 of 2024 while enhancing the monetary limit, retaining the exceptions of Circular 5 of 2024 made it applicable to the pending appeals also.

2 *Capital Broadways (P.) Ltd. vs. ITO [2024] 167 taxmann.com 533 (Delhi)*

Notice for reopening - section 148 of the Income Tax Act 1961 - validity - mechanical approval granted by Commissioner by endorsing 'yes, I am satisfied' - suffers from non-application of mind – notice invalid.

Facts

The assessee filed its return of income for AY 2010-11 declaring a total income of ₹ 1,95,711/-. The AO received certain information from the investigation wing that an entity named Jain Brothers through their paper companies, provided accommodation entries to various beneficiaries in the guise of share-capital, share-premium, etc. The list of the beneficiaries allegedly contained the name of the Assessee. Based on the said information, a notice dated 28th March 2017 was issued under section 148 of the Act requiring the Assessee to file his return on income. In response to the above notice, the assessee requested the AO to treat the original return of income as the return of income filed in response to the section 148 notice. The Assessee also requested to provide copy of the reasons recorded prior to the issuance of notice under section 148 of the Act. The AO furnished the recorded-reasons along with the proforma for seeking necessary approval of the Principal Commissioner Income-tax. The assessee challenged the notice issued under section 148 of the Act by way of a writ petition before the Hon'ble Delhi High Court. One of the contentions raised by the Assessee in this writ petition was grant of sanction by the Principal Commissioner to the impugned section 148 notice in a mechanical manner.

Ruling of High Court

Hon'ble High Court was pleased to allow the writ petition filed by the assessee and quashed the notice issued by the AO under section 148 of the Act by observing that there was no whisper of any material that may have weighed for the grant of approval. Even the bare minimum requirement of the approving authority having to indicate what the thought process was, was missing in the sanction. While elaborate reasons may not have been given, at least there should be some indication that the approving authority has examined the material prior to granting approval. Mere repeating of the words of the statute, mere rubber stamping of the letter seeking sanction or using similar words "Yes, I am satisfied" will not satisfy the requirement of the law.

3 *Talati and Talati LLP vs. ACIT [2024] 167 taxmann.com 371 (Gujarat)*

Faceless assessment of income escaping assessment – section 151A of the Income Tax Act – as per Explanation 1 and Explanation 2 to section 148, method of automated allocation, for issuance of notice under section 148 in a faceless manner, cannot be applied to case of search and seizure under section 132 of the Act.

Facts

The assessee a Limited Liability Partnership firm filed its return of income within the

due date specified under section 139 of the Act for the AY 2021-22. The jurisdictional AO issued a notice under section 148 of the Act to reopen the assessment of the assessee on the basis of certain search and seizure information. The assessee assailed the reopening notice before the Hon'ble Gujarat High Court on the ground that the section 148 notice was issued in violation of provisions of section 151A, as has been inserted by the Taxation and Other Laws (Relaxation and Amendments of Certain Provisions) Act 2020 w.e.f. 1st November 2022 which provides for faceless assessment on income escaping assessment.

Ruling of the Hon'ble High Court

Hon'ble Delhi High Court dismissed the writ petition filed by the assessee by observing that the Section 147 empowers AO to assess and reassess an Assessee's case, if any income chargeable to tax has escaped assessment. This is subject to provisions of section 148 to section 153 of the Act. Section 148A prescribes the procedure that has to be complied with prior to issuing a notice under section 148. However, the first proviso to section 148A, carves out an exception to this procedure in certain cases of search and seizure based on section 132 and section 132A of the Act. Further, from a careful reading of the notification dated 29.03.2022, along with the statutory provisions, the aforesaid notification does not cover a case where notice under Section 148 is issued by the Jurisdictional Assessing Officer (JAO) on the basis of the information received by him in the matter of Search and Seizure under Section 132 of the Act' 1961, or requisitioned under Section 132A of the Act.

4 ***PCIT vs. Gravita Metal Inc. [2024] 168 taxmann.com 379 (Jammu & Kashmir)***

Income - section 5 of Income Tax Act 1961 - entries in books of account is not conclusive to determine income under provisions of Act - no tax can be charged on an amount which is not actually earned during the year under consideration.

Facts

The assessee filed its return of income for the assessment year 2016-17, declaring a nil income after setting off brought forward losses. During the assessment proceedings, the Assessing Officer observed that the assessee had treated the excise duty refund as a capital receipt and had claimed exemption under Section 10. The Assessing Officer, however, was of the opinion that following the amendment in the Finance Act, 2015, and the introduction of the amended Section 2(24)(xviii), any assistance provided by the government or any authority in the form of subsidies, grants, etc., should be treated as income. The AO therefore is of the view that the excise duty refund also fell within this category and issued a show-cause notice to the assessee, asking why the excise duty refund, which had been claimed as a capital receipt and exempted under Section 10, should not be considered as a revenue receipt and taxed accordingly. In reply the assessee clarified that no actual excise refund was received during the year in question. The amount booked was merely a notional figure for accounting and quantification purposes.

However, the Assessing Officer concluded that the assessee excise duty refund is a revenue receipt under the amended Section 2(24)(xviii) of the Act and added the same to the total income of the assessee.

On appeal, the Commissioner (Appeals) partly allowed the appeal of the assessee by holding that part of the amount, could not be taxed as income for the assessment year 2016-17 since the Excise Department was not obliged to pay the 64% of the excise duty collected by the assessee during that year. The balance amount, representing 36% of the net excise duty, was to be treated as income of the assessee in light of Notification No. 19 of 2008 and the amended Section 2(24)(xviii).

Being aggrieved by the order of the Ld. CIT(A) the assessee as well as department challenged the same before the Appellate Tribunal. The Appellate Tribunal dismissed the department's appeal and allowed the assessee's appeal. The department challenged the order of the Tribunal before the Hon'ble High Court under section 260A of the Act.

Ruling of the Hon'ble High Court

Hon'ble High Court was pleased to dismiss the appeal filed by the department by observing that exemption from excise duty does not fall in definition of income as envisaged under section 2(24)(xviii) and, thus, the exemption claimed of excise duty is not an income but a capital receipt not taxable under provisions of Act. Hon'ble High Court further observed that as the assessee had not received any excise duty refund during the year under consideration, the same cannot be charged to tax merely because the assessee had recorded the same in its books of account. Recording of entries in books of account is not conclusive to determine income under provisions of Act, and as such, no tax can be charged on an amount which is not actually earned during the year under consideration.

"We are responsible for what we are, and whatever we wish ourselves to be, we have the power to make ourselves. If what we are now has been the result of our own past actions, it certainly follows that whatever we wish to be in the future can be produced by our present actions; so we have to know how to act."

— *Swami Vivekananda*

DIRECT TAXES
Tribunal

CA Nikhil Mutha

CA Viraj Mehta

CA Kinjal Bhuta
Advocate

1 ***Rajkamal Stone Metal Works vs. ACIT (ITA No. 691/Pune/2024 dated 25.10.2024)***

Section 45 – Transfer of Land owned by partnership firm to its partners – Transferred at cost by Book Entry – Adjusted against Capital Balance of Partner – Not taxable as Capital Gains

Facts

During the course of assessment proceedings, the Assessing Officer (Ld. AO) noted from the capital account of the partner that an amount has been debited of ₹ 62,70,540/- under the head 'lands.' On being questioned by the Ld. AO, it was submitted that the assessee firm purchased the said lands for its business use, but the purchase deeds were made in the name of the partners who had contributed the capital for the purchase of the properties, and the firm paid the amount. As no business was carried out on these lands, the partners decided to transfer the said lands to both partners at cost price by passing necessary journal entries. Such transfer of lands was not offered to capital gain tax. The Ld. AO held that as no business was carried on in these lands, the same was transferred to the partners which amounts to a transfer resulting into a capital gain. Therefore, an addition was made as a capital gain on the value which was passed as a journal entry. On appeal, CIT(A) upheld the assessment order. Being aggrieved with the order, appeal is filed by assessee before Hon'ble ITAT.

Held

The Hon'ble ITAT held that perusal of the Balance Sheet of the assessee firm shows that the opening value of such land as on 01.04.2016 was shown as ₹ 2,28,29,180/- which was transferred to the two partners on the ground that the lands were registered in their name originally. It is an admitted fact that there was no revaluation of such lands and no excess amount other than the cost of the lands has been credited to the capital accounts of the partners which is otherwise eligible for withdrawal by the partners. It was further held that it is also an admitted fact that the lands were transferred to the capital accounts of the partners at book value only and therefore, no capital gain has arisen. Since there was no revaluation of any asset and the assets were transferred at cost price to the partners The Hon'ble ITAT distinguished the Apex Court case of Mansukh Dyeing and Printing Mills (please give citation). Further relying on the Bombay High Court in the

case of ***CIT vs. M.J. Mehta and Bros. [1992 (9) TMI 11 - BOMBAY HIGH COURT]*** it was held that the transfer of immovable property belonging to the firm to its partners by means of book entry was not valid. Once the transfer is treated as not valid because of the mere passing of book entry, the Hon'ble ITAT held that there cannot be any capital gain. On above basis, appeal filed by the assessee was allowed and therefore additions were deleted.

2 ***Shital Piyushkumar Patel vs. ITO Ward-4, Mumbai [ITA No. 407/AHD/2024 dated 23.10.2024] [AY: 2009-10]***

Section 54EC – Investment made in specific bonds before the date of transfer of capital asset – deduction to be allowed if the investment made from advance received on sale of capital asset

Facts

Assessee has inherited immovable property from her late husband who was one of the co-owners of the property. The assesssee had claimed exemption u/s. 54EC from the capital gains computed on the said sale. The subject matter of the present appeal pertains to the admissibility of a deduction claimed u/s. 54EC, in respect of an investment of ₹ 50,00,000 in bonds issued by the National Highway Authority of India (NHAI). This assessment had travelled to Hon'ble ITAT and was set aside for verification on some issues. The Ld. AO, in the original assessment order, had allowed the deduction under Section 54EC. However, upon subsequent examination, it was observed that the investment in the said bonds was made on June 25, 2008, with a deemed allotment date of July 31, 2008, whereas the transfer of the property occurred at a later date, i.e., August 16, 2008. The lower authorities were of the view that the stipulated conditions u/s. 54EC had not been fulfilled, as the investment was required to be made after the transfer of property. Accordingly, it was concluded that the deduction had been inappropriately claimed as the investment was not sourced from the capital gains arising from the property transfer but rather from the assessee's personal funds. The assessee has preferred an appeal before the Hon'ble ITAT challenging the addition made by the Ld. AO.

Held

The Hon'ble ITAT in its order dated 12.07.2017, remanded the matter to the Ld. AO for reconsideration in light of the clarification issued by the CBDT Circular, which specified that investments made prior to the transfer of the asset, provided they are out of advances received, are also eligible for exemption u/s. 54EC. The Hon'ble Bench directed the AR to produce the bank statement to establish the nexus between the advance received by the assessee on account of the sale of property and the subsequent investment in the NHAI Bonds, as per section 54EC. The bank statement submitted demonstrated that the advance for the sale of the property was received by the assessee on 25.06.2008. On the same date, the assessee issued a demand draft for the purpose of investing in NHAI Bonds. It was argued that the bank statement clearly establishes a direct nexus between the advance received by the assessee from the sale of the property and the investment made in NHAI Bonds. It was held by the Hon'ble ITAT, CBDT Circular No. 359 dated 10.05.1983, clarifies that if the assessee invests earnest money or advance money in specified assets before the transfer of the asset, such investment qualifies for exemption u/s. 54EC. Further, they also considered the Bombay HC decision in the case of ***CIT vs. Subhash Vinayak***

Supnekar (77 taxmann.com 226) held that when an amount received as advance under an agreement to sell a capital asset is invested in specified bonds, the benefit of Section 54EC is available to the assessee. It was held that since the assessee has established a direct nexus between the advance received for the sale of the property and the investment made; the assessee is eligible to claim the deduction u/s. 54EC.

3 ***Shri Bipinchandra Shantilal Shah vs. ITO (ITA No. 2933/Mum/2023 dated 22.10.2024)***

Section 56(2)(x) – Conversion of tenancy right to ownership rights – definition of transfer u/s 2(47) not relevant – conversion not taxable u/s 56(2)(x) – no immovable property received

Facts

During the year under consideration, the ownership rights of the property were transferred to the assessee in lieu of tenancy rights. The assessee was asked to show cause as to why the addition of ₹ 1,13,70,000, being the difference in the fair market value adopted by the stamp duty valuation authority and the consideration paid by the assessee, be not made under section 56(2)(x). The assessee submitted that he had not purchased any additional immovable property during the year under consideration, and his landlord has only converted his 25 years old tenancy in respect of the tenanted residential flat into ownership by executing a Deed for Conversion of tenancy rights into ownership rights. However, Ld. AO did not accept the submissions of the assessee and considered a sum of ₹ 1,13,70,000 (i.e. ₹ 1,38,70,000 minus ₹ 25,00,000 (amount paid for conversion)) as income under the head "income from other sources" as per the provisions of section 56(2)(x)(b) on account of purchase/conversion of tenancy rights in to ownership rights of the immovable property. On appeal, the CIT(A) upheld the assessment order. Being aggrieved with the order, the appeal is filed by the assessee before the Hon'ble ITAT.

Held

The Hon'ble ITAT held that as per section 56(2)(x), if any person receives any immovable property from any person or persons on or after 01/04/2017 for consideration, the stamp duty value of such property as exceeds such consideration shall be considered as its income from other sources. Thus, for the applicability of the provisions of section 56(2)(x) , it is firstly relevant that the person receives the immovable property on or after 01/04/2017; secondly, the same is received for a consideration which is less than the stamp duty value of such property; and thirdly, such excess should be more than the amount as noted above. It is pertinent to note that while assigning the meaning to the term "property" in the Explanation to section 56(2)(x) r/w the Explanation to section 56(2)(vii), the term "immovable property" has been defined to mean land or building or both. Hon. ITAT held that it will not cover the improvement of rights, which is already held by the assessee. Therefore, from the bare reading of the aforesaid provisions, it is discernible that receipt of immovable property for the purpose of section 56(2)(x) only includes within its ambit receipt of land or building or both. In other words, section 56(2)(x)(b) cannot be so exhaustively interpreted to even cover the transaction of improvement of any right in the immovable property. It further held that in light of the various judicial pronouncements as noted and also in light of the detailed analysis of the provisions of section 56(2)(x)(b), since the assessee, being a protected tenant since

1992, has merely acquired an ownership right of the Flat earlier occupied by him as a protected tenant and not any immovable property vide Deed for Conversion dated 05/12/2019, therefore section 56(2)(x)(b) is not applicable. Further, reliance on the definition of the term “transfer” as provided in section 2(47) is immaterial as no addition on account of capital gains was made either in the hands of the assessee or the landlord. On above basis, appeal filed by the assessee was allowed and therefore additions were confirmed to be deleted.

4 ***Archit Gupta vs. ACIT, [ITA No. 2624 & 2625/Del/2022 dated 06.11.2024] [AY 2012-13 & 2013-14]***

Section 68 – Assessee submits all documents of the transactions of exempt LTCG alleged to be in penny stock company – AO has no material to prove that transactions is not genuine – no addition can be made merely based on Investigation wing report

Facts

The assessee had acquired 1.5 lakh equity shares of 'A ' Ltd., subsequently renamed 'W' Ltd., for a total consideration of ₹ 18 lakhs. During the relevant assessment year, the assessee sold 38,900 of these shares, resulting in the realisation of long-term capital gains (LTCG) claimed exempt u/s. 10(38). Subsequently, during a search conducted on one 'R', the Ld. AO discovered that the shares of 'W' Ltd. were allegedly utilised as accommodation entries for generating artificial LTCG. Based on this information, the Ld. AO initiated reassessment proceedings against the assessee, asserting that the LTCG was derived through these accommodation entries. During the re-assessment proceedings, the assessee submitted the relevant documents. A Summons was issued and the statement was recorded of the assessee. The Ld. AO added the entire LTCG as unexplained cash credit u/s. 68 on the basis of the investigation report. Aggrieved by the reassessment, the assessee filed an appeal before the CIT(A), who upheld the additions made by the Ld. AO. Dissatisfied with the decision of the CIT(A), the assessee preferred a further appeal before the Hon’ble ITAT.

Held

Before the Hon’ble ITAT, it was submitted by the assessee that he was a regular investor, and there was no adverse report of SEBI against the appellant. The assessee had submitted that transactions were done through a demat account, routed through a bank account and on a recognised stock exchange. It was also argued that the assessment has been completed by replying on investigation report alone, and no independent enquiries were conducted. It was observed by the Tribunal that merely because the assessee made huge profits does not make the scrip a penny stock. It was also observed that no discrepancies have been identified in the documentation furnished by the assessee in support of the claim for deduction under Section 10(38). The Hon’ble ITAT held that the revenue has failed to produce any concrete evidence linking the assessee to dubious transactions, such as entry operations, price manipulation, or exit facilitation. Additionally, SEBI report does not implicate the assessee or mention any involvement in alleged fraudulent activities. The assessee's role in the transaction appears to be limited to that of an investor seeking to capitalise on investment opportunities for profit. The addition made by the Ld. AO is based on presumptions and the application of human probability, without substantiating

the same with material evidence against the assessee. It was held that the Ld. AO and CIT(A) have applied the principle of human probabilities to conclude that the impugned scrips constitute penny stocks without bringing on record how the assessee is involved in unscrupulous activities or any direct connection with individuals engaged in the manipulation or rigging. The Hon'ble ITAT relying on the decision of Hon'ble Bom HC in the case of ***Pr. CIT vs. Ziauddin A Siddique in Income Tax Appeal No. 2012 of 201***7 held that in the absence of any substantive material evidence to support the findings of the tax authorities regarding the non-genuineness of the transactions, the appeal of the assessee was allowed.

5 ***ITO vs. Pushpak Realities Pvt. Ltd. (ITA No. 4812,4814, 4816/ Mum/2024 dated 07.11.2024) (AY 13-14, AY 14-15, AY 15-16)***

Section 148A - Reassessment- Conducting inquiry, providing opportunity before issue of notice - Following the ratio in *UOI vs. Rajeev Bansal [2024] 167 taxmann.com 70 (SC)* the time limit for issue of notice was extended only up to 30-6-2021- Assessment year 2013-14 the notice was issued on 29-7-2022, for the Assessment year 2014-15 the notice was issued on 31-7-2022 and for the Assessment year 2015-16 the notice was issued on 28-7-2022 - All the notices are barred by limitation-Reassessment is quashed. [S. 147, 148, 148A(b), 148A(d), 149(1), TOLA, S. 2, 3]

Facts

- For A.Y.2013-14 was reopened by Ld. Jurisdictional AO by issue of notice u/s. 148 on 23/04/2021 and then ld. AO stated that in view of the decision of the Hon'ble Supreme Court in the case of ***Union of India vs. Ashish Agarwal reported (444 ITR 1)*** wherein it has been held that notice u/s. 148 issued during the period 01/04/2021 to 30/06/2021 under the old law are deemed to be show-cause notice issued under 148(b) under the new law and has directed the ld. AO to follow the procedure with respect to such notices. Accordingly, ld. AO provided the information and material relied upon the issue of notice u/s.148 to the assessee on 28/05/2022 as per the provision of Section 148A(b) and order u/s. 148A(d) was passed and simultaneously notice u/s.148 was issued on 29/07/2022.
- For A.Y. 2014-15, notice u/s. 148 was issued on 23/04/2021 and thereafter, another notice was issued u/s. 148 on 26/04/2021. The reasons for reopening were provided on 04/08/2021 against which assessee filed an objection on 24/09/2021 which was disposed of by the ld. AO vide order dated 13/12/2021. The ld. AO thereafter, issued a letter dated 28/05/2022, in view of the decision of the Hon'ble Supreme Court in the case of ***Ashish Agarwal (supra)*** wherein, ld. AO treated the notice u/s. 148 issued on 26/04/2021 as notice issued u/s. 148(b) which was issued by the JAO. Order u/s. 148A (d) passed on 28/07/2022 and notice u/s. 148 was issued on 31/07/2022.
- For A.Y.2015-16 first notice and second notice was issued on 23/04/2021 and 26/04/2021 and assessee objection was disposed of on 13/12/2021. However, later on ld. AO issued a letter dated 28/05/2022 stating that now in view of the decision of the Hon'ble Supreme

Court in the case of Ashish Agarwal notice u/s.148 was issued on 26/04/2021 as notice issued u/s. 148A(b). Finally, the ld. AO passed an order u/s. 148A(d) on 28/07/2022 and notice u/s. 148 was issued on 29/07/2022.

Above were the chronologies of notices issued for all 3 years. On above basis, Ld. AO passed the reopening order and made the additions. On appeal, CIT (A) has quashed the notices for all 3 years thereby quashing the assessment order passed on basis that notices issued are time barred. Being aggrieved with the same, appeal is filed by department before Hon. ITAT.

Held

The Hon'ble ITAT held that issue has been settled by the judgment of the Hon'ble Supreme Court in the case of ***Union of India vs. Rajeev Bansal in Civil Appeal No.8629 of 2024*** along with other civil appeal numbers. Relying on the Apex Court case the Hon'ble ITAT held that after 01/04/2021, the Income Tax Act has to be read alongwith substituted provisions of TOLA, TOLA will continue to apply after 01/04/2021 if any action or proceedings provided under the substituted provision of the Income Tax falls for completion between 21/03/2020 to 31/03/2021 and Section 3(1), overrides Section 149 of the Income Tax Act; Similarly, TOLA will extend the time limit for grant of sanction by the authorities specified u/s. 151 and if the time limit of three years falls between 21/03/2021 and 31/03/2021 then the specified authority u/s. 151(i) has extended time limit till 30/06/2021. The direction of Shri Ashish Agarwal will extent to all re-assessment notice issued in old regime i.e. from 01/04/2021 to 30/06/2021 and finally Court held that ld. AO was required to issue re-assessment notice u/s.148 under the new regime within the time limit surviving u/s.148 of the Income Tax Act r.w. TOLA. Thus, in all such instances for the relevant assessment years under question the time limit was extended only up to 30/06/2021 for issuance of notice u/s.148. For A.Y. 2013-14 after 148A (b), notice u/s.148 was issued on 29/07/2022; for A.Y. 2014-15 it was issued on 31/07/2022; and for A.Y. 2015-16 it was issued 28/07/2022. Thus, in all these years as noted above the original time limit for six years for A.Y. 2013-14 was upto 31/03/2020; for 2014-15 it was 31/03/2021; and for A.Y. 2015-16 it was 31/03/2022. Even under the TOLA, the time limit for issuance of notice u/s 148 had expired on 30/06/2021 both for A.Y. 2013-14 & A.Y. 2014-15. For the A.Y. 2015-16, the Revenue itself has contended before the Hon'ble Supreme Court, all the notices issued on or after 01/04/2021 will have to be dropped as they will not fall for completion during the period prescribed under TOLA. Here notice u/s. 148 for the A.Y. 2015-16 has been issued on 28/07/2022 which is admittedly barred by limitation under the new provision of Section 149(1) and it is not covered under TOLA. Accordingly, Hon. ITAT quashed all the notices being barred by limitation and thereby, department appeals were dismissed.

6

KD Lite Developers Pvt. Ltd. vs. DCIT, TDS (ITA Nos. 5305, 5325, 5354, 5356 & 5357/MUM/2024 dated 29.11.2024)

Section 194A - No TDS Liability on Reimbursement of Interest Paid Through Group Companies

Facts

KD Lite Developers Pvt. Ltd. ("the Assessee") utilized funds borrowed through its group companies, which had availed a credit facility

from a bank. The group companies were not engaged in the lending business and merely facilitated the transfer of borrowed funds to the Assessee. The Assessee reimbursed the interest paid by the group companies to the bank. During a search under Section 132 on the Ruparel Realty Group (Group concern), the Ld. AO concluded that the Assessee failed to deduct tax at source (TDS) on the interest payments under Section 194A. Proceedings under Sections 201(1) and 201(1A) were initiated against the Assessee for non-deduction of TDS. The Assessee argued that:

(a) The payments were reimbursements for interest paid to the bank and did not qualify as 'interest' in the form of income, as contemplated under Section 194A.

(b) The group companies acted as intermediaries, and the transactions reflected a flow of funds rather than a lending arrangement. Relevant documents, including financial statements, were furnished to substantiate that the liability was shown in the names of the group companies rather than the bank.

Held

The Hon'ble ITAT observed that Section 194A applies only to interest payments that constitute income for the recipient. In this case, the payments were purely reimbursements made to group companies, which acted as intermediaries for settling the bank's credit facility. The Hon'ble ITAT emphasized that since the group companies were not earning income from the transaction, the provisions of Section 194A were not applicable. It was noted that the assessee provided sufficient evidence to establish the nature of the transactions as reimbursements. The Hon'ble ITAT relied on precedents such as ***Neo Sports Broadcast (P.) Ltd (69 Taxmann.com 422)*** and ***Onward e-Services Ltd (22 Taxmann.com 60)***, which held that reimbursements not constituting income do not trigger TDS obligations. The Hon'ble ITAT ruled that the Assessee was under no statutory obligation to deduct TDS under Section 194A. The proceedings initiated under Sections 201(1) and 201(1A) were quashed.

7 ***Indian Education Society vs. CIT (E), Mumbai [ITA No. 2923/MUM/2024 dated 30.10.2024] [AY: 2016-17]***

Section 263 – Revisionary proceedings against the order u/s. 147 invoked – held to be barred by limitation as the issue raised in revisionary proceedings different from the re-assessment issue u/s. 147 – time limit to be ascertained from 143(1) order and not 147 order

Facts

The assessee, a charitable trust registered under Section 12A of the Income-tax Act, 1961, had as its primary objective the promotion and imparting of education. The assessee filed its return of income declaring a total income of NIL. Subsequently, the Ld. AO (AO) received information from the Investigation Wing alleging that the assessee had collected capitation fees, misrepresenting such collections as voluntary donations from benevolent donors, thereby claiming false exemptions under Section 10(23). Based on this information, the AO formed the belief that the assessee had received capitation fees or development funds in cash or kind, which were not disclosed in the return of income, resulting in escapement of income. Accordingly, the AO initiated reassessment

proceedings under Section 147. Upon examining the details and evidence submitted by the assessee, the AO concluded that the corpus donations received by the assessee should be treated as general donations to the trust. Consequently, the AO recomputed the exemptions available under Sections 11 and 12. Subsequently, the Commissioner of Income Tax (Exemptions) [CIT(E)] observed that the assessee, in Form 10 filed for Assessment Year (AY) 2016-17, had disclosed accumulations pertaining to AY 2015-16. It was noted that in the computation of income for AY 2016-17, the assessee claimed utilization of the accumulated amount, with the remaining balance being added back to its income. The CIT(E) formed a prima facie view that the reassessment order was erroneous and prejudicial to the interests of the Revenue u/s. 263. This appeal was filed against the revision order u/s. 263 by CIT(E).

Held

Before the Hon'ble ITAT, The AR argued on the jurisdictional issue of the order passed u/s. 263 being barred by limitation. He submitted that originally the return was processed u/s. 143(1) for which intimation was issued on 07.12.2017, accepting the returned income with no adjustments made therein. The Ld. AR contended that the reassessment proceedings u/s 147 were initiated based on the issue of alleged receipt of capitation fees/development fund. It was contended by the AR that the subject matter of revisionary proceedings u/s. 263 has not come to the notice of the ld. Ld. AO in the course of re-assessment proceedings u/s. 147 and there is no occasion for ld. CIT(E) to invoke revisionary proceedings for the reassessment order passed u/s. 147. It was held by the Hon'ble ITAT that, the issues dealt by AO in the re-assessment proceedings and the one dealt in the revisionary proceedings u/s. 263 by ld. CIT(E) are altogether un-related and different in their character. Ld. CIT(E) has sought to revise the re-assessment order on a subject matter which had not come to the notice of the AO in the re-assessment proceedings since the issue dealt by him as recorded in the reasons to believe was on a different footing. For the issue raised by the ld. CIT(E) to invoke revisionary proceedings u/s. 263, it had to necessarily relate to intimation passed u/s. 143(1) which falls beyond the bracket of two years prescribed u/s. 263. While holding that the revisionary order is barred by limitation the Hon'ble ITAT relied on the decision of the Apex Court in case of ***Alagendran Finance Ltd (293 ITR 11)***. Hon'ble Bombay High Court in the case of Lark Chemicals Ltd. Hon'ble Madras High Court in the case of ***Indira Industries (supra)*** Hon'ble Supreme Court in the case of ***Alagendran Finance Ltd. (supra)***.

"beleive in yourself and the world will be at your feet"

— *Swami Vivekananda*

INTERNATIONAL TAXATION
Case Law Update

Dr. CA Sunil Moti Lala
Advocate

A. HIGH COURT

1 ***PCIT vs. TT Steel Service India (P.) Ltd. - [2024] 168 taxmann.com 515 (Karnataka)***

The Hon'ble HC held that clause (i) of section 92BA having been omitted by Finance Act, 2017 with effect from 1-4-2017, the resultant effect is that it had never been passed and thus, reference made by AO to the TPO for specified domestic transaction mentioned in clause (i) of section 92BA was not valid.

2 ***Cadence Design Systems (India) vs. DCIT- [2024] 168 taxmann.com 122 (Delhi)***

The Hon'ble HC held that entities having high brand value (TCS E-Serve and Infosys BPO Ltd.) being able to command greater profits could not be selected as comparables.

B. TRIBUNAL

3 ***Attachmate Corporation. vs. ACIT- [2024] 168 taxmann.com 152 (Delhi – Trib.)***

Where assessee, a non-resident, had entered into International Distributor/Reseller Agreements with distributors in India for supplying software products and for providing ancillary support services and had received certain amounts from Indian distributors for providing software updates and patches, the Hon'ble Tribunal held that since no cogent material/evidence was produced to establish that the 'make available' condition stood satisfied, amount received by assessee for providing software updates and patches could not be treated as FIS under article 12(4)(b) of India-USA DTAA.

4 ***DCIT vs. Doosan Power Systems India (P.) Ltd. [2024] 168 taxmann.com 502 (Chennai – Trib.)***

Where assessee-company made payment of freight charges to a Korean company for availing logistics services in connection with

shipment of goods from various ports outside India to India, the Hon'ble Tribunal held that since said payments were mere simplicitor freight charges and not for any right to use equipment i.e. ship, the same could not be taxed as royalty u/s 9(1)(vi). Further, since the Korean company did not have any place of business/office in India through which business activities of assessee were carried on, there existed no business connection in India. Therefore, no income arose through business connection in India under section 9(1)(i). Further, as per the India-Korea tax-treaty, the business profits of a foreign company would not be taxable in India, if such company does not have a permanent establishment in India through which the business is carried on. Therefore, since the Korean company did not have any place of business/office in India through which business activities of the company were carried on, the profits arising from logistics services would be taxable only in the resident state i.e., Korea. Even on perusal of provisions of section 195, it attracts tax only on chargeable income, if any, paid to a non-resident. Since there was no tax liability, the question of tax deduction would not arise. Thus, the disallowance under section 40(a)(i) made by the AO was devoid of merits.

5 ***Bharti Airtel Ltd. vs. ACIT [2024] 168 taxmann.com 10 (Delhi – Trib.)***

a) **The assessee had paid agency fee to foreign banks without deduction of tax at source and the AO held the assessee liable u/s 201(1)/(1A). The Hon'ble Tribunal held that, since Indian branches of said banks had not played any role of facility agent, no part of agency fee could be attributed to Indian Branches, even if they were held as PE and consequently the assessee was not liable to deduct tax at source and could not be held to be assessee in default.**

b) **The Hon'ble Tribunal held that where assessee, Indian telecom service provider, made remittance towards bandwidth charges to foreign service providers, such bandwidth charges could not be treated as royalty either under treaty provisions or under section 9(1)(vi) [see Facts & Decision below].**

Facts – (b)

i. The assessee, a resident corporate entity providing mobile telecom services in India, remitted bandwidth charges to certain Foreign Telecom Service Providers, without deduction tax source.

ii. The AO observed that while remitting such amounts to the Foreign Telecom Services Providers, the assessee had failed to deduct tax at source. Therefore, a show-cause notice was issued to the assessee, as to why the tax and interest thereon under section 201(1)/201(1A) should not be levied. The AO held that the payments made were in the nature of royalty (liable for tax withholding @ 20%) as they were basically for the use or right to use of equipment or process. Consequently, he passed order u/s 201(1)/(1a).

iii. The CIT (A) held that the remittances towards bandwidth charges made to foreign telecom service providers could not be treated as royalty in cases where such foreign telecom service providers were located in countries with whom India had signed DTAAs. However, he held that the remittances could

be treated as royalty in cases where payments were made to foreign telecom service providers located in countries with whom India had not signed any agreement. Accordingly, he disposed of the issue by granting partial relief to the assessee.

iv. Appeal was filed to the Hon'ble Tribunal.

Decision - (b)

i. After having examined the relevant facts and nature of payments made, the Hon'ble Tribunal found that the issue stood conclusively decided in favour of the assessee by the decision of the Jurisdictional HC in case of ***CIT vs. Telstra Singapore Pte. Ltd. [2024] 165 taxmann.com 85 (Delhi).***

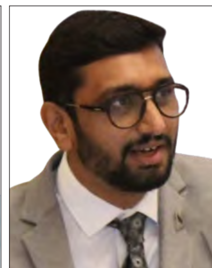
ii. It noted that the Jurisdictional HC had occasion to interpret the provisions contained under section 9(1)(vi) and, more specifically, what is meant by secret formula/process etc. as used in Explanations 2, 5 and 6 under section 9(1)(vi). After a detailed analysis, the Court finally came to the conclusion that bandwidth charges could not be treated as royalty for use or right to use of an equipment, secret formula or process.

iii. It further noted that the Court had held that the amendment made to domestic law, cannot automatically be imported to the treaty provisions without making corresponding changes in them.

iv. It further held that it was clearly discernible from the observations of the Jurisdictional HC; while interpreting the provisions of Explanations 2 and 6 to section 9(1)(vi), that availing of services provided by the telecom service providers had not accorded a right over the technology possessed or infrastructure used by it. The Court had further observed that the customer had not been provided a corresponding general or effective control over any intellectual property or equipment. The Court had also observed that the consideration that the service recipient paid also could not possibly be recognized as being intended to acquire a right in respect of a patent, invention, process or equipment.

v. The Hon'ble Tribunal finally concluded that, the ratio laid down by the Jurisdictional HC as noted above would not only apply to the payees located in treaty countries but also to payees located in non-treaty countries. Thus, in the ultimate analysis, it held that the bandwidth charges remitted by the assessee to the service providers could not be treated as royalty either under the treaty provisions or under section 9(1)(vi) and therefore, the assessee was not required to deduct tax at source on these remittances.

CA Rajiv Luthia


CA Keval Shah

INDIRECT TAXES
Service Tax

1 *M/s Integrated Global Solutions Pvt Ltd vs. Commissioner of Central Excise And Service Tax, Chandigarh-I 2024-TIOL-1096-CESTAT- Chandigarh*

Backgrounds and facts of the case

- The appellant is engaged in providing customer care services to M/s Spice Communications Limited under an agreement dated 01.07.2004. The appellant has paid the service tax on the entire consideration after claiming cenvat credit on the input services and filed the returns as per the provisions of the Finance Act, 1994.

- The Department entertained the view that the part of the said service rendered by the appellant would fall under Call Centre Service, which is exempt and thereby, issued show cause notice for restricting the Cenvat credit utilization up to 20% on the ground that the appellant was providing taxable as well as exempted services. The Adjudicating authority as well as the appellate authority confirmed the demand and dismissed the appeal of the appellants, hence the present appeal.

Arguments by Appellant Assessee

- The impugned order is not sustainable in law and the same has been passed without properly appreciating the facts and the law and the binding judicial precedents on the identical issue.

- The Ld. Commissioner has not considered the appellant's submissions that its customer services were not for the purpose of sales, telemarketing or payments and therefore, it cannot be described as call centre as defined under Notification No. 8/2003-ST dated 20.06.2003 w.e.f. 10.09.2004.

- The service under agreement dated 01.07.2004 with M/s Spice Communications Limited is taxable as a business auxiliary service and therefore, the appellant had correctly paid the service tax on the entire consideration received under said agreement and the provisions of Rule 6(3) of the Cenvat Credit Rules are not applicable in the present case.

- The provisions of the Finance Act, 1994 have been overlooked under which it is not obligatory to avail the benefit of exemption notification under law, service provider is free to claim the

benefit of notification or to pay service tax on the same.

- Further, it has been consistently held by the Tribunal that credit on inputs is not required to be reversed when duty has been paid wrongly on the final product.
- Appellant is providing customer care service under Business Auxiliary Services (BAS) by providing Call Support Service as per the scope of the service as stated in the agreement and further a portion of the service supplied cannot be dissected and considered as a separate call centre service.
- The Hon'ble CESTAT Hyderabad, in ***Phoenix IT Solutions Ltd vs. Commissioner of Central Ex Visakhapatnam. - 2011 TIOL 2045***, held that assessee providing call centre service on behalf of the client would fall under BAS within the purview of Service Tax.
- The Hon'ble Karnataka HC in ***CCE vs. Federal Mogul TPR India Ltd – 2015-TIOL.1805*** - held that service tax exemption to job-work activity/services is optional and not mandatory and therefore, job-worker may decide not to avail of exemption under Notification 8/2005-ST & pay service tax.
- The Hon'ble Supreme Court in ***CCE vs. Narayan Polyplast – 2004-TIOL.110*** wherein the assessee, instead of availing exemption available to final products under a particular notification, took credit of duty paid on inputs and paid duty on the final product utilizing the credit and the Revenue sought to deny credit based on Rule 57C of the Central Excise Rules stipulating that credit is not admissible of duty paid on inputs used in the manufacture of exempted product, the Supreme Court held that the credit availed and duty paid is identical and hence the issue is Revenue neutral and accordingly dismissed the appeal of the Revenue.
- Further, Cenvat Credit has wrongly been denied on management consultant's Service, Security Agency, and maintenance or Repair service which has been held to be an input service in the case of ***Adani Port and SEZ Ltd. vs. Commissioner of Service Tax, Ahmedabad- 2016 (42) S.T.R. 1010***.
- The entire demand is barred by limitation as the Department was fully aware of the activities of the appellant prior as far back as 16.11.2005, when the Department was conducted the audit of the appellant. As the demand itself becomes unsustainable so the question of interest and penalty does not arise.

Arguments by Department

- Ld. AR reiterated the findings of the impugned order.

Decision of the Hon'ble Tribunal

- The tribunal finds' that as per the terms of the agreement entered into by the appellant with M/s Spice Communications Limited, the appellant is supplying the customer care service under BAS by providing call support service.
- According to the Notification No. 8/2003-ST, Call Centre means a commercial concern which provides assistance, help or information through telephone on behalf of another person

whereas one of the activities covered by Business Auxiliary Service is provision of service on behalf of the client and service incidental to that service. When we look at the agreement between the companies in this case, role of call centre is to receive complaints, record the nature of the complaints, date and time of complaint. Call centre is required to help maintain a database of telephone numbers of Fuse off call centre/distribution section offices sub-division offices/division offices/circle offices etc. and the complaints are required to be referred to concerned persons. The software is required to help in monitoring of complaints till the same are resolved.

- Hon'ble CESTAT Hyderabad, in ***Phoenix IT Solutions Ltd vs. Commissioner of Central Excise Visakhapatnam - 2011 TIOL 2045*** dealt with classification of services provided by an Electricity Call Centre and whether these services should be considered under Business Auxiliary Service (BAS) or SSBC (Specialized Services Business Classification).

- Nature of Call Centre Services: The role of the Electricity Call Centre involves receiving and recording complaints, maintaining a database of contact information, and monitoring the resolution of complaints. However, it does not provide assistance, help, or information directly to customers as per the definition of "Call Centre" under Notification No. 8/2003-ST.

- Classification into Business Auxiliary Service (BAS): The services provided by the Call Centre, including complaint registration and monitoring, as well as the collection of payments and maintenance of accounts, align with activities defined under BAS in the Finance Act, 1994. These services are performed on behalf of the electricity company, such as customer care, payment collection, and account management, which fall under clauses (ii), (vi), and (vii) of BAS.

- Classification into SSBC: SSBC covers customer relationship management, accounting, and processing of transactions. However, since the Call Centre is directly interacting with customers on behalf of the electricity company, the services provided align more closely with BAS rather than SSBC.

- The services provided by the Electricity Call Centre, including complaint registration, monitoring, payment collection, and account management, are best classified under Business Auxiliary Service rather than SSBC, as the Call Centre acts on behalf of the electricity company in managing customer-related tasks.

- Hon’ble Karnataka HC in ***CCE vs. Federal Mogul TPR India Ltd – 2015-TIOL.1805*** dealt with the issue of whether service tax exemption is optional or mandatory. Section 5A(1A) of the Central Excise Act grants the power to exempt excisable goods from the duty of excise. It specifically states that when an exemption is granted absolutely, the manufacturer of the goods is not required to pay the excise duty on those goods. The phrase "shall not pay" in this provision indicates that it is mandatory for the manufacturer to avoid paying the duty on exempted

goods. However, this mandatory requirement is not present in Section 93 of the Service Tax Act, and Section 83 of the Finance Act, 1994, which applies certain provisions of the Central Excise Act to service tax, does not include Section 5A. Therefore, the exemption provisions under Section 5A of the Central Excise Act do not apply to the Finance Act, 1994.

- Department has failed to establish any of the ingredients which is required for invoking the extended period of limitation.
- When the facts are already known to the Department, it cannot be alleged that the appellant had suppressed or mis-declared any material facts with intention to wrongly avail the benefit of exemption from duty resulting in evasion of payment of duty.
- In view of our above discussion, we are of the considered view that the impugned order is not sustainable in law on merits as we as on limitation, therefore, we set aside the impugned order by allowing the appeal of the appellant with consequential relief, if any as per law.

2 *M/s Nissan Motors India Pvt Ltd vs. Commissioner of GST and Central Excise, Chennai 2024-TIOL-1093- CESTAT- MAD*

Backgrounds and facts of the case

- The Appellant has entered into 'Secondment Agreement' with M/s. Nissan Motor Company Ltd, Japan (Nissan, Japan) for obtaining employees to the appellant unit in India and the dispute arose over whether payments of salary to secondees in Indian currency will form part of ‘gross amount charged’ for arriving at the taxable value under section 67 of Finance Act, 1994.
- It appeared to department that the deputation of foreign expatriates by Nissan, Japan to appellant company would fall under import of service, of Manpower Recruitment or Supply Agency Service and the appellant is liable to pay service tax under Reverse Charge Mechanism. The Adjudicating authority confirmed the demand, interest and imposed penalties, hence the present appeal.

Arguments by Appellant Assessee

- Appellant had employed certain expatriates to whom part of salary, bonus and allowances were paid directly in India. In addition, certain reimbursements of social welfare cost incurred by Nissan, Japan were made. Service tax was discharged on such reimbursements made to Nissan, Japan.
- Since the impugned salary payments are made directly to the employees and never charged by Nissan, Japan, the ground for the levy (under Section 67 read with Rule 5 of Valuation Rules) of service tax fails and this fact has been undisputedly confirmed by the impugned OIO.
- The Hon’ble CESTAT Chennai in CCE v. Neyveli Lignite Corporation Limited held that to include the amount in the taxable value, the amount must be "charged" by the 'service provider' as consideration (or costs) towards taxable services.

- CBEC vide Circular No. 199/11/2023-GST clarified that GST is not applicable on the salary component in respect of internally generated services.

- The Hon'ble CESTAT Delhi in ***Boeing India Defence Pvt Ltd vs. Principal Commissioner of Central Tax, New Delhi*** held that perquisites such as reimbursable expenses paid to seconded employees are outside the ambit of Section 67 of the Finance Act, 1994 as there are not being a consideration paid for there is no quid pro quo for rendering any services.

- Payments made to the secondee, held to be taxable in the impugned order, is paid to the secondees in India by the appellant in Indian Currency, and is not charged by Nissan on the Appellant and hence does not represent 'consideration' for the service. Hence, the salary, bonus and allowances paid by the appellant to the secondee in India will not form a part of consideration and cannot be taken for the purpose of computing the value of the service.

Arguments by Department

- Expatriate employee provides service on contract basis to an associate company of the employer and therefore the activity of supplying employees to appellant unit would fall under Manpower Recruitment or Supply Agency so the appellant is liable to pay service tax under (RCM) under Section 66A and Section 68 of Finance Act, 1994, read with Place of Provision of Service Rules 2012.

- Referring definition of "Manpower Recruitment or Supply Agency's Service" the activity of deputing the technically qualified staff from one associate company to another associate company for a consideration would amount to providing Manpower Supply or Recruitment Agency Service. (MRSA).

- Emphasized that the classification of certain goods and the valuation methods applied by the appellant were incorrect and did not align with the tax laws. Service tax liability should have been discharged on the entire remuneration and not on that part of salary i.e. borne by Nissan Japan and reimbursed by the appellant.

- Deputation would not have taken place if the salary and other benefits are not paid/or not agreed to be paid in Indian currency to the employee who is working in India. This is an important condition of the contract. Thus, the second contract entered by appellant with employees is only offshoot of the secondment agreement and not a separate independent agreement.

- Suppressed the fact of paying part of the salary in INR and had discharged service tax only on the amount paid to Nissan, Japan, which was reimbursed. The short payment has come to light only on audit of accounts. Hence, the invocation of extended period and penalties imposed are legal and proper.

Decision of the Hon'ble Tribunal

- We observe that while the control, (over performance of the seconded employees' work) and the right to ask them to return, if their functioning is not as is desired, is with the assessee, the fact remains that their overseas employer in

relation to its business, deploys them to the assessee, on secondment. Secondly, the overseas employer - for whatever reason, pays them their salaries. Their terms of employment - even during the secondment - are in accord with the policy of the overseas company, who is their employer. Upon the end of the period of secondment, they return to their original places, to await deployment or extension of secondment.

- The appellant reimburses to Nissan, Japan only part of the salary which is borne by Nissan Japan. In other words, part of the salary is paid by the foreign company, viz. Nissan Japan and part of the salary is paid directly in Indian rupees to the employee by the appellant. This is mainly because; the social security contribution of Japan is shouldered by Nissan Japan. The remaining salary and perquisites are borne by appellant and paid directly to employee. This part of the salary is not charged on Nissan Japan. As per the secondment agreement the seconded employee continues to be an employee of Nissan Japan during period of secondment agreement. Therefore, the activity definitely falls under Manpower Recruitment. or Supply Agency Services.

- When Nissan makes a proposal for deputation of secondees to the Appellant for a certain consideration, which when accepted by the Appellant becomes a promise. Then Nissan is the promisor and the Appellant the promisee. The promise forming the consideration is an agreement. Hence when at the desire of Nissan, the Appellant has agreed to pay the consideration as an amount in money to the secondee. This is further split as per the desire of Nissan, and paid to the secondee directly and also indirectly through Nissan (amount paid by Nisan Japan to the secondee is reimbursed to Nissan by the Appellant). Such an act involving the payment by the Appellant of the gross amount of the contract for supply of manpower by Nissan, as salary, bonus and allowances to the secondee, is the consideration for the promise made in the Agreement. In other words, the amount paid by the Appellant to the overseas manpower supply service provider i.e. Nissan is the gross amount charged by them as consideration for the services and is equivalent to the salaries, bonus and allowances of the seconded employees. The mode of this payment is by the Appellant disbursing the monies to the secondee as per the instructions of Nissan.

- A look at the secondee Agreement shows that the appellant company has accepted the promise of Nissan for services of skilled employees on payment of the gross amount charged by Nissan as per certain conditions including a split formula to be decided by Nissan, for payment of salary. It is clear from the agreement that Nissan dictates the terms of employment, of the deputed employees to the appellant. The appellant has no discretion to vary the terms of employing the deputed employees. Hence by full filling the conditions of the Agreement and making payment/debiting the books of account to pay the secondee his full salary, bonus and allowances as per the gross amount 'charged' by the overseas supplier i.e. Nissan, service tax gets attracted.

- The principle of equivalence is in-built into the concept of service tax and the different colour or name of the currency or the formula/route adopted for making/ paying the agreed consideration to the overseas service provider, cannot change its nature and substance. Hence the appellant's plea does not succeed.

- As regards the question of revenue neutrality is concerned, the assessee principal contention was that assuming it is liable, on reverse charge basis, nevertheless, it would be entitled to refund; it is noticeable that the two orders relied on by it (in SRF and Coca Cola) by this Court, merely affirmed the rulings of the CESTAT, without any independent reasoning. Their precedential value is of a limited nature. This Court has been, in the present case, called upon to adjudicate about the nature of the transaction, and whether the incidence of service tax arises by virtue of provision of secondment services. That a particular rate of tax - or no tax, is payable, or that if and when liability arises, the assessee, can through a certain existing arrangement, claim the whole or part of the' duty as refund, is an irrelevant detail. The incidence of taxation, is entirely removed from whether, when and to what extent, Parliament chooses to recover the amount.

- The decisions of the Hon'ble Apex Court, according to us, clearly hold that the definition of manpower recruitment or supply agency is wide enough to include 'recruitment as well as supply' of manpower. The expression supply is of a wider connotation than recruitment. We are therefore of the view that the ratio of the above rulings squarely applies to this case and thus, there is no escape for the appellant before us from Service Tax liability in respect of manpower recruitment or supply agency service under reverse charge mechanism.

- As such, we hold that the appellant is required to pay applicable Service Tax for the normal period along with interest. However, we agree with the contention of the appellant there is no suppression of facts involved and that being the case, the penalties imposed are set aside.

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

— *Swami Vivekananda*

CS Makarand Joshi

CORPORATE LAWS
Case Law Update

CASE – 1

SECURITIES AND EXCHANGE BOARD OF INDIA'S ADJUDICATION ORDER IN THE MATTER OF ROYAL ORCHID HOTELS LIMITED DATED 11 OCTOBER 2024

Facts of The Order

- ROHL is a public company engaged in operating hotels and providing other allied services. Ksheer Sagar Developers Private Limited (KSDPL) is jointly owned by Royal Orchid Hotel Limited (ROHL) and Tambi Group, each holding a 50 percent stake.

- On 4th March, 2022, ROHL informed the stock exchanges that KSDPL was no longer its subsidiary. According to the ROHL, this declaration was made because its nominee directors no longer made up for the majority of KSDPL's board.

- Under the Memorandum of Understanding ('MOU') dated 18th April 2007, KSDPL would have five directors, three nominated by ROHL and two by Tambi Group. On 2nd March ,2022, two independent directors were nominated, making the total directors to seven. With this, ROHL no longer could constitute the majority of the Board of KSDPL (three out of seven).

- Therefore, when it published its financials on 30th May, 2022, it excluded the financials of KSDPL as a subsidiary. SEBI received a complaint against ROHL wherein it was *inter alia* alleged that ROHL, despite having control over KSDPL, did not include KSDPL as a subsidiary company in its consolidated financial statements for the financial year 2021-22, and by doing so, ROHL had overstated/inflated its profit for the said FY.

- SEBI conducted an investigation to ascertain whether ROHL had misrepresented/misstated its consolidated financial statements while accounting for one of its subsidiary companies ('**KSDPL**') for FY 2021-22 and whether the said misrepresentation/ misstatement, if any, was in violation of the provisions of Securities and Exchange Board of India Act, 1992 (**SEBI Act**), SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015 (**LODR Regulations**), SEBI (Prohibition of Fraudulent and Unfair Trade Practices Relating to Securities Market) Regulations, 2003 (**PFUTP Regulations**).

- Pursuant to the investigation, it was *prima facie* found that ROHL

had wrongly classified KSDPL as an associate company instead of a subsidiary and published financial statements for FY 2021-22, thereby showing an overstated/inflated consolidated profit of INR 26.78 crore instead of INR 3.63 crore. Further, influenced by the overstated profit of ROHL, the scrip price surged and the promoter group entities, viz. Chander Kamal Baljee and Keshav Baljee, offloaded their holdings and made a total gain of INR 20.83 crore.

Based on the findings of the investigation, SEBI passed an interim order cum show cause notice dated March 31, 2023 (**SCN**) and issued directions stated at end therein against ROHL and its promoter/directors viz., Chander Kamal Baljee, Keshav Baljee and Amit Jaiswal.

Charges Levied

The Show Cause Notice (SCN) alleged that CK Baljee, Keshav Baljee and Mr Amit Jaiswal have violated Regulations 3(b), 3(c), 3(d), 4(1), 4(2)(e), 4(2)(f), 4(2)(k), 4(2)(r) of SEBI (PFUTP) Regulations, 2003, Section 12A(a), (b), (c) of SEBI Act, 1992 and Regulations 4(2)(f)(i)(2), 4(2)(f)(ii)(2),4(2)(f)(ii)(6), 4(2)(f)(ii)(7), 4(2)(f)(iii)(7) and 17(8) of the SEBI(LODR) Regulations 2015 r/w Section 27 of SEBI Act, 1992 and Regulations 4(1), 33(1)(a), 33(1)(c), 33(3)(b), 34(2)(b), 34(3) and 48 of SEBI (LODR) Regulations, 2015.

Contentions by the Noticee

- **KSDPL cannot be defined as a subsidiary as defined u/s 2(87) of the Companies Act 2013 [‘the Act’]:** Noticees have relied on the observations of the Hon’ble SAT in the case of ***DLF Ltd. & Ors. vs. SEBI*** *(decided on 13 March, 2015)*. The Hon’able SAT in the case of DLF held that the composition of the board of directors of a company shall be deemed to be controlled by another company only if that other company exercises power at its sole discretion to appoint or remove the Directors of the other company. Noticees have stated that ROHL does not have “sole discretion” to appoint or remove directors of KSDPL. **KSDPL can be treated as a subsidiary of ROHL only by virtue of the majority of board membership** of KDSPL (3-ROHL and 2-Tambi group) and that with the appointment of two independent directors on the Board of Directors of KSDPL, ROHL **ceased to have majority representation on the Board of Directors of KSDPL.** Reliance was placed in the matters of *G.L. Sultania (supra) and Vodafone India Limited (supra)* and it was submitted that a company which holds only 50% shareholding of another company cannot be its subsidiary.
- With respect to the allegation of control over the composition of the board of directors, the Noticees have submitted that as per the Articles of Association of KSDPL [‘AOA’], it is not necessary for the chairman of the company to also act as chairman of the meeting of the shareholders and AOA contemplates that the directors may elect one of amongst them to be the chairman of the meeting. Further, the Noticees have relied on the judgements in the matters of *Oriental Industrial Investment Corporation Limited (supra), M. Velayudhan (supra), Manmohan Sharma (supra) and DLF Limited (supra)* and submitted that only if the AOA gives absolute power to appoint or remove the majority of

directors, holding-subsidiary relationship can be established.

- Noticees further contended that the '**casting vote power**' which is exercisable by the chairman of the meeting **is only a tie-breaker exercisable only in extraordinary events of equality of votes.** The Noticees have also submitted that even if clause 63 [viz. *In the case of an equality of votes, whether on a show of hands or on a poll, the Chairman of the meeting at which the show of hands takes place or at which a poll is demanded, shall be entitled to a second or casting vote'] was* absent from AOA of KSDPL, the chairman of the meeting would have had a casting vote as mandated by secretarial standards and Section 118(10) of the Act. Reliance was placed on the judgements in the matters of *Arcelormittal India Private Limited (supra), Subhkam Ventures (I) Private Limited (supra) and Vishwapradhan Commercial Private Limited (supra)* and submitted that casting vote is a reactive power only to break a deadlock and cannot amount to "control".

- The decision to classify KSDPL as an associate company was taken **based on professional consultation and submitted the opinion** provided by a firm of Chartered Accountants - S. Ramanand Aiyar & Co. and a Practicing company secretary - G. Shankar Prasad.

- The SCN alleged that as per the MoU executed between ROHL and the Tambi group, the rights/control relating to operations, management, supervising, service and directions etc. of the hotel were with ROHL. The "relevant" activities highlighted by SEBI were not right or power but operational authority that an Operator of a Hotel must have to run a hotel effectively and the same does not tantamount to control.

Submissions by SEBI Adjudication Officer

- SEBI stated that the order of Hon'able SAT in the matter of DLF referred **to the definition of 'subsidiary' in the Companies Act, 1956. The definition in question in this Order is under the Companies Act, 2013**, the provisions of which do not use the expression "sole discretion". The allegation made in the Interim Order cum SCN points out to the ability possessed by ROHL to decide the composition of the board of KSDPL. The said order refers to the MoU and the AoA of KSDPL which, when read together, states that the Chairman of KSDPL would be appointed by ROHL and that the Chairman would have a casting vote in the event when there is a tie in voting results. Given the 50-50 shareholding structure in KSDPL, every conflict in deciding the appointment of a director is bound to be decided in favour of one of the shareholder groups i.e. ROHL, since the Chairman is appointed by it and in the specific facts of this case, the Chairman was in fact a CFO i.e. an employee of ROHL. Therefore, the findings of **the Hon'ble SAT in the DLF case, referred to by the Noticees, were in the context of a different set of facts and circumstances and do not aid the defence put forth by the Noticees.**

- The determination of the Holding-subsidiary relationship is based on the definition provided under section 2(87) (ii) of the Companies Act, 2013 as well as based on Ind AS 110 and is not dependent on the number of

independent directors or whether they are in fact independent.

- Ind AS 110 defines a “subsidiary” as an entity that is controlled by another entity known as the parent and also provides that an investor controls an investee if and only if the investor has all the following.

  I Power over the investee and current ability to direct the relevant activities i.e. the activities that significantly affect the investee’s returns;

  II. Exposure, or rights, to variable returns from its involvement with the investee; and

  III. The ability to use its power over the investee to affect the amount of the investor’s returns.

  As per Ind AS 110 As per the MoU executed between ROHL and the Tambi group, the rights/control relating to operations, management, supervising, service and directions etc. of the hotel are with ROHL. Further, as per ROHL’s letter dated 28 January, 2023, ROHL has admitted that it was able to direct relevant activities viz. selling and purchasing of goods or services, managing financial assets during their life, selecting acquiring or disposing of assets and determining a funding structure or obtaining funding in accordance with Ind AS 110 in respect of KSDPL. Mr. Amit Jaiswal, Chairman of KSDPL and CFO of ROHL, in his statement recorded before SEBI on 23rd February, 2023 has *inter alia* stated that all the operations of KSDPL were taken care of by ROHL and the key persons who head the operations are also employees of ROHL.

- ROHL **controls the composition of the Board of KSDPL** through the casting vote of the Chairman of the General Meeting of Shareholders, who is the nominee of ROHL. Therefore, the aforesaid contention of the Noticees and the said judgements relied on by the Noticees do not address the specific allegation

- Clause 16 of the MoU states that the Board of Directors (of KSDPL) will have a Chairman from ROHL. Clause 59 of the AoA states that the Chairman of the Board of KSDPL shall preside as the Chairman at every General Meeting of the Company (KSDPL). Additionally, Clause 63 of AoA states that the Chairman of the Meeting shall be entitled to a second or casting vote in case of equality of votes. From a conjoint reading of the aforesaid clauses, it is observed that the nominee of ROHL would be the default Chairman of the General Meeting of the Shareholders and he/the Chairman would be entitled to a casting vote in case of tie. Although Clause 60 of the AoA provides that directors can elect one of them as the Chairman of the Meeting, as contended by the Noticees, it can be noted that the same is only an exceptional case if the Chairman of the Board was not available. The MoU makes it clear that the Chairman of the Board would be from ROHL. Therefore, the casting vote of the Chairman of the General Meeting of Shareholders of KSDPL was essentially a discretion vested in ROHL.

- Any Chairman would have a casting vote to break a deadlock. However, ROHL and Tambi group had a shareholding in the ratio of 50:50 in KSDPL. In the event of conflict,

there would invariably be deadlock in decision making. But because the casting vote vested with the Chairman who in turn was appointed by ROHL (as per the MoU), and therefore assumed to be acting on the instruction of or in favour of ROHL as a shareholder of KSDPL, every decision requiring an Ordinary Resolution would invariably go in favour of ROHL. Therefore, effectively, ROHL had control over the outcome of any ordinary resolution in a General Meeting of Shareholders of KSDPL and particularly in the context of the appointment or removal of directors on the board of KSDPL.

- The opinions specifically obtained from the professionals mentioned that they were rendered on the basis of the facts presented to them. These opinions do not take into account the aspect of casting vote providing the right to remove a director. The Professionals have examined the issue only from the perspective of the actual composition of the Board of KSDPL and have not ventured into whether ROHL or any other company was in a position to control the composition of the said Board. These facts do not appear to have been placed before the aforesaid Chartered Accountant and Practising Company Secretary. Hence, relying on these opinions, which have taken into account incomplete facts, would be inappropriate.

- As per the MoU executed between ROHL and the Tambi group, the rights/control relating to operations, management, supervising, service and directions etc. of the hotel are with ROHL. Further, as per ROHL's letter dated 28 January, 2023, ROHL has admitted that it was able to direct relevant activities viz. selling and purchasing of goods or services, managing financial assets during their life, selecting acquiring or disposing of assets and determining a funding structure or obtaining funding in accordance with Ind AS 110 in respect of KSDPL. Mr. Amit Jaiswal, Chairman of KSDPL and CFO of ROHL, in his statement recorded before SEBI on 23rd February, 2023 has *inter alia* stated that all the operations of KSDPL were taken care of by ROHL and the key persons who head the operations are also employees of ROHL.

Order

- ROHL satisfies two out of the four factors necessary to determine whether it is the decision maker or the agent. The first two factors i.e., scope of decision-making authority and rights held by other parties carry a significant weightage out of the 4 factors and therefore, ROHL is the decision-maker and that it has the ability to use its power to affect the returns of KSDPL.

- Since ROHL satisfies all the three conditions provided under Ind AS 110 KSDPL is a subsidiary of ROHL, as per the Indian Accounting Standards and therefore in accordance with the mandate of regulation 4(1) of LODR Regulations, ROHL should have consolidated financial statements including there in KSDPL as a subsidiary.

- For failing to ensure the integrity of the listed entity's accounting and financial reporting systems, Noticees 2 and 3, being directors on the Board of ROHL, have also violated regulations

4(2)(f)(i)(2), 4(2)(f)(ii)(2), 4(2)(f)(ii)(6), 4(2)(f)(ii)(7) and 4(2)(f)(iii)(7) of the LODR Regulations.

- As per Regulation 17(8) of LODR Regulations, the CEO and CFO shall provide the compliance certificate to the board of directors as specified in Part B of Schedule II, which states that the company's annual accounts that financial statements present a true and fair view of the company's affairs in compliance with existing accounting standards, applicable laws and regulations.

- Chander Kumar Baljee (Noticee no. 2) was the Chairman and Managing Director of ROHL and Amit Jaiswal (Noticee no. 4) was the Chief Financial Officer of ROHL during the investigation period. These Noticees certified, as CEO and CFO, the company's annual accounts for the financial year 2021-22 stating that the financial statements present a true and fair view and are in compliance with the existing accounting standards, applicable laws and regulations. Therefore, Noticee nos. 2 and 4 are in violation of regulation 17(8) of LODR Regulations for providing a false compliance certificate.

- Noticee no. 2 was a Promoter and the Chairman and Managing Director of ROHL during the investigation period. Keshav Balji (Noticee no. 3) was a Promoter Non-Executive Non-independent director on the Board of ROHL during the investigation period. Noticee nos. 2 and 3, by virtue of their positions on the Board of ROHL as CMD and Director respectively, were in-charge of operations and the decision-making process. Noticee no. 4 was the CFO of ROHL and the Chairman of KSDPL with the casting vote during the investigation period.

- Therefore, Noticee nos. 2, 3 and 4 are vicariously liable for the misrepresentation of the consolidated financial statements of ROHL for FY 2021-22. Thus, I find that Noticee nos. 2, 3 & 4 have violated Section 12A(c) of the SEBI Act, Regulations 3(d), 4(1), 4(2)(e), 42(f), 4(2)(k) and 4(2)(r) of PFUTP Regulations and Regulations 4(1), 33(1)(a), 33(1)(c), 33(3)(b), 34(2)(b), 34(3) and 48 of LODR Regulations read with section 27 of the SEBI Act.

CASE – 2

In the matter of BMW India Financial Services Private Limited vs M/s Koyenco Autos Private Limited, NCLT Kochi bench, order dated 22nd June 2023.

Facts of the case

- In this case, BMW India Financial Services Private Limited is the 'Financial Creditor' and Koyenco Autos Private Limited is the 'Corporate Debtor/'Company'. Vibin Vincent (hereinafter referred to as Applicant/ Petitioner), is the liquidator of the Corporate Debtor.

- P.P. Ashique ('hereinafter called as R1/First respondent') and Shameena Ashique ('hereinafter called as R2/ Second respondent') ['Respondents'], are the directors of the Corporate Debtor. The Corporate Debtor has 84% shareholding in a company called Platino Classic Motors Private Limited (hereinafter called as R3), wherein directors of the Corporate Debtor (R1 & R2) are shareholder directors.

- The Corporate Debtor went into CIRP in October 2021 and the Applicant herein was appointed as Resolution Professional ('RP'). Thereafter, in November 2022, the Company went into liquidation. After examining the books of accounts of the Company, the Applicant noticed some discrepancies and therefore, it was decided to conduct a forensic audit of the Company. Based on the findings of the forensic audit report, the Applicant has filed the present petition against the directors of the Corporate Debtor. The present application is filed by Vibin Vincent, the liquidator of the Corporate Debtor against R1 and R2, the directors of the Corporate Debtor under section 66 of Insolvency and Bankruptcy Code 2016 ('IBC') for seeking direction from Hon'able NCLT Kochi to direct R1 and R2 to repay that amount to the company which was allegedly fraudulently siphoned by them.

Petitioner's contentions

- As on 06th October 2021, ₹ 34,17,335/- is shown as interest-free loan outstanding from R2. This loan is in violation of sub-section (1) of section 185 of the Companies act 2013 ['the Act']. Further, there is no board resolution authorizing the grant of such a loan.

- An amount of ₹ 3.69 crore has been taken as a loan from IDBI Bank for business purposes by R1, R2 and Corporate Debtor as co-borrowers providing the company's 29500 sq. ft commercial property as security and the amount was released to R1's account by the IDBI bank. Since the loan amount was credited to R1's bank account and the Company's asset was provided as security, this transaction was also in violation of section 185 of the Act.

- The Corporate Debtor invested in the shares of R3 by purchasing the equity shares from R1 and R2. However, R3 was a loss-making company and went into winding up. The Corporate Debtor did not conduct any enterprise valuation before purchasing the said shares. Also, no share transfer documents were presented by R1 and R2 in support of said transfer. The consideration for the shares transferred by R1 and R2 was adjusted against the loan amount given to R1 and R2. Therefore, it appears that the said share transfer was undertaken in order to defraud the creditors of the Corporate Debtor.

- An amount of ₹ 3,60,000/- which was rent amount receivable from Autostarke Private Limited by the Corporate Debtor on 2nd November 2021 and 1st December 2021 was transferred directly to R1's personal bank account instead of the Corporate Debtor account. The amount due pertains to the CIRP period and R1 is not legally bound to collect the same and is alleged as an intentional diversion of funds.

Respondent's contentions

- The Applicant has not placed any material on record to prove any intent of fraud or a fraudulent purpose." Reference was made to the judgement of Hon'ble Supreme Court in ***Anuj Jain vs. Axis Bank Limited & Ors.*** to substantiate the contention that without the element of fraud or dishonest intention to defraud creditors or a fraudulent purpose, the case would not stand under surmise of section 66 of IBC. Bad commercial decisions cannot

be considered as wrongful or fraudulent under section 66 of the IBC.

- It was further contended that to restart the operation of the Corporate Debtor, a loan from IDBI bank was taken by the Company on 30th July 2016 and the amount was disbursed to the account of the Corporate Debtor as seen in the bank statement of the Company. It was from this that an amount of 4.5 crore was transferred to R1 account on 11th August 2016 and the said amount was invested in R3 on 16th August 2015.

- The R3 was earlier making profits but went into losses in 2017-18. The Corporate Debtor was also looking for new dealerships in automobile and it is in this interest that the Corporate Debtor decided to invest in R3 for restarting the operations of the Company.

- Board resolutions passed by the Corporate Debtor and return of allotment in Form PAS-3 filed by R3 is submitted by Respondents evidencing the share transfer. It is stated that the said transfer was intimated to the Financial Creditor herein and hence it was argued that there was no fraudulent intention on the part of respondents.

- With regard to the diversion of rent amount to the personal account of R1, it was stated that the said amount was transferred to carry out repair work, tax payments and to meet out expenses of the Corporate Debtor as the account of the Company was not able to be operated. The transaction receipts were also submitted by the Respondent's. It was further submitted that a mere violation of section 185 of the Act does not mean there is a fraudulent intention on the part of respondents.

Held

- After ordering the CIRP, there is no need for the First respondent to carry out any repair work and make any payment to the public authorities as it is against the provision of the IBC 2016. The moment CIRP is ordered the property of the Corporate Debtor vests with the RP. If any payment is post this by the suspended Board of Directors of Corporate Debtor to any of the creditors it is void ab initio. In this situation the amount credited into the personal account of the First respondent (viz. ₹ 3,60,000/-) had to be credited to the accounts of the Applicant.

- Section 66 of IBC 2016 defines that if the business is carried on with intent to defraud creditors or for any fraudulent purpose it comes under section 66 of IBC 2016. The fraud is defined under to section 447 of the Act. It states as follows: "*Explanation. -- For the purposes of this section-- (i) 'fraud", in relation to affairs of a company or anybody corporate, includes any act, omission, concealment of any fact or abuse of position committed by any person or any other person with the connivance in any manner, with intent to deceive, to gain undue advantage from, or to injure the interests of, the company or its shareholders or its creditors or any other person, whether or not there is any wrongful gain or wrongful loss; (ii) "wrongful gain" means the gain by unlawful means of property to which the person gaining is not legally entitled; (iii) "wrongful loss" means the loss by unlawful means of property to which the person losing is legally entitled.*

- In our case the First and Second respondents, knowing that they are

forbidden under section 185 of the Act to avail the loan from the Corporate Debtor, and to create a charge over the property of the Corporate Debtor for the loan availed by the R1, carried out these acts by abusing their position as directors of the Corporate Debtor with intent to gain undue advantage and cause injuries to the interest of the Corporate Debtor.

- In this case, the Respondents availed the loan from the Bank in the name of Corporate Debtor and transferred the amount into their personal accounts. Similarly, the loan availed from the Bank in the name of the Corporate Debtor and the amount paid towards the joint venture agreement to the Corporate Debtor were utilized by the First and Second respondents as consideration towards the share transfer. These factors show that the Respondents utilized the name of the Corporate Debtor to avail loans from the Bank and instead of using the loan amounts to the business of the Corporate Debtor, took the amount to themselves.

- In this case, the Respondents acted in violation of section 185 of the Act, by abusing their position as directors, with intent to gain undue advantage and injury to the company. This act is specially declared by the Companies Act 2013 as 'fraud'. Thus, the acts of the First and Second respondents come under the purview of fraud, in consequence it proves that the First and Second respondents indulged in fraudulent transactions as provided under section 66 of IBC.

- As Respondents indulged in fraudulent transactions with an intention to gain unlawfully and cause injury to the interest of Corporate Debtor they are held liable for their acts. In these circumstances, Respondents are liable to pay the amount as claimed in this application.

- In the result:

(i) The First and Second respondents are directed to pay jointly and severally a sum of ₹ 9,59,60,000/- to the Applicant within one month from today, failing which the amount ₹ 9,59,60,000/- will carry 12% interest per annum from the date of this order to till the date of realization,

(ii) The First respondent is directed to pay a sum of ₹ 4,06,54,4351- to the Applicant within one month from today, failing which the amount ₹ 4,06,5 4,435/will carry 12% interest per annum from the date of this order to till the date of realization of amount. and

(iii) The Second respondent is directed to pay a sum of ₹ 34,17,355/-to the Applicant within one month from today, failing which the amount ₹ 34,17,335/will carry 12% interest per annum from the date of this order to till the date of realization of amount.

OTHER LAWS

FEMA – Updates and Analysis

CA Hardik Mehta CA Tanvi Vora

In this article, we have discussed recent amendments made in FEMA through Notifications, Circulars and Press Notes & Press Releases.

A. Update through A.P. (DIR Series) Circulars

1. Operational framework for reclassification of Foreign Portfolio Investment to Foreign Direct Investment

Schedule II of the Foreign Exchange Management (Non-debt Instruments) Rules, 2019 (the Rules) notified on 17 October 2019 prescribes that investment made by Foreign Portfolio Investors (FPI) along with its investor group shall be less than 10 per cent of the total paid-up equity capital on a fully diluted basis. FPI investing in breach of this limit shall have the option of divesting the holdings or reclassifying such holdings as Foreign Direct Investment (FDI) subject to the conditions specified by the RBI and the Securities and Exchange Board of India (SEBI), within 5 trading days from the date of settlement of the trades causing the breach.

The RBI has provided an operational framework for reclassification of Foreign Portfolio Investment by FPI to FDI in case of breach of investment limit. The FPI shall follow the below operational framework if it intends to reclassify its foreign portfolio investment into FDI.

However, the reclassification shall not be permitted in any sector prohibited for FDI. Also, the foreign portfolio investor along with its investor group shall be treated as a single person for the purpose of the reclassification.

Step 1: Obtain following approvals/concurrence before intending to acquire equity instruments beyond the prescribed limit:

i) Applicable Government approvals, including approvals required in case of investment from land bordering countries

ii) Concurrence of the Indian investee company for reclassification of the investment to FDI to enable such company to ensure compliance with conditions pertaining to sectors prohibited for FDI, sectoral caps and government approvals under the Rules.

The FPI should also ensure that the acquisition beyond prescribed limit is made in accordance with the provisions applicable for FDI i.e. the investment is in adherence to entry route, sectoral caps, investment limits, pricing guidelines, and other attendant

conditions for FDI under Schedule I to the Rules.

Also, if the necessary prior approvals/ concurrence have not been obtained by the FPI, the investment beyond prescribed limit shall be compulsorily divested.

Step 2: Articulate the intent to reclassify existing foreign portfolio investment into FDI and provide copy of necessary approvals and concurrence to its Custodian pursuant to which the Custodian shall freeze the purchase transactions by such FPI in equity instruments of such Indian company till completion of the reclassification.

Step 3: The entire investment held by the FPI shall be reported within the timelines as specified under the Foreign Exchange Management (Mode of Payment and Reporting of Non-Debt Instruments) Regulations, 2019 as follows:

i) By the Indian company in Form FC-GPR where the investment beyond the prescribed limit is resulting from fresh issuance of equity instruments by an Indian company to such FPI

ii) By the FPI in Form FC-TRS, where the investment beyond the prescribed limit is due to acquisition of equity instruments by such FPI in the secondary market

iii) AD bank concerned shall report the amount of reclassified foreign portfolio investment as divestment under the LEC (FII) reporting.

Step 4: FPI shall approach its Custodian with a request for transferring the equity instruments of the Indian company from its demat account maintained for holding foreign portfolio investments to the account maintained for holding FDI.

After ensuring that the reporting for reclassification is complete in all aspects, the custodian shall unfreeze the equity instruments and process the request.

Step 5: In terms of the provisions contained in Schedule II to the Rules, the reclassification or divestment of the holdings, as the case may be, shall be completed within the prescribed time.

Important aspects post reclassification

— Post reclassification of foreign portfolio investment to FDI, the said investment shall be governed by Schedule I to the Rules.

— The date of investment causing breach in such cases shall be considered as the date of reclassification.

— Thereafter, the entire investment of the FPI in the Indian company shall be considered as FDI and shall continue to be treated as FDI even if the investment falls to a level below ten percent subsequently.

A.P. (DIR Series) Circular No.19 dated November 11, 2024

(Comments: While the Rules prescribe divestment by the FPI on breach of the prescribed limit (otherwise the investments would be reclassified as FDI), there were no guidelines issued regarding the method of reclassification. The circular provides clarity regarding this reclassification process. This step of the RBI will be well received by the FPI community as it gives them the flexibility as well as the precise action points and timeline to tackle breach of investment limits prescribed. Also, prescribing a framework for way forward after breach of limit prevents panic and

misinterpretation among FPI – they have the option to convert the investment to FDI and will not be forced to divest.

Also, SEBI[1] has recognised the reclassification of Foreign Portfolio Investments to FDI in compliance with foreign exchange rules and circulars.)

B. Other Circulars

1. 'Fully Accessible Route' for Investment by Non-residents in Government Securities – Inclusion of Sovereign Green Bonds

Vide A.P. (DIR Series) Circular No. 25 dated March 30, 2020, RBI in consultation with the Government of India had introduced a scheme for a separate route viz., Fully Accessible Route (FAR) for investment by non-residents in Government securities. Vide this circular certain specified categories of Central Government securities were opened fully for non-resident investors without any restrictions, apart from being available to domestic investors as well.

The Government Securities that are eligible for investment under the FAR have been notified over the years by RBI vide the following circulars besides the above mentioned circular:

a) FMRD.FMID.No.04/14.01.006/2022-23 dated July 07, 2022;

b) FMRD.FMID.No.07/14.01.006/2022-23 dated January 23, 2023;

c) FMRD.FMID.No.04/14.01.006/2023-24 dated November 08, 2023; and

d) FMRD.FMID.No.03/14.01.006/2024-25 dated July 29, 2024.

In order to enable institutional and retail investors to plan their investments efficiently and to provide transparency and stability to the Government Securities Market, the RBI in consultation with the Government of India, notified the indicative calendar for issuance of Government dated securities, including Sovereign Green Bonds (SGrB) in the second half of fiscal year 2024-25, vide Press Release issued by the RBI on 'Issuance Calendar for Marketable Dated Securities for October 2024 - March 2025' dated September 26, 2024. It has now been decided to also designate Sovereign Green Bonds of 10-year tenor issued by the Government in the second half of the fiscal year 2024-25 as 'specified securities' under the FAR.

FMRD.FMD.No.06/14.01.006/2024-25 dated November 7, 2024

(Comments: This move by RBI would open more avenues for Non residents to invest in India apart from existing equity and debt markets. It would also bring more long - term foreign investments in India and would support the Indian currency.)

1. Circular No.SEBI/HO/AFD/AFD-POD-3/P/CIR/2024/152 dated November 11, 2024 read with Master Circular for Foreign Portfolio Investors, Designated Depository Participants and Eligible Foreign Investors" No. SEBI/HO/AFD/AFD-PoD-2/P/CIR/P/2024/70 dated May 30, 2024

Rahul Hakani
Advocate

Niyati Mankad
Advocate

Best of The Rest

M/S AJAY PROTECH PVT. LTD. VS. GENERAL MANAGER & ANR. – JUDGMENT DT 22/11/2024 [2024 INSC 889] [SUPREME COURT]

Section 29A(4) of the Arbitration and Conciliation Act, 1996 ("Act, 1996")- An application for extending an arbitral tribunal's mandate, can be filed post-expiry of statutory deadlines if "sufficient cause" is established - The Court's discretion ensures that procedural rigidity does not hinder arbitration's goal of effective dispute resolution

Facts

The Appellant, M/S Ajay Protech Pvt. Ltd., entered into a works contract with the Respondent. Disputes led to the initiation of arbitration proceedings, with a sole arbitrator appointed by the High Court in 2019. Pleadings were completed by October 2019, commencing the statutory timeline for the arbitral award u/s 29A of the Act, 1996. Extensions agreed by the parties and the COVID-19-related Supreme Court orders (excluding certain periods for limitation) pushed deadlines. Despite this, the Appellant filed for an extension of the Arbitral Tribunal's mandate in August 2023, after its statutory termination, leading to the High Court dismissing the application citing excessive delay.

Issues Involved

1. Whether an application under Section 29A(4) can be filed after the termination of the Arbitral Tribunal's mandate due to time expiration.

2. If such filing is permissible, whether the circumstances justified extending the Tribunal's mandate to allow the award's conclusion.

Held/Conclusion

The Supreme Court ruled that Section 29A(4) permits courts to extend the Tribunal's mandate even after its statutory termination, provided sufficient cause is shown. The Court relied on ***Rohan Builders (India) Pvt. Ltd. vs. Berger Paints India Ltd. [2024 SCC OnLine SC 2494],*** emphasizing that strict timelines should not undermine arbitration's objectives. Considering the pandemic's disruptions and mutual agreements to seek an extension, the Court found sufficient cause to extend the Tribunal's mandate until December 31, 2024. Relevant provisions like Section 29A(1), (3), and (4) were analyzed, with emphasis on efficiency and fairness in arbitration proceedings.

MURLIDHAR KRUSHNARAO VIRULKAR VS. KU. NEHA KRSSHNARAO VIRULKAR – JUDGMENT DT 03/12/2024 PASSED IN CRIMINAL REVISION APPLICATION (REVN) NO. 280/2022 [BOMBAY HIGH COURT, NAGPUR BENCH]

Section 125 of Code of Criminal Procedure ("Cr.P.C.") - An unmarried adult daughter, unable to maintain herself and without any physical or mental abnormality, cannot claim maintenance under Section 125 of Cr.P.C. but may do so under Section 20(3) of Hindu Adoptions and Maintenance Act, 1956 ("HAMA, 1956") - A Family Court, unlike a Magistrate, has jurisdiction to grant maintenance under both provisions, ensuring comprehensive justice and avoiding multiple litigations.

Facts

The case involves a dispute between a father and daughter over maintenance. The daughter filed a petition under Section 125 of the Cr.P.C. before the Family Court No.2, Nagpur, claiming that her father harassed her and that she lacked a source of income to support herself. The Family Court granted maintenance of ₹ 3,500 per month to the daughter until her marriage or her ability to earn. The father challenged this decision, arguing that under Section 125 of Cr.P.C., an unmarried adult daughter can claim maintenance only if she has a physical or mental abnormality, which was absent in this case.

Issues Involved

1. Whether an unmarried adult daughter can claim maintenance from her father under Section 125 of Cr.P.C. without suffering from a physical or mental abnormality?
2. Whether the Family Court has the jurisdiction to grant maintenance to an unmarried adult daughter unable to maintain herself under Section 20(3) of the HAMA, 1956, in addition to Section 125 of Cr.P.C.?

Held

The Bombay High Court upheld the Family Court's decision, emphasizing that while Section 125 of Cr.P.C. restricts maintenance for adult daughters to cases of physical or mental disability, Section 20(3) of HAMA, 1956, permits maintenance for an unmarried adult daughter unable to maintain herself. ***Citing Abhilasha vs. Parkash (2021) 13 SCC 99 and Jagdish Jugtawat vs. Manju Lata (2002) 5 SCC 422,*** the Court noted that Family Courts can exercise jurisdiction under both statutes to avoid multiplicity of proceedings. The Court dismissed the father's revision application, affirming that the Family Court's order was valid and justifiable under the dual jurisdiction it possesses.

RAIAN NOGI KARANJAWALA AND ANR. VS. BOARD OF MUMBAI PORT AUTHORITY AND OTHERS – JUDGMENT DT 06/12/2024 PASSED IN WRIT PETITION (L) NO.12916 OF 2024 [BOMBAY HIGH COURT]

Public Premises (Eviction of Unauthorized Occupants) Act, 1971 ("Public Premises Act") - The Public Premises Act applies to eviction proceedings initiated by statutory authorities against lessees of public lands - Section 4(4)(a) of the Bombay Rent Control Act provides protections to sub-lessees of buildings constructed on such lands but does not shield the original lessee from eviction - Rights under Rent Control legislation must predate the Public Premises Act's applicability and

are confined to the relationship between lessees and their tenants, not between the lessor and lessee

Facts

The petitioners, successors to a lessee who entered into a lease agreement with the Mumbai Port Authority in 1962, contested eviction proceedings initiated by the Authority under the Public Premises Act. The lease required the lessee to construct a building on the land, which was sublet. After termination of the lease in 2010, the Port Authority sought eviction, claiming the premises constituted "public premises" under the Public Premises Act. The Petitioners contended they were protected by the Bombay Rent Control Act, 1947, and the Maharashtra Rent Control Act, 1999. The Estate Officer held that such protections were not available, prompting the Petitioners to file the present writ petition.

Issues Involved

1. Does the Estate Officer under the Public Premises Act have jurisdiction to entertain the eviction proceedings?
2. Are the premises excluded from the definition of "public premises" under the Public Premises Act due to protections under the Rent Control Acts?
3. Does Section 4(4)(a) of the Bombay Rent Control Act apply, granting the petitioners immunity from eviction under the Public Premises Act?

Held

The High Court dismissed the petition, holding that Section 4(4)(a) of the Bombay Rent Control Act applies to sub-lessees or tenants of buildings constructed on leased government land but does not extend protection to the original lessee vis-à-vis the lessor. The premises fell under the Public Premises Act as amended to include lands held by the Port Authority. Citing precedents such as ***Kanji Manji vs. Trustees of Port of Bombay AIR 1963 SC 468*** and ***Nagji Vallabhji & Co. vs. Meghji Vijpar & Co (1988) 3 SCC 68***, the Court affirmed that Rent Control protections were limited to sub-tenants. The Estate Officer was correct in asserting jurisdiction, and the Petitioners could not claim immunity under the Rent Control Acts.

> "Each work has to pass through these stages—ridicule, opposition, and then acceptance. Those who think ahead of their time are sure to be misunderstood."
>
> — *Swami Vivekananda*

CA Mehul Sheth
Hon. Jt. Secretary

CA Neha Gada
Hon. Jt. Secretary

THE CHAMBER NEWS

Important events and happenings that took place online/ physical between **November 1, 2024 to November 30, 2024** are being reported as under:

I. ADMISSION OF NEW MEMBERS

The details of new members who were admitted in the Managing Council Meeting held on November 19, 2024 are as under:

Type of Membership	No. of Members
Life Member	22
Ordinary Member	16
Student Member	31
Associate	0
Total	**69**

II. PAST PROGRAMMES

Sr. No.	*Date*	*Topics*	*Speakers*
PUNE STUDY GROUP			
1	9.11.2024	Life of Reassessments after Recent TOLA Decisions	CA & Advocate Dharan Gandhi
STUDENT			
1	12.11.2024	Interactive E-Workshop on GST Annual filings (GSTR-9 & GSTR-9C)	CA Sumit Jhunjhunwala

Sr. No.	*Date*	*Topics*	*Speakers*
INDIRECT TAXES			
1	13.11.2024	Study Circle - Issues related to Valuation aspects under GST including Related Party Transactions	**Group Leader** CA Aditya Surte **Chairman** CA Vasant Bhat
2	27.11.2024	Study Circle - GST Issues in Travel and Tourism Sector	**Group Leader** CA Umang Talati **Chairman** Adv. (CA) Kalpesh Shah
DIRECT TAXES			
1	14.11.2024	Half Day Seminar on "Demystifying VSV 2.0 – Jointly with IMC Chamber of Commerce & Industry and Bombay Chartered Accountants Society	
a		Keynote address	Shri Raj Tandon, Pr. CCIT, Mumbai
b		Outline of provisions of Direct Tax Vivad Se Vishwas Scheme, 2024 (VSV 2.0)	**Chairman & Moderator** CA Ravikant Kamat **Panel Speakers** 1) CA Bhadresh Doshi 2) CA Jimit Devani
c		Panel discussion demystifying key critical & practical issues under VSV 2.0	Chairman Shri R S Syal, Vice-President, Income-tax Appellate Tribunal (Retd) **Panel Speakers** 1) Mr. Ashish Kumar, Ex-IRS 2) Adv. Dharan Gandhi
2	15.11.2024	Taxcon- 2024 - Jointly with WIRC of ICAI, AIFTP (WZ), BCAS, MCTC & GSTPAM	
a		Keynote Address	Dr. Subramanian Swamy
b		Critical Issues under GST	Sr. Adv. V. Sridharan
c		Case Studies on Post Search issues in GST & Income Tax	Sr. Adv. Rohan Shah
d		Panel Discussion on Related Party Transaction – Impacts under DT/IDT	**Moderator** CA A.R. Krishnan **Panelists** CA Sushil Solani CA Darshak Shah

Sr. No.	*Date*	*Topics*	*Speakers*
a	16.11.2024	BEPS 2.0 – A Global response to Tax Heaven Exploitation and profit sharing and its relevance for Indian Corporates	CA Geeta Jani
b		Critical Issues in TDS under Income Tax	CA Avinash Rawani
c		AI's impact – Redefining the future of Tax Practice	CA Dinesh Tejwani
d		Panel Discussion on Income Tax and GST issues – Joint Development Agreements/ Joint Ventures	**Moderator** CA Rajat Talati **Panelist** CA Jagdish Punjabi CA S.S. Gupta
3	26.11.2024	ISG - Recent Important Decisions Under Direct Tax	Ms. Radha Halbe, Advocate
		DELHI CHAPTER	
1	22.11.2024	Panel Discussion on Assessment, Reassessment and way ahead	**Moderator** CA Saurav Bhattacharya **Panelists** Adv Aseem Chawla and Adv Rohit Jain
2	28.11.2024	Important issues on Black Money and Benami Law	**Moderator** Mr. Ruchesh Sinha, Advocate **Panelists** Mr. V. Sridharan, Senior Advocate Dr. Manas Shankar Ray, Advocate – EX CCIT and Ex SEBI Member
		INTERNATIONAL TAXATION	
1	22.11.2024	Study Circle - India-US Tax corridor	Adv (CA) Priyanshi Chokshi
2	29.11.2024	FEMA Study Circle - Cross-border Private Family Trust – FEMA perspective	CA Dhruv Shah
		SELF AWARENESS SERIES	
1	28.11.2024	Joint Management and Stress Management	Dr Ashwini Borate

Glimpses of the Seminar on TAXCON - 2024 [Jointly with WIRC of ICAI, AIFTP (WZ), BCAS, MCTC & GSTPAM] held on 15th & 16th November, 2024 at ICAI Tower, BKC, Mumbai

TAXCON Organising Team

Glimpses of the Half Day Seminar on "Demystifying VSV 2.0" Jointly with IMC Chamber of Commerce & Industry and Bombay Chartered Accountants Society held on 14h November at Babubhai Chinai Hall, IMC, Mumbai.

On Dias – (L-R) CA Rajan Vora, Mr. Raj Tandon (Principal CCIT, Mumbai), Mr. Ajit Mangrulkar, CA Vijay Bhatt (addressing the audience), CA Zubin Billimoria

Panel Discussion (L-R) CA Anil Sathe, CA Jimit Devani (Panel Member), CA Ravikant Kamat (Moderator), CA Bhadresh Doshi (Panel Member)Subramanian Swamy during the Inaugural function

Panel Discussion (L-R) CA Viraj Mehta, Mr. Ashish Kumar, Ex-IRS (Panel Member), Shri R S Syal, Vice-President, Income-tax Appellate Tribunal (Retd), (Moderator), Adv. Dharan Gandhi (Panel Member)

View of the Audience

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